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The end of the progressive income tax

The new IRS rules for global income reporting could break the system

By Richard Rahn

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July 1 might go down in history as the beginning of the end of the comprehensive, progressive income tax. A progressive income tax, in which the government attempts to tax all labor income and capital income, such as interest, dividends and capital gains more than once, cannot help becoming so complex that it eventually dies of its own weight. This is particularly true when the government attempts to tax the worldwide income of its “tax persons” rather than the income located in its own territory. The complexity is caused by the never-ending attempt to define what income is and what should be exempt (loopholes).

Press reports now state that the U.S. tax code is more than 77,000 pages and growing at a rapid rate. Obviously, no one individual or even teams of lawyers and accountants can fully understand all of this, including people at the Internal Revenue Service (IRS). When laws are too complex and increasingly subjective in their interpretation, it inevitably leads to corruption. All but the willfully blind now understand that the IRS has both become corrupt and incompetent.

On July 1, the IRS extended its reach to perhaps 100,000 foreign financial institutions and millions of other non-Americans who receive or make payments to Americans. This global power grab was the logical extension of the effort to tax the worldwide income of all Americans, which requires the IRS to know about all payments to and from the United States and which financial institutions are involved in the transmittal and holding of accounts. The paperwork is unending and incomprehensible. (If you think I am overstating the case, download the new “W-8BREN-E” tax form from IRS.gov, which certain foreign recipients of U.S. payments are required to complete. Even tax lawyers tell me that it is nearly impossible to fill out the form without perjuring oneself, owing to the form’s endless ambiguity and lack of clarity.) This requirement is freezing many international bank payments, which will reduce foreign investment in the United States and add to systemic risk of the global financial system.

The economy and tax revenues are being dragged under by the uncertainty engendered by the tax code and the IRS, which is accelerating with the new global requirements. At some point, the American people will demand that Congress not just tinker with tax and IRS reform, but throw the whole stinking mess out. Fortunately, there is an alternative — the simple, low-rate flat tax, which can fit on a postcard. It would tax all salary and wage income at one simple rate, after a generous basic exemption so as to not burden low-income people. It would not double-tax

capital gains, interest and dividends, or income earned outside the United States (a territorial tax system followed by almost all other countries).

There would be no need for the vast number of people who work at the IRS and are now able to play favorites and intrude into people's personal lives, particularly regarding how they choose to spend, save and invest their money. All of that would go away.

There are some who will argue that a flat tax with a rate no higher than 20 percent will benefit the rich. The fact is, over the long term, income-tax rates above 20 percent do not bring in additional tax revenue to government, as Scottish-British economic Nobel Laureate James Mirrlees proved several decades ago. People will go to great lengths to avoid paying taxes. In the short run (months and even a few years), people can be forced by governments to pay high tax rates before they have a chance to figure out how to avoid the tax — even by not working. Very prosperous places such as Switzerland, Hong Kong and Singapore have low tax rates and also provide a very high level of government service. The United States could easily do the same by going to a flat tax of no more than 20 percent, while at the same time getting rid of the many useless and counterproductive spending and regulatory programs.

The next financial crisis will hit because of ever-increasing debt, the crumbling and destructive progressive tax system and the corrupt IRS. At that point, the political class can either continue to grasp at power by imposing capital, price and wage controls, and more taxes, including wealth taxes. Or it could choose to free the people and reignite economic growth by radically downsizing government and moving to a simple, low-rate flat tax.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.