Statement of
The National Taxpayers Union
Prepared for
The President's Advisory Panel on Tax Reform
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Note: Owing to Panel guidelines for brevity, these comments only constitute an outline of National Taxpayers Union's tax reform stance.

Dear Chairman Mack, Vice Chairman Breaux, and Distinguished Panel Members:

On behalf of the 350,000-member National Taxpayers Union (NTU), I am pleased to submit comments regarding the defects of America's current tax system and options for reform. As you know, few other citizen groups in Washington can match NTU's 36-year history of participation in the vital national debate over restructuring our nation's tax system. Further perspectives and research on this topic are available on our website, www.ntu.org. I will briefly address the Panel's guidelines in order of issuance.

Comment Request 1: "Headaches, unnecessary complexity, and burdens that taxpayers – both individuals and businesses – face because of the existing system."

Although Congress and the Administration have taken the welcome step of reducing personal income tax burdens for most Americans since 2001, it is important to keep this trend in historical perspective.

Since adoption of the 16th Amendment to the U.S. Constitution over 90 years ago, federal tax revenues of all kinds have increased by roughly 175,000 percent. Given this trend, it is understandable that many taxpayers believe they are still giving over far too much of their hard-earned money to the federal government. By most measurements, they will continue to do so – according to the Bush Administration's FY 2006 budget, federal revenues are projected to consume a progressively larger share of the nation's economic output (GDP), from 16.3 percent in 2004 to 17.7 percent in 2010.

Even as the burden of *paying* taxes remains unacceptably high to many Americans, the burden of *filing* taxes has become onerous in its own right. This phenomenon can be quantified thanks to "A Taxing Trend," a study NTU has conducted since 1999 that focuses on how changes in the law affect the typical tax filer. According to our research:

- The increase in the tax law's complexity alone has added roughly 1 billion hours in annual paperwork burdens over the last 10 years – part of the overall IRS-induced paperwork load estimated at a staggering 6.7 billion hours per year. Tax form paperwork burdens alone account for just over 80 percent of the total paperwork burden hours of the entire federal government.
- The 1040A, or "short" form, along with the common Schedule 1, takes nearly as long to prepare as the regular 1040 "long" form did just nine years ago.
- Today, taxpayers must wade through 128 pages of instructions for the standard 1040 form, which is more than triple the number in 1975 and over double the number in 1985, the year before taxes were "simplified."

These estimates are probably too low since they ignore the countless hours spent on tax minimization strategies and the lost productivity for individuals and businesses.

Comment Request 2: "Aspects of the tax system that are unfair."
Comment Request 3: "Specific examples of how the Tax Code distorts important business or personal decisions."

Both of these comment requests are closely related to each other, since the very disruption that the Tax Code exerts on Americans' daily lives is one of the key aspects of the system's unfairness.

One unfair feature of the tax system concerns the Alternative Minimum Tax (AMT), which a 2004 NTU Policy Paper explored in-depth. By the end of this decade more than 30 million taxpayers will be forced to complete a second tax return for the AMT. The existence of this tax trap forces productive individuals and businesses to re-consider decisions on items ranging from Incentive Stock Options to private activity bonds – not because of their economic potential but rather due to their tax consequences.

Aside from the fact that the AMT will soon hit millions of unintended targets, the moral unfairness of this tax demands the attention of policymakers. The AMT is designed not to stamp out illegal tax evasion, but rather legal tax avoidance. Why should anyone be penalized with a second set of laws merely because, in Congress's political judgment, an individual has benefited "too much" from existing laws?

Equally arbitrary is the federal estate and gift tax, whose temporary repeal in 2010 remains problematic. That is because millions of American workers and employers who don't *pay* the death tax are still *affected* by it in other ways. A 2001 NTU Issue Brief provides an illustrative example, in the personal experience of paper company executive Donald Clampitt. He was advised to set up an insurance policy on his father, who founded the company, in order to cover the estate tax liability when the father passed away. But as Clampitt pointed out, "paying the insurance premiums on a $5-$10 million policy on a 79-year-old man" was "enough to impact the cash flow of our firm" as it struggled to operate.

Businesses are forced to pursue these costly strategies now because owners can't possibly know what their estates will be worth when they die 10 or 20 years in the future. If, for example, Congress forgoes repeal of the death tax after 2010 and merely boosts the exemption to $2 million – or $5 million, or $10 million – businesses will still need to spend precious resources on tax planning to be sure they stay on the "right side" of that exemption.

Other fairness problems manifest themselves in the layers of taxation heaped upon telecommunications services, including a 3 percent telephone excise tax and "Universal Service Fund" surcharges. Worse, state and local governments have already slapped wireless customers with double-digit tax burdens, and have begun eyeing Voice over Internet Protocol (VoIP) technologies for new revenue sources. An even bigger problem looms in the form of the Streamlined Sales Tax Agreement (SSTA), a multi-state cartel that could effectively force companies offering goods and services over the Internet to remit sales taxes to as many as 7,600 different jurisdictions across the U.S.

Meanwhile, federal tax policy toward air travel has been wreaking havoc on the economic vitality of the commercial aviation sector. A plethora of excise taxes, mandated charges, and fees has pushed the average tax burden on an airline ticket past 25 percent.

Middle-class travelers are now likelier to pay a higher marginal tax rate on airline tickets than they do on their 1040 tax returns.

These are just two of the most egregious examples of how federal tax policy unfairly weighs upon consumers of a particular product. Technologies and services that are delivering – and could deliver still more – innovation and productivity gains to the American economy are being slowed in their advance by punitive taxes.

Ultimately, however, the entire structure of the income tax "distorts important business or personal decisions." According to Congress's own Joint Economic Committee, over 2/3 of all personal income tax returns in the top bracket report at least some earnings from a sole proprietorship, partnership, or "S" corporation.

Starving these small businesses of the capital they need to create jobs is short-sighted, while singling out certain sectors of private industry for discriminatory tax burdens will prevent the free market from finding the most beneficial use of money flowing through the economy. This axiom applies no less strongly to those businesses paying the so-called "corporation income tax" – essentially a tax on business owners, managers, shareholders, employees, and consumers.

Finally, there is the vague and seemingly ephemeral nature of the tax laws themselves. In 1999 NTU conducted a computerized analysis of all legislation introduced during two sessions of Congress, and found a total of 856 bills that would have amended the U.S. Tax Code. The vast majority provided credits, deductions, or exemptions for narrowly defined categories of taxpayers, including but not limited to:

> State lobbyists, yacht builders, limo drivers, train engineers, pilots to sparsely populated islands, defense contractors, whaling captains, life insurance salesmen, U.S. Olympic Committee members, and unemployed talk radio "shock jocks;" employers who hire butlers, caddies, or displaced homemakers; business owners who are women, employ women, or both; taxpayers who own child safety seats, cows, horses, planes, ferries, trains, mines, oil wells, casinos, and closed military bases; consumers or firms who drive an electric car, use wind-power, heat their homes with kerosene, or convert animal dung to electricity; and, Americans who bought a Christmas tree, used a bow and arrow, telecommuted, conducted biomedical research, lived on an Indian Reservation, or owned an historic home.

Not all of these proposals became law, but the political impulse behind them has persisted. The 2004 American Jobs Creation Act, for example, contained a long list of carve-outs for interests ranging from "subsistence whalers" to ethanol producers.

Comment Request 4: "Goals that the Panel should try to achieve as it evaluates the existing tax system and recommends options for reform."

Over its 36-year history, NTU has developed and advocated four principles toward which federal, state, and local tax policy should strive:

- **Reduce tax rates and burdens** so as to allow citizens to keep more of the money they've earned;
- **Simplify the tax system** to make administrability of the law transparent and less difficult for those who must comply with it;

- **Minimize economic distortion** by replacing punitive taxes on individuals or businesses who have been singled out for political convenience, with a tax structure that treats everyone the same.
- **Protect taxpayer rights** with procedural safeguards against the tendency of tax law administrators to abuse citizens, as well as the tendency of elected officials to constantly tinker with the tax system.

The President's Advisory Panel on Tax Reform can make numerous recommendations that reflect these principles, for the near-term and the years to come.

Short-Term Recommendations

The panel should recommend permanent and complete repeal of the Alternative Minimum Tax as well as the federal estate and gift taxes. These actions, combined with making permanent the 2001 and 2003 income tax rate reductions, will establish a solid foundation for predictable tax policy that has been sorely lacking in recent years. Policymakers could then build a more rational tax structure on this stable footing.

Along with recommending an end to double- or triple-taxation of savings and investments, the Panel should also call for consolidating the three types of current-law Individual Retirement Accounts into a single Retirement Savings Account (RSA). After-tax annual contributions of $5,000 per person or more could be allowed with no restrictions on income. Earnings in these accounts would grow tax-free and distributions after age 58 would also be tax-free. Creation of RSAs would be another healthy step toward the removal of the bias against savings that is currently embedded in our Tax Code, and would complement any effort to reform the Social Security system through the creation of personal retirement accounts.

Calling for a permanent ban on Internet access taxes, rejection of the SSTA, limits on the reach of Business Activity Taxes, and a policy of restraint on VoIP taxes would provide fairer treatment of vital communications and information technologies. Reducing harsh tax burdens on air travel could allow that industry to overcome fiscal turbulence and thrive once again. Rolling back discriminatory tax rates on legal products such as tobacco and distilled spirits could restore the principle that Americans shouldn't punished for what they choose to consume in moderation.

During deliberations over the 1998 IRS Restructuring and Reform Act, Congress rejected several tax reform proposals that the Panel ought to resurrect today. A Quadrennial Tax Simplification Commission, staffed by volunteers in the private tax preparation community, could provide real-world feedback and recommendations to Congress and the Executive Branch for making the system less complex. A Citizen Review Board for the IRS, constructed along the lines of similar entities overseeing large metropolitan police departments, could allow for more structured public input to help the tax agency improve its procedures.

The Quadrennial Simplification Commission process would be especially helpful in clearing away the horrendous thicket of tax law provisions affecting corporations. Last year Congress took several preliminary steps in clarifying rules on worldwide income, but much more work remains to be done in adopting a streamlined, low-tax policy across all sectors of business that will be vital to America's international competitiveness in the years to come.

Options to Avoid

Recently the Panel has heard calls for a new dual-component tax system consisting of a simplified income tax and a consumption tax (possibly in the form of a Value-Added Tax, or VAT). From NTU's perspective, this scheme would rank among the worst of all possible alternatives. VATs have proven to be administratively complex and notoriously conducive to expanding government's share of the private economy's output. Allowing the proliferation of major federal taxes would only provide elected officials with a larger field on which to play their game of political favor-trading, all while gradually ratcheting up the burdens on taxpayers.

Others have suggested that tax administration could be greatly simplified by allowing the IRS to compute liabilities and send "returns" to millions of taxpayers for their signatures. This truly appalling idea, now in the state-level "pilot program" stage with California's Franchise Tax Board, would turn tax reform on its head. Taxpayers would be discouraged from maximizing the savings that the laws may allow them under individual circumstances; and to the convenience of politicians, taxpayers would be disconnected from yet another process that reminds them of the high price they pay for government.

Long-Term Recommendations

NTU Board Member Richard Vedder has long documented that states which have no or low, flat-rate income taxes generally record better personal income and employment growth than states with high-rate, "progressive" structures. This evidence is beginning to accumulate on the international level as well. According to a March 8 story by Andreas Tzortzis in the *Christian Science Monitor*, the movement toward flat-rate income taxes is already underway:

> Last January, Slovakia became the sixth Eastern European country to adopt a flat tax. …Since then, Romania and Georgia have followed suit, creating a global proving ground for the concept. In the process, flat-taxers have moved Eastern Europe from a communist backwater to an investment spring, pressuring its higher-taxed Western neighbors to adapt to the new environment.

Another emerging concept for tax reform holds even greater promise – a national retail sales tax. At a recent meeting of the World Taxpayers Associations in Brisbane, Australia, Dr. Vedder demonstrated how countries with low VATs could improve their economic performance by replacing their tax systems with retail-level consumption taxes. During April 2000 hearings of the House Ways and Means Committee, notable economists showed how transition from the personal and corporate income tax to a single-rate consumption tax would remove "embedded" tax burdens in the prices of many goods and services, while allowing Americans to see more clearly – right on their cash register receipts – how much they are paying for federal programs.

Given this impressive body of research and practical experience, the Panel should recommend that Congress and the President pursue a retail-level national sales tax in place of the current system. As a second option, the Panel could advise replacement of the Tax Code with a flat-rate personal and corporation income tax. Two plans that NTU has endorsed this year are:

- The "FairTax" proposal, which would repeal federal income and personal payroll taxes and replace them with a 23 percent retail-level sales tax with universal rebates based on household size designed to shield purchases of basic necessities from the tax. Since businesses would no longer face a federal income tax, the burden of remitting federal sales tax would be relatively small (and in any case would be administered largely by states overseen by a small federal tax agency).

- A reformed income tax, which would allow taxpayers the option of switching to a simpler tax system featuring a flat rate (ultimately 17 percent) and a generous exemption that would amount to $36,600 for a family of four in 2005 (the amount would rise with inflation). Businesses would also be able to opt for a 17 percent rate, featuring a simplified base consisting of the costs of taxed inputs subtracted from sales. Only employee wages and pensions would be deductible, and immediate expensing of all capital expenditures would be allowed.

In order to protect the gains from tax reform, the Panel should recommend adoption of Constitutional safeguards, namely:

- An amendment requiring a 2/3 "supermajority" of both Houses of Congress to pass any legislation that raises taxes – whether through higher rates, lower exemptions, or new levies.
- In the case of a new retail sales tax system, a measure to repeal the 16th Amendment to the Constitution that currently allows the federal government to impose progressive income taxes.

Virtually all of the recommendations described above have been proposed in the 108th or 109th Congresses as legislation. However, the Panel's endorsement of these proposals would not be an exercise in redundancy. In fact, it would elevate these well-researched concepts to the prominence on the national agenda that they deserve.

Our nation's economy, civil society, and political environment would all flourish under fundamental tax reform. Entrepreneurial energies could be unleashed to usher in an era of prosperity the likes of which our nation has never seen. The freedoms that Americans enjoy could be much more secure. Finally, the unbalanced lawmaking and electoral processes that too often serve *special* interests would be replaced with a new dynamic that works in the *national* interest.

Mr. Chairman, we hope that you and your colleagues will call upon National Taxpayers Union for any additional perspectives or analyses you may require in your deliberations. We are also ready and willing to testify before the Panel at any time. Once again, I am grateful for the opportunity to present our views.

Sincerely,

Pete Sepp
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