America’s Tax System and How to Fix It

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Abstract

Abraham Lincoln signed into law the first national income tax on August 5, 1861. Since 1913, the content of the Internal Revenue Code has increased from the 27-page tax law of that year to over 5000 pages today. As time has passed and the length of this document has increased, so has the expense and complexity of abiding by its statutes. The inefficiencies of the current system indicate that something must be done about the United States tax system, but no one has agreed on what to do. Many proposals to correct the problem have been brought forward over the years, and those proposals need to be studied and analyzed to find the one that is best for America and its people. The results of the analysis indicate that the FairTax would best suit the needs of the United States government and its people.

America's Tax System and How to Fix It

The United States, since its founding in 1776, has been able to generate revenue from devices such as tariffs and customs duties, sometimes called external taxes, and the sale of public land. These means alone used to be the only ones necessary to meet the obligations of the federal government, which took on fewer responsibilities then than now. Now, Americans are faced with the burden of sales taxes, income taxes, property taxes, and more. Most taxpayers are accustomed to the current method of taxation, with federal and state income tax, as well as Social Security and Medicare taxes, being withheld from their gross pay, but that is not how it has always been. To address this burden on taxpayers, a history of the United States income tax system, back to 1861, should first be considered to determine whether reform is necessary and which plan of reform might be superior.

History of the Income Tax

Pre-Civil War

The first income tax did not make its way through Congress until 1861, during the Civil War. However, 50 years before, during the War of 1812 and James Madison's administration, it almost came about. According to Sheldon Pollack (2014) in his article "The First National Income Tax," Madison's administration adopted a system of *internal* taxes which included taxes on land, dwellings, and slaves, and excise taxes on carriages, refined sugar, alcohol, and other so called "luxury" commodities (para. 3). The Treasury Secretary at the time, Alexander J. Dallas, proposed a national income tax to help fund the war. Congress took no action on the proposal, so the implementation of the first national income tax was delayed. After the War of 1812 ended, the internal taxes were lifted, and the federal government was again able to create sufficient revenue through the use of customs duties, tariffs, and the sale of public land. According to Pollack (2014), "fiscal stability and budget surplus … prevailed throughout the antebellum period, up to the beginning of the Civil War" (para. 4). The issue of an income tax, or even internal taxes, would not come up again for almost 50 years.

The Civil War

Income tax of 1861. In 1860, Abraham Lincoln had been elected President of the United States. Not long after his inauguration, eleven delegates, mostly from southern states, left Washington, and their respective states started seceding from the Union. After the battle at Fort Sumter on April 12, 1861, common sentiment in the North was, according to Pollack (2014), that the "insurrection would be suppressed in a matter of months" (para. 5). After the First Battle of Bull Run, policymakers set out to build a strong military presence. However, creating a strong military is an expensive endeavor, and the United States government would need to raise significant funding to make it happen.

Treasury Secretary Salmon P. Chase's first course of action was to negotiate with the large banks in the country to initiate massive borrowing to fund the war, but he also understood that new taxes would be necessary. Chase presented a comprehensive tax plan to Congress that included internal taxes like those seen back during the War of 1812, but also present in his plan was a 10% income tax. Debate over Chase's plan ensued, and while the internal taxes and excise taxes that had been successful 50 years before were met with some acceptance, the debate between filling the rest of the revenue gap with a property tax or an income tax, according to Pollack (2014), was heated.

The land tax was deemed to be inequitable and, according to Pollack (2014), "odious" (para. 8) by members of Congress, but the income tax was also seen as an unattractive option. The income tax was viewed by the Republicans as the "least objectionable among the various 'odious' and 'obnoxious' options" (para. 13). James F. Simmons, a Senator representing Rhode Island, proposed a national income tax with a personal exemption of $1,000. Pollack (2014) quotes Simmons as saying, "let us tax property in the last resort … but I do not believe this country has come to pass to be driven to a resource [the land tax] of such extreme measures" (para. 14). The measure was approved quickly by the House and the Senate and America's first national income tax was signed into law by President Lincoln on August 5, 1861. Pollack (2014) explains that the final version of the law imposed a 3% flat tax with a personal exemption of $800.50. Income for securities, similar to the current capital gains tax, was to be taxed at half that rate, 1.5%.

Income tax of 1862. The income tax measure passed in 1861 never resulted in any collections. Instead, Treasury Secretary Chase questioned the wisdom of implementing the tax on the grounds that its projected yield was going to be lower than the cost of collection. Congress further deliberated, according to Pollack (2014), and on July 1, 1862, a bill imposing a tax of 3% on income above $600 was signed into law by Lincoln. This second tax law also introduced to America the idea of a graduated tax schedule, with income exceeding $10,000.63 being taxed at 5% (para. 19-20). Another result of this law was the establishment of the Office of the Commissioner of Internal Revenue (para. 21), known today as the Internal Revenue Service (IRS). This income tax system was adjusted and debated over multiple times in the following years, but it eventually was allowed to expire in 1871, and Republicans returned to their “longstanding commitment to a system of public revenue based on high protective tariffs” (para. 35). It would take a little over four decades for the government to again turn to an income tax to generate revenue.

The 20th Century

The sixteenth amendment. After years of debate on tariff reform and with an 1894 Supreme Court decision declaring unapportioned direct taxes unconstitutional keeping Congress from making progress with how to continue funding the government, something had to change. According to Sheldon Pollack’s (2013) article, “Origins of the Modern Income Tax,” a resolution was brought by Senator Norris Brown from Nebraska for a constitutional amendment that would give Congress the power to enact an unapportioned income tax on the population. The resolution was brought up for debate on July 5, and by the end of the day, the resolution passed 77-0. Just a week later, the House also used one day of debate and passed the measure by a lopsided vote of 318-14. With the two-thirds vote by Congress established, the Amendment still needed to be ratified by three-fourths of the state legislatures.

Unlike the quick decision made by Congress, the ratification by the states took until February 3, 1913, about 3 and a half years, when the 36th state, Delaware, ratified the amendment, with a total of 42 states ratifying the measure by the time of its adoption. Pollack (2013) stated that as of February 3rd, Congress now had the “power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration” (para. 51).

The income tax of 1913. In the 1912 election cycle, the Democratic party gained control of the presidency and both houses of Congress at the same time for the second time since the Civil War. According to Pollack (2013), President Woodrow Wilson, soon after being inaugurated, quickly asked Congress to take up the issue of Tariff Reform (para. 53). Oscar W. Underwood, Congressman from Alabama and the Chair of the House Committee on Ways and Means, got to work.

House Resolution 3321, known as the Underwood Bill, was brought to the House floor on April 21, 1913. The bill included tariff reductions as well as an income tax. Addressing the income tax, Democrat William H. Murray, from Oklahoma, said, "The purpose of this tax is nothing more than to levy a tribute upon that surplus wealth which requires extra expense, and in doing so, it is nothing more than meting out even-handed justice" (para. 53). The bill provided for a personal exemption of $4,000 and was passed on May 8 with a vote of 281-139.

When the bill reached the Senate, it was met with an opposing measure led by Senator Furnifold Simmons from North Carolina, the chairman of the Finance Committee. President Wilson lobbied for what became known as the Simmons Bill which provided a $3,000 exemption instead of the Underwood Bill's $4,000. However, the issue of a progressive tax rate was a hotly debated one in the Senate. According to Pollack (2014), "Neither traditional Democrats nor mainstream Republicans were willing to use income taxation to redistribute wealth" (para. 56). The argument was made that higher income earners benefitted more from high tariffs, making it just for them to pay a fair share of income tax to compensate for it (para. 57). The Simmons Bill passed on September 9, 1913, with a vote of 44-37 (Pollack, 2014). Just three weeks later, a compromise bill was passed by both houses and signed into law by Woodrow Wilson on October 3, 1913.

The Underwood-Simmons Act imposed a relatively minor tax. The individual exemption of $3,000 was only exceeded by 4% of American families, and the tax rate was a measly 1%, with an extra 1% added above $20,000 of income, and a marginal tax rate of 7% for individuals making over $500,000. Earned and unearned income were both taxed the same way, and the number of exemptions, exclusions and deductions were few (Pollack, 2014), but it would not be long before all of that would change.

Leading up to the new millennium, this progressive tax rate structure would change dramatically through times of war and peace. According to a paper by William Woolsey and Sheila Foster (2009), marginal tax rates would reach as high as 91% until the 1960s, and investment income over $215,000 was, at one time, assessed a 70% tax (para. 7). With the constant struggle to come to an agreed upon, equitable and efficient solution to the income tax problem, drastic reforms to the system became more and more prevalent near the end of the twentieth century.

Tax Reform Proposals

Reasons to Consider Reform

By the late 20th century, many proposals for tax reform had been brought before Congress. The growth in the number of deductions and credits, and the complexity caused by other policies like phase-out restrictions, made the possibility of adopting a new, simpler system an idea worth looking into. In Henry J. Aaron and Harvey Galper's 1985 book, *Assessing Tax Reform,* they provide the following introduction:

> The U.S. tax system has become a swamp of unfairness, complexity, and inefficiency. The accumulation of credits, deductions, and exclusions designed to help particular groups or advance special purposes conflict with one another, are poorly designed, and represent no consistent policy. The tax system causes investors to waste resources on low-yield investments that carry large tax benefits, while high-yield investments without such benefits go unfunded. The result is a shrunken tax base that requires needlessly high rates on wages, salaries, and other taxable income … The time has arrived for basic reform. (p. 1)

Aaron and Galper (1985) condemn the use of taxes to advance special interests. They lament over the decrease in the tax base, caused by lower investments in higher yielding instruments. This resulted in other types of income being taxed at an unnecessarily high rate. Other arguments for tax reform include criticism that the system is inefficient. A paper published by Jones, Thomas, and Lang (2012) about income tax reform mentions that the Internal Revenue Service "admits that the current tax code requires taxpayers to devote 6.6 billion hours each year to their tax return" (p. 4). Also, they mention that despite all the time and effort that taxpayers put into filing their returns, errors are still very common (p. 4).

Another heated issue involving the current tax system is progressivity. Simply put, a progressive tax rate means that the higher the taxable income, the greater the proportion of taxes paid on that income. While someone living in poverty will not pay any taxes, and, therefore, having a 0% tax rate, an individual making over half a million dollars could very well have an average effective tax rate of over 30%. This redistribution of wealth seems to take advantage of the work of the wealthy to take care of those who either will not or cannot work. Because those in poverty do not have to pay tax, but the wealthy pay a large share of taxes, the wealthy basically pay for some of the government aid programs that assist those in poverty Although many wealthy people are philanthropic and do not mind helping out those that are less fortunate, the U.S. government has not proven to be a good steward of the finances with which they are entrusted. A study by Timothy Matthews (2013) detailing trends in the degree of federal income tax progressivity indicates that multiple "studies show the U.S. Federal income tax has become more progressive in recent decades" (p. 98). The study also indicates that progressivity was actually higher in 1942 than in 2009, the last year in the study, but as of 2009, the federal income tax had been "more progressive in the past decade than at any other time since the early-1940s" (p. 98). Another study, conducted by Daniel Carroll and Eric Young (2011), shows that "increasing the progressivity … leads to increases in aggregate capital, aggregate labor input, and, as a consequence, aggregate income" (p. 1470). This seems to indicate a significant benefit to progressivity, but as a tax schedule becomes more progressive, the greater the gap between the effective tax rate of low income and high income individuals, which could be seen as unfair.

One more major complaint against the current income tax system is the Alternative Minimum Tax (AMT). According to Jones, Thomas, and Lang (2012), the system was supposed to be a way to keep some taxpayers from using deductions and other part of the tax code to an extent that "they could avoid paying their fair share of taxes" (p. 3). Unfortunately, the system now requires taxpayers to calculate their taxes twice because of the differing rules between the AMT and the normal calculation of income tax liability.

The Heritage Foundation also weighs in on the need for tax reform. Curtis S. Debay (2014) from the Foundation presented multiple reasons involving the impact the current system has on families. His summary of reasons is that “the tax code imposes rates that are too high, is biased against saving and investment, and wrongly picks winner and losers” (para. 6). He explains that having earnings taxed and having interest and capital gains taxed discourages families from saving for things like down payments for a house or car purchase. The effect of the current system is not just evident at the family level, but small businesses also are negatively affected by the tax system. According to the National Federation of Independent Business (n.d.), “high tax rates and the complexity of the current tax code are persistent problems” and they argue that lower tax rates would allow “small business owners [to] keep more of their money to reinvest in and grow their business” (para. 2). These and other problems indicate the need for reform. Before a new system can be chosen to improve and simplify the continually lengthening and complicated nature of the current tax system, they must be introduced and explained.

The Flat Tax

The flat tax can be categorized as a tax simplification reform strategy. According to Michael Keen, Yitae Kim, and Ricardo Varsano (2008), the definition of the flat tax is, very simply, a uniform tax rate applied to an individual’s personal income minus an allowance (p. 714). However, there can be differing applications of the flat tax.

Two colleagues from the Hoover Institution, Robert Hall and Alvin Rabushka, created a system that is most commonly used when the flat tax is discussed. This system, developed in the 1980s, would replace the current one with a consumption tax. According to the paper by Jones, Thomas, and Lang (2012), income would only be taxed "as it is withdrawn or at the point at which it is earned" (p. 6). Both individuals and businesses would be taxed at the same rate, about 19%, with a family exemption, but deductions and credits would be totally done away with. This would not be a true flat tax though, because the exemption, proposed to be $25,500 for a family of four, still creates a progressive average effective tax rate.

Alan Feld (1995), pointed out four components that a flat tax would eliminate that the current income tax system currently has. First, bracket arbitrage, which is the practice of higher earners using deductions excessively to keep more of their income taxed at lower rates, would be eliminated. Second, the need for depreciation expensing would not be necessary for tax calculation purposes. Third, the distinction between ordinary income and capital gains would be moot. Fourth and finally, the tax would be imposed in a way that only the cash basis of accounting would be necessary, eliminating the possibility of differing accounting systems producing different taxable amounts. More recently, Congressman Michael Burgess has pushed for the adoption of the flat tax. His version would use the 19% tax rate, but the exemptions would be higher than those proposed by Hall and Rabushka in the 1980s. According to a mailer produced by Congressman Burgess' office, the bottom 42% of taxpayers would pay no income tax (Burgess, burgess.house.gov).

Some other proposed flat taxes include the Armey Flat Tax plan that, according to Roger Lirely (2000), would impose a tax of 17% on individuals and businesses. Lirely (2000) explained, the plan would exempt passive income, so that only wage income and pension distributions would create the base for the tax. The Specter Flat Tax plan is slightly different than the Armey one, in that it would use a higher rate of 20% with lower deductions and exemptions than Armey's. While the Armey Flat Tax would repeal all deductions and credits—besides standard deductions and personal exemptions—the Specter Flat Tax would still allow deductions for charitable contributions and interest on home mortgages.

James John Jurinski (2000), in his book *Tax Reform*, supports the Armey Tax Plan, saying that it "is true to the uniquely American definition of fairness: it treats everyone the same" (p. 161). He also argues that it would increase economic growth and raise wages, referencing a study by Dr. Alan Auerbach of the University of California at Berkeley, that the Hall-Rabushka flat tax of 19% would make the economy 5.7% larger after a five-year period than if the current tax system was left in place. The flat tax would clearly simplify the way Americans pay their taxes, and supporters believe that its adoption would help grow the economy, but more study is necessary to determine its equity, efficiency, and revenue potential.

Progressive Consumption Tax

A progressive consumption tax measure was introduced in 1995 by three Senators; Pete Domenici, Sam Nunn, and Bob Kerrey, known as the USA (Unlimited Savings Allowance) Tax bill. Laurence S. Seidman (1997) writes that this tax would encourage the practice of saving and investing. However, unlike the flat tax, the progressive consumption tax in the USA Tax bill would largely maintain the progressivity of the current income tax system. The goal of increasing savings through the new tax would address the decline in American saving and would hopefully keep the United States from further falling behind other economically strong countries who have maintained higher savings rates than the U.S. for the past several decades. Seidman (1997) believes that “[r]aising our savings rate will increase our capital stock, output, consumption, and real wages in the future” (p. 65). The USA Tax would do this by making savings tax deductible, only taxing it when it is withdrawn to be consumed. There is much to say about increasing savings, namely, a decrease in consumer borrowing. Freeing taxpayers from needing to borrow from credit card companies or other lenders could result in consumers being able to pay cash for what they want instead of putting everything on a card and hoping to pay for it later.

Value-added Tax

A value-added tax (VAT) is a system used by many countries already. Michael Graetz’s paper (2014) defines a VAT as “a tax on sales of goods and services, collected by withholding the tax at all stages of production and distribution” (p. 422). He also indicates that 25 countries were already using a VAT system by 1980, and at the time of the publication, in 2014, the number of countries employing the method exceeded 160. Graetz’s critique of the current system goes as far as to say that the U.S. “hobbles itself” because of how heavily the country relies on income taxes (p. 422). Graetz proposes a Competitive Tax Plan that would enact what is called a destination-based VAT, which would be a broadly based consumption tax on goods and services that would be like the VAT employed by many other countries. Interestingly, his plan does not fully replace the income tax. Instead, he proposes that the revenue produced by the VAT would be used to allow the income tax exemption for a family to be increased to $100,000. The other two components of his plan include decreasing the corporate income tax rate to 15% and protecting lower income wage earners from any tax increase that would be created by the

VAT by using payroll tax credits and expanded refundable tax credits for children. While the flat tax discussed earlier is very simple, the VAT is slightly more complicated.

Leonard Burman and Joel Slemrod (2013), in their book *Taxes in America*, explain how a VAT works. Specifically, they explain the subtraction-method with the following example of the production and sale of a loaf of bread:

> [S]uppose a farmer grows wheat using only his own labor and sells it to the miller for 10 cents. He'd owe a penny in VAT at a 10% rate on his sale to the miller. The miller grinds up the flour and sells it to the baker for 40 cents. His value-added is 30 cents…, on which he'd owe 3 cents in tax. The baker makes the bread and sells it to the grocery store for 80 cents, owing 4 cents in tax on her value-added. And the retailer sells it to the consumer for a dollar, owing 2 cents in tax on the final value-added. (p. 99)

In the example, the total tax on the loaf of bread would be 10 cents, which the authors point out would be the same as if retail sales tax of 10% were only charged on the final sale. However, they argue that the subtraction-method VAT is advantageous in that even if one party in the supply chain fails to remit the tax, the government still gets paid, even if it is not the full 10%. The other method, the credit-invoice VAT is slightly more complicated, but can be enforced more easily. Also, the typical VAT tax rate, as quoted by Burman and Slemrod (2013), is about 18%. The VAT would be an option that would only affect individual taxpayers in the possibility of higher prices, but there would be no extra income tax charged directly to taxpayers.

The FairTax

The FairTax is another consumption based tax strategy that has been floating around Congress since 1999, when Congressman John Linder first introduced it to the House of Representatives, known as the FairTax Act of [insert year here] in every Congress since the turn of the century. According to author Neal Boortz and Congressman John Linder (2006), the FairTax would repeal multiple taxes, including, but not limited to, the individual income tax, alternative minimum tax, taxes on passive income, corporate and business taxes, social security taxes, and the self-employment tax. Instead of all of the listed taxes, a single-rate consumption tax, only levied on new goods and services, as a sales tax would be employed. The authors argue that the FairTax is not a VAT similar to those seen in Europe, because it is only imposed at the cash register, not at every step. Boortz and Linder (2006) also emphasize the fact that their proposal would not be an addition to the current tax system, but a replacement that would be able to raise the same amount of revenue as "our old and complicated code does today" (p. 75). The rate set by the FairTax act is 23%.

As with the current system and most proposals to replace it, there is the concern for unnecessarily increasing the burden of poverty-stricken Americans with the collection of tax. To counteract this, the legislation also provides a *prebate* that would cover taxes a family under the federal poverty level would otherwise pay. Everyone would receive this prebate on a monthly basis, and it would replace the current system's standard deductions and personal exemptions. Boortz and Linder (2006) claim that individual and income taxes are really embedded in the price of the goods that taxpayers already buy, so the implementation of the FairTax would, hopefully, not produce a significant effect on prices.

Other Options

Some other options worth mentioning, but to be excluded from a more in-depth analysis, include a cash-flow tax to be assessed on corporations to replace the current corporate income tax. Christ Edwards (2003) writes about what he considers to be three fundamental flaws with the corporate income tax. First, he explains that the U.S. statutory tax rate, on corporations, “is the second highest among the 30 major industrial countries” (p. 291). Second, he believes that the complexity of taxing net income or profits is problematic because of concepts that cause consistent application to be difficult. Third, he proposes that Congress has been inconsistent with their additions to the tax code, which Edwards (2003) says has “played a key role in the tax shelters exploited by Enron” and “they distort capital markets and channel investment into less productive uses” (p. 292). Edwards' answer to these flaws is a cash-flow tax. The calculation of the taxable income for a cash-flow tax would require businesses to “include receipts when cash is received, and deduct the full costs of materials, inventories, equipment, and structures when they are purchased” (Edwards, 2003, p. 293). Basically, the cash-flow tax would take the net income of a company, using the cash basis for accounting.

Another option for tax reform takes a much more modest approach by broadening the tax base of the current system. Jane Gravelle (2010) details some benefits to this base-broadening, including being able to cut individual tax rates in half and corporate rates being reduced by almost a third while still producing the same revenue. Yet she also admits that there are barriers to their implementation just like with any other major tax reform including administrative costs and political obstacles. Deductions such as the mortgage interest deduction are popular among taxpayers now, so trying to remove this and other deductions would be politically difficult.

Analysis

Assumptions

To fairly assess some of the different proposals to reform the current U.S. Tax Code, some assumptions will have to be made that will apply to all of the options. Data from the U.S. Department of Commerce's Bureau of Economic Analysis and the U.S. Census Bureau will be used to measure the effectiveness of each proposal. According to Table 1.12 in the Bureau's interactive data detailing national income by type, the 2014 total national income was $15.1 trillion. According to Table 2.1, showing personal income and its disposition, personal income totals $14.69 trillion, and only $1.78 trillion of that amount goes to paying taxes while personal consumption expenditures totaled $11.87 trillion for tax year 2014. For the assumed annual total for business profits, which will be necessary in measuring the effectiveness of the VAT proposal, Table 1.12 shows corporate profits of $2.07 trillion. An explanation for why corporate profits plus personal income total more than the national income of $15.1 trillion, could be explained by the fact that business income eventually gets distributed to an individual, causing some redundancy.

Also from the Department of Commerce and in conjunction with the Census Bureau, a report, *Income and Poverty in the United States: 2014*, which was issued in September 2015 provides valuable information about poverty that can be used to determine the price tag associated with granting exemptions to those living below the poverty level. According to the report (2015), 14.8%, or 46.66 million Americans live in poverty. Also, of the 147.7 million workers in the United States, 10.2 million of them live below poverty. This shows that just 6.9% of people who work full or part time jobs in the country live below poverty, compared to the total poverty percentage of 14.8% (p. 13). Also, to standardize the exemption for all the proposals, the poverty threshold of $19,078 for a family of three with one child, as determined by the table published by the U.S. Census Bureau shown below, will be used in conjunction with the number of taxable households in the U.S. The number of households in the U.S.—to be used to calculate the total revenue cost of exemptions—is 124.6 million for 2014 (p. 23).

A few more significant numbers that may be utilized include some from the Internal Revenue Service. According to their filing season statistics for the 2015 filing season (for tax year 2014), 150.7 million individual tax returns were filed and a total of $306 billion were issued in refunds. Also net collections for fiscal year 2014 for individual, business, estate, and trust income, employment, estate, and gift taxes, totaled $2.62 trillion (IRS.gov).

Flat Tax

For the flat tax, the Hall-Rabushka tax rate of 19% will be used first to determine the financial effect of the proposal. If the flat rate of 19% is imposed on the total national income of $15.1 trillion, gross revenue from the tax would be just $2.87 trillion, and this is before the decrease in taxes payable due to the exemption. Using the aforementioned exemption of $19,078 and awarding that to 124.6 million taxable households decreases the revenue from the flat tax by $452 billion down to $2.42 trillion. This falls short of being revenue neutral with the current system that collected $2.87 trillion

Table 1. *Poverty thresholds from U.S. Census Bureau.*

Size of family unit	Related children under 18 years								
	None	One	Two	Three	Four	Five	Six	Seven	Eight or more
One person (unrelated individual)......									
Under 65 years..............................	12,331								
65 years and over..........................	11,367								
Two people....................................									
Householder under 65 years...........	15,871	16,337							
Householder 65 years and over.......	14,326	16,275							
Three people....................................	18,540	19,078	19,096						
Four people......................................	24,447	24,847	24,036	24,120					
Five people.......................................	29,482	29,911	28,995	28,286	27,853				
Six people...	33,909	34,044	33,342	32,670	31,670	31,078			
Seven people.....................................	39,017	39,260	38,421	37,835	36,745	35,473	34,077		
Eight people......................................	43,637	44,023	43,230	42,536	41,551	40,300	38,999	38,668	
Nine people or more...........................	52,493	52,747	52,046	51,457	50,490	49,159	47,956	47,658	45,822

Source: U.S. Census Bureau.

in fiscal 2014. If tax evasion were to be taken into effect, and it is assumed that tax evasion takes away 6% of the potential total tax liability for the country when the tax rate is under 20%, the net collections from the 19% flat tax could decrease almost another $200 billion to $2.23 trillion.

A flat tax of 21% would bring the proposal closer to being revenue neutral by bringing the net collections to about $2.67 trillion, but the higher rate could encourage a greater rate of tax evasion. If 8% were used as the potential loss to tax evasion, the proposal’s net collections would fall flat, and would be about $180 billion lower than the current system. To be revenue neutral, the tax evasion percentage would have to be 2% for the 21% flat tax to succeed. Alternatively, the tax rate could be increased further.

A study by Amy Dunbar and Thomas Pogue (1998) that analyzed the tax years and 1988 and 1991 show similar results. Their tax neutral rate for 1988 was 21.13% (Dunbar and Pogue, 1998). However, the 1991 rate was lower at 19.13%. Their explanation is that 1988 was a year of recession while 1991 was a year of high employment. This seems to indicate that if the flat tax were to be assessed at a rate of about 21%, it would be able to weather fluctuations in the economy.

Another issue that may be difficult to quantify is raised by Roberts and Sullivan (1996). The authors, called accounting experts by the article's subheading, say that the flat tax is the tax that the "wealthiest individuals in America" would design to "most benefit" themselves (p. 24). Because the flat tax's base excludes passive income such as dividends, interest, and capital gains, the wealthy Americans who have these types of income, but no wage income, would be paying no tax at all. If this indeed is a weakness of the flat tax, it would have to be addressed before being seriously considered to replace America's current system.

Progressive Consumption Tax

For the progressive consumption tax, namely the Unlimited Savings Allowance (USA) tax, it was stated that the progressivity of the current system would remain the same. Also, according to Department of Commerce data used for the other assumptions, in 2014, the total of personal savings was $620.2 billion. If this amount were to increase by 50% as a result of tax-deferred savings, the amount would increase to $930.3 billion. This would decrease the pre-exemption income tax base from $15.1 trillion to approximately $14.2 trillion, preventing the USA tax from being revenue neutral if current income tax rates were kept in place. The USA tax would probably not be a viable option immediately, but possibly after the savings rate leveled out, consumption would increase to match the current income tax base. Another option that could possibly help make the USA tax revenue neutral would be to create a temporary income tax increase that would be phased out over time, presumably over the amount of time it would take for the annual amount of savings to level out.

Value-added Tax

The value-added tax (VAT) that would supplement the current tax system is proposed to be able to increase the current family exemption to $100,000. If it is assumed that 70% of the $2.07 trillion pre-tax of corporate profits in 2014 were attributable to the sale of products—instead of services—and the VAT were to be assessed at 18%, the increase in tax revenue would amount to $260 billion. This increase in tax revenue would only allow the family exemption to be increased by about $2,000, if it were to be distributed equally among the 124.6 million households filing returns. However, corporate profit totals may not be the most helpful method for calculating the effect of the VAT. To be able to calculate the VAT, the value-added to products at each stage of production would have to be known, which is difficult to do without the cooperation of businesses having to comply with the tax, which puts that calculation out of the scope of this paper.

The FairTax

For the FairTax, the national sales tax, the tax base can be calculated with the help of some information from FairTax.org. According to their estimations of personal consumption—purchases—the tax base would be about 81% of the gross domestic product (GDP). The Department of Commerce tables say that GDP for 2014 was $17.35 trillion. Therefore, the tax base for the FairTax would be 81% of that, or $14.05 trillion.

If the national sales tax is imposed at a rate of 23%, as proposed by Boortz and Linder, as well as the FairTax Act, the gross revenue from the tax would be $3.23 trillion.

However, using the exemption figure above, of $19,078 per family/household, and 124.6 million of these households, an exemption expense of $544.1 billion is calculated, bringing the net revenue of the FairTax down to $2.69 trillion, which would actually be $70 billion more than actual net collections by the IRS for 2014 of $2.62 trillion. If a minimal amount of tax evasion is considered, then the FairTax would probably almost be exactly in line with the current system as far as revenue generation is concerned.

In response to any inquiry regarding how prices would increase as a result of a national sales tax, Boortz and Linder (2006) wrote that "22 percent of the price paid for a consumer product represents embedded taxes" (p. 53-4). This means that the FairTax would have a minimal effect on the final price paid for goods, possibly a variance of less than 1%. Such a small change in the final price may help consumers accept the possibility of a new sales tax of over 20%.

Conclusions

Difficulties of enacting tax reform

Although it seems reasonable to adopt a new, simpler plan for how the United States collects taxes through the use of either a flat tax or national sales tax, there are still barriers that would make enacting any tax reform difficult. One major issue that may keep tax reform from happening is risk. Because of how long the current income tax system has been in place, estimating the collections from it is relatively easy. Unfortunately, unless a new tax system is actually implemented, there can be no guaranteed return from the new system. According to a paper by Jonathan Ackerman and Rosanne Altshuler (2006), George W. Bush's Advisory Panel on Federal Tax Reform constrained their proposals for tax reform to ones that would be revenue neutral. Because of these constraints, that panel was only able to come up with some changes to the current system that included repealing all credits, itemized deductions, and special preferences included in the current tax code and eliminating the alternative minimum tax. The constraint placed on this panel shows how politically sensitive lawmakers in Congress might be to trying to bring about tax reform.

Politics may play an even more vital role in the lack of major tax reform than economics do. According to a study by Castanheira, Nicodème, and Profeta (2012), "political variable carry more weight in triggering reforms than economic…variables" (p. 620). This observation indicates that events like recessions or depressions are less likely to encourage reform by the country's lawmakers. To make change happen, the political climate would need to shift, and constituents would need to become more involved in voicing their opinion on the tax system. If policymakers figure out that they will have a better chance at re-election by pushing tax reform, it may finally get done.

Favored Proposals

While most of the proposed reforms analyzed appear to produce revenue neutral or potentially positive results compared to the current system, the two most favorable proposals would be the flat tax and the FairTax. Both of these tax systems would not only simplify how taxable income or taxable purchases is calculated, but they would both be a much fairer system. Both systems still allow for those living under the poverty level to continue to not pay taxes while decreasing the overall progressivity of the system. However, the flat tax's exclusion of passive income makes it a weaker alternative to the FairTax and its effect on purchases. Wealthy people may be able to change the way their taxable income is calculated, but they will still have to make purchases.

The FairTax is particularly favorable because it allows taxpayers to keep all of their income instead of having it withheld before they ever get ahold of it. With a national sales tax replacing the income tax, consumers would not have to pay taxes unless they spent their money. As far as the implementation of the system, Boortz and Linder (2006) point out that 45 states already administer their own sales tax making it relatively easy for them to begin collecting and remitting a national sales tax to the federal government. The FairTax even proposes compensating states and businesses one quarter of 1% of the taxes they collect in exchange for that service. If the FairTax were to be enacted and corporate income taxes were repealed, businesses that have either outsourced parts of their operations or participated in what has been called a tax inversion to enjoy the lower rates of another country, will return to America. Over time, this should increase GDP and will increase the base for the FairTax which will make supporting the federal government easier as more businesses make purchases in the U.S.

Final Thoughts

The government must certainly levy some sort of tax to fund its operations and continue protecting its citizens militarily. However, there is no reason that the method of funding the government should involve an income tax and associated U.S. Tax Code that is over 5,000 pages in length. Implementing a type of reform such as the flat tax or the FairTax, not only simplifies the calculation and collection of tax revenue, but ends the favoritism of certain activities that the current law includes in the form of selective deductions or credits.

Specifically, the FairTax Act should be up for debate and voted on in Congress. The measures included in the bill will open the door for economic growth in the country by allowing Americans more freedom to save and invest before since their money would no longer be taken away as soon as it is earned in the form of payroll withholding. Also, businesses small and large would be encouraged to come to or return to the U.S, creating more jobs and increasing the purchasing power of the people. America deserves a better tax system, and the FairTax may be that system.

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