Barry Law Review

Volume 19
Issue 2 *Spring 2014*

Article 1

2014

Fiscal Illusion, Taxpayer Disconnect, and a Flawed Tax System: Catalysts for Income Tax Reform

Timothy Hurley

Katherine Hetherington

FISCAL ILLUSION, TAXPAYER DISCONNECT, AND A FLAWED TAX SYSTEM: CATALYSTS FOR INCOME TAX REFORM

Timothy Hurley & Katherine Hetherington[*]

I. INTRODUCTION

Congress's inability to pass spending bills for fiscal year 2014 necessitated the October 1, 2013, government shutdown and highlighted two of the most pressing topics in current political discourse: (1) the all-time high budget deficit and debt, and (2) the need for tax reform.[1] To end the shutdown, Congress reached a short-term deal to suspend the debt limit until February 7, 2014, but did nothing to create an expedited process for tax reform.[2] These two topics should, of course, be complimentary—tax reform can bring a more balanced budget and less debt. Tax reform, however, is not simply about raising tax rates or increasing taxes on the rich to reach a desired revenue level. Instead, tax reform means bringing about fundamental change to the tax system, so that it meets the economic and societal needs of the country—in other words, having a "good" tax system.

Economist Adam Smith was the first to establish criteria for a good tax system. In 1776, he noted that there are four "canons of taxation"—equity, certainty, convenience, and economy.[3] Since that time, economists have added additional canons, including simplicity and productivity.[4] The idea behind these canons is that, in addition to providing enough revenue to ensure a stable government, a tax system should (1) be fair so that no one group is advantaged or disadvantaged; (2) provide taxpayers with some degree of certainty concerning their tax liability from year to year; (3) be simple and easy to understand and administer; (4) have low compliance and administration costs; and (5) not change taxpayer behavior.[5]

Unfortunately, the tax system in the United States has gone awry of these canons. The President's Advisory Panel on Federal Tax Reform described our tax system as follows: "[O]ur current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair

---

* Timothy Hurley, CPA, M.B.A., J.D., LL.M. (taxation), Assistant Professor of Accounting, San Francisco State University, THurley@sfsu.edu; Katherine Hetherington, J.D., LL.M. (taxation), Assistant Professor of Accounting, San Francisco State University, kkmh@sfsu.edu.

1. Mel Schwarz, *Budget Agreement Fails to Expedite Tax Reform, Delay Medical Excise Tax or Fully Resolve Budget Crisis*, GRANT THORNTON LLP (Oct. 17, 2013), http://www.grantthornton.com/issues/library/alerts/tax/2013/Legislative-Update/Budget-agreement-October-17.aspx.
2. *Id.*
3. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 676–77 (2005), *available at* http://www2.hn.psu.edu/faculty/jmanis/adam-smith/wealth-nations.pdf.
4. Hunbbel Meer, *Canons of Taxation in Economics*, HUBPAGES, http://hunbbel-meer.hubpages.com/hub/Canons-of-Taxation-in-Economics (last updated Oct. 21, 2013).
5. *Id.*

principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth."[6] This flawed tax system, combined with increasing taxpayer disconnect, is causing a dramatic expansion of fiscal illusion. This article examines fiscal illusion, explores the causes of taxpayer disconnect, and suggests comprehensive tax reform as the solution to both systemic problems.

II. FISCAL ILLUSION

Fiscal illusion is not a new concept. In fact, the seminal work on the topic dates back to 1903.[7] Today, however, the problem of fiscal illusion is greater than at any time in history. Fiscal illusion is the idea that "the institutional manner in which citizens are required to pay for government can affect taxpayer perceptions of the price of government, and, hence, the size of the public sector."[8] Economists James Buchanan and Richard Wagner describe fiscal illusion as follows:

> Fiscal illusion suggests that when government revenues are not completely transparent or are not fully perceived by taxpayers, then the cost of government is seen to be less expensive than it actually is. Since some or all taxpayers benefit from government expenditures from these unobserved or hidden revenues, the public's appetite for government expenditures increases, thus providing politicians incentive to expand the size of government.[9]

A simple example using local government and property taxes will help illustrate this theory. Renters may vote for an expansion of a local government program funded by property taxes. The property owner, of course, may increase the rent in the next lease term to offset the tax increase. Fiscal illusion suggests that these renters, who do not pay property taxes, do not experience the direct effect of the increase in taxes. The renter supports the initiative because the renter fails to immediately realize the cost, which is hidden in a rent increase. The same idea applies at the federal level because taxpayers fail to realize the cost of government.

There are many hypotheses offered to explain fiscal illusion. One hypothesis is that financing government with debt, as opposed to tax revenue, appears less costly because taxpayers fail to account fully for the future liability.[10] A second suggests that taxpayers, during inflationary periods, will object less strenuously when government spending is financed with progressive taxation than with

---

6. PRESIDENT'S ADVISORY PANEL, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005), *available at* http://www.taxpolicycenter.org/taxtopics/upload/tax-panel-2.pdf. Although this report is seven years old, the complexity of the tax code has only increased.

7. Richard E. Wagner, *Revenue Structure, Fiscal Illusion, and Budgetary Choice*, 25 PUB. CHOICE 45, 45 n.2 (1976).

8. *Id.* at 46.

9. JAMES BUCHANAN & RICHARD E. WAGNER, DEMOCRACY IN DEFICIT: THE POLITICAL LEGACY OF LORD KEYNES (1977).

10. Wagner, *supra* note 7, at 46.

proportional.[11] A third argues that indirect taxation will appear less costly than direct taxation.[12] Finally, income tax payments made through withholding will appear less costly than if taxpayers wrote an annual check directly to the government.[13] Economists empirically proved each of these hypotheses more than thirty years ago.[14] They still hold today. This article discusses aspects of these hypotheses, but also advances its own theory. The budget deficit and massive accumulating debt, the complexity of the income tax system, compliance costs, the tax system's inefficiency, and its impedance to economic growth fuel fiscal illusion and are all catalysts for comprehensive tax reform. There is, however, an even more compelling argument for tax reform. American taxpayers are increasingly disconnected from the government, generally, and from the tax system, specifically. This disconnect exacerbates fiscal illusion and results in greater government expenditures than in an ideal system in which taxpayers are aware of their share of the cost of government.[15] This high level of fiscal illusion, fueled by disconnect, is the driving force behind the need for comprehensive tax reform.

III. THE DISCONNECT

Before the 2011 riot in London, the worst riot in decades was the poll tax riot of 1990.[16] More than 400 people were injured and hundreds more arrested for assault and looting.[17] The reason was "[a] new tax proposed by the government."[18] Of course, it has been a long time since the tax system has evoked such violence in the United States (and violence is not suggested).[19] Our nation's origin, however, has its "roots in colonial indignation over taxes imposed by England."[20] The Boston Tea Party was a protest of such tax policies.[21] Taxpayers no longer seem concerned with reforming the tax system. In fact, in recent years, the most animated taxpayers have been about tax reform was the establishment of the recent

11. *Id.*

12. *Id.* A direct tax is imposed on and collected from a group of people. The income tax is an example of a direct tax. A sales tax is an example of an indirect tax because it is collected from the sales merchant but imposed on the consumer.

13. *Id.*

14. *See generally* Wagner, *supra*, note 7, at 46 n.3–6 (several economists have proved and written about the hypotheses in the 1960s and 1970s).

15. *See generally* Wagner, *supra* note 7; Jim Angle, *As Non-Taxpayer Ranks Grow, So Does Cost to Government*, FOX NEWS (Sept. 24, 2012), http://www.foxnews.com/politics/2012/09/24/as-non-taxpayer-ranks-grow-so-does-cost-to-government/ (explaining that taxpayers desire more government spending if they are disconnected from the tax system).

16. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 57 (4th ed. 2008). The government, led by Prime Minister Margaret Thatcher, had replaced a real estate tax based on property values with a poll tax. The poll tax or "community charge" was a flat tax "levied on all adults living in a jurisdiction." The people opposed the tax because it charged the same amount to the rich and poor.

17. *Id.*

18. *Id.*

19. *Id.* at 58.

20. *Id.*

21. *Id.* at 58. "An excise tax on distilled spirits spurred the Whiskey Rebellion of 1794, which caused several deaths and much property damage; to quell the rebellion, President Washington nationalized 13000 militiamen, an army three times as large as the one he commanded at Valley Forge during the Revolution." *Id.* at 56.

grass roots movement known as the Tea Party.[22] Most taxpayers, however, seem content with raising taxes on the wealthy and not with comprehensive tax reform that would benefit all Americans.[23] In fact, a recent survey found that:

> [M]any Americans believe rich people to be intelligent and hardworking but also greedy and less honest than the average American.[24] Nearly six in [ten], or 58[%], say the rich don't pay enough in taxes, while 26[%] believe the rich pay their fair share and 8[%] say they pay too much.[25]

Indignation toward the tax system in America seems to have transitioned back to indignation for the rich, as it was in 1913 when the United States adopted the modern-day income tax system.[26] Beyond reverting to a "soak the rich" income tax ideology, taxpayers generally have an extreme disconnect, if not complacency, with the tax system.[27]

For example, would you know the answer if I asked you the total amount of *all* taxes, not just federal income tax, that you paid in 2012? After you fill your car with gas, do you multiply the number of gallons you pumped by 18.4 cents to calculate the federal gas tax? Don't forget the state gas taxes ranging from eight to 50.6 cents a gallon.[28] Add in federal excise taxes for your phone.[29] What about state and county sales and use taxes? Do you record those for all purchases? Do not forget property tax, state income tax, and payroll tax. The point is that we, as taxpayers, do not keep track of all of these taxes. In fact, we have no idea what the various governments charge us in taxes every year.

Did you forget about the corporate income tax? In 2012, the United States assumed the number one position—it has the highest corporate income tax rate in the world at 39%.[30] Many Americans believe that if corporations are paying more

---

22. *12 Days of Solutions, Day 5: Two Tax Reform Proposals*, TEA PARTY PATRIOTS (Dec. 14, 2012), http://www.teapartypatriots.org/misc/12-days-of-solutions-day-5-two-tax-reform-proposals/.
23. Paul Steinhauser, *Trio of Polls: Support for Raising Taxes on Wealthy*, CNN (Dec. 6, 2012, 10:19 AM), http://politicalticker.blogs.cnn.com/2012/12/06/trio-of-polls-support-for-raising-taxes-on-wealthy/; Steven Shepard, *Poll: Americans Don't Want Congress Messing with Their Tax Breaks*, NAT'L J. (July 24, 2013), http://www.nationaljournal.com/congressional-connection/coverage/poll-americans-don-t-want-congress-messing-with-their-tax-breaks-20130724.
24. Associated Press, *Most Americans Say Rich Should Pay More Taxes, According to New Survey*, CBS (Aug. 27, 2012, 5:44 PM), http://www.cbsnews.com/news/most-americans-say-rich-should-pay-more-taxes-according-to-new-survey/.
25. *Id.*
26. *History of the United States Tax Systems*, POL'Y ALMANAC, http://www.policyalmanac.org/economic/archive/tax_history.shtml (last visited Mar. 25, 2014).
27. Taxpayer Advocate, *The Time for Tax Reform Is Now*, IRS *available at* http://www.taxpayeradvocate.irs.gov/files/MSP1_Tax%20Reform.pdf (last visited Mar. 28, 2014).
28. *Facts and Figures: How Does Your State Compare*, TAX FOUND. (2013) *available at* http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff2013.pdf (last visited Nov. 12, 2013).
29. *Understanding Your Telephone Bill*, FCC, http://www.fcc.gov/guides/understanding-your-telephone-bill (last visited Mar. 25, 2014).
30. Heritage Foundation, *United States Has the Highest Corporate Tax Rate, Driving Businesses Abroad*, OPPOSING VIEWS (Aug. 30, 2012), http://www.opposingviews.com/i/politics/no-surprise-us-corporate-taxes-driving-businesses-abroad.

in taxes, then individuals are paying less.[31] That is unequivocally false. The Tax Policy Center (TPC), a nonpartisan think tank, explains it as follows: "The incidence of all taxes is on households, who bear the burden of taxes through reductions in income from one or more sources (such as wages, interest, and dividends), or through higher prices for goods and services they consume."[32]

Congressman John Linder and Neal Boortz, in *The Fair Tax Book*, agree. "When it comes right down to it, *no* corporation or business really pays taxes. The burden—all of it—falls on us."[33] Consider an illustrative example they created: If a company has gross revenue of $20 million a year and expenses, including labor and all federal taxes, of $18 million, then the company has $2 million in profit.[34] The government decides to increase the corporate income tax 5%, or for this company $100,000.[35] Consider where this additional tax money will come from. First, it could come from the $2 million profit.[36] But this profit belongs to the shareholders.[37] In fact, the TPC now estimates that the corporate income tax is borne 80% by shareholders.[38] Second, the additional tax could come from employees. The TPC estimates that the other 20% of the corporate income tax is borne by employees.[39] The corporation could simply reduce wages or cut back on employee benefits. Finally, the corporation could solve its tax burden by increasing prices on consumer goods and services. Congressman John Linder and Neal Boortz sum up the corporate tax best:

> It's plain as the nose on George Washington's face: Only individuals create wealth. Only individuals retain wealth. Only individuals can have their wealth seized by the government in the form of taxes. Sure, the money may sift through corporate hands on the way to the U.S. Treasury, but the corporations only serve the role of collection agents and remitters. The bottom line: You pay the price.[40]

If we confine our discussion simply to the federal income tax, the result is similar—taxpayers are disconnected from the tax system. Over the past few years, on or around April 15, I, like many tax commentators, have asked several college-educated friends, "How much income tax did you have to pay this year?" All responded as follows, "I didn't have to pay. I got a refund." Unfortunately, this would be the response of a lot of taxpayers, who are ignoring the fact that every

---

31. NEAL BOORTZ & JOHN LINDER, THE FAIR TAX BOOK 31 (2005).
32. Jim Nunns, *How TPC Distributes the Corporate Income Tax*, TAX POL'Y CTR. 2 (Sept. 13, 2012), *available at* http://www.taxpolicycenter.org/UploadedPDF/412651-Tax-Model-Corporate-Tax-Incidence.pdf.
33. BOORTZ & LINDER, *supra* note 31, at 32.
34. *Id.*
35. *Id.* at 33.
36. *Id.*
37. *Id.*
38. Nunns, *supra* note 32, at 2, 10.
39. *Id.* at 10.
40. BOORTZ & LINDER, *supra* note 31, at 34.

paycheck they received the prior year had a substantial reduction for federal income tax. Then on April 15, I ask how much tax they had to pay in income tax and they have absolutely no clue; all they can tell me is how much of a refund they are getting. Many Americans, in fact, have no idea how much they earn during a pay period.[41] If asked, they would say something along the lines, "I take home about five hundred dollars a week."[42] *Take home*. They just know the amount left after the federal government takes the federal income and payroll taxes. "That money is gone—and the average worker doesn't even consider it part of his earnings in the first place."[43] Americans are disconnected from the tax system.

The government withholding taxes is nothing new. The 1913 income tax statute authorized "withholding of income taxes 'at the source'—that is, extraction of income taxes from taxpayers' pay envelopes before salaries were paid."[44] Unlike today, there was great public outcry and criticism about withholding.[45] It caused then Treasury Secretary William G. McAdoo to declare that "'it would be very advantageous to . . . do away with the withholding of income tax at the source' because it would 'eliminate a great deal of criticism which has been directed against the law.'"[46] As a result, in 1917, Congress repealed the authority to withhold income tax and the United States did not see it again until the 1940s.[47] In 1943, Congress passed the Current Payment Tax Act, establishing what we know as modern day income tax withholding.[48] The funding of World War II demanded greater resources than the income tax was currently bringing into the government.[49] As a result, the government played on the patriotism of Americans to broaden the income tax and to renew withholding.[50]

Since the 1940s, there have been several attempts by the government to expand withholding. In the 1970s, President Jimmy Carter attempted to extend withholding to interest and dividends as a means of increasing compliance.[51] The effort failed. In 1982, however, Congress, with the support of President Ronald Regan, authorized 10% withholding on interest and dividends citing the budget deficit as the reason.[52] "Public opposition was profound. By August 5, 1983, one month after withholding was to have taken effect under TEFRA [the Tax Equity and Fiscal Responsibility Act of 1982], the Interest and Dividend Tax Compliance Act of 1983 *repealed* TEFRA's provision for withholding on interest and dividends."[53]

41. *Id.* at 21.
42. *Id.*
43. *Id.* at 22.
44. Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 CATO J. 359, 369 (1995), *available at* http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1995/1/cj14n3-1.pdf.
45. *Id.*
46. *Id.* (quoting U.S. Treasury Department (1916) Annual Report of the Secretary of the Treasury on the State of Finances for the Fiscal Year Ended June 30, 1915. Washington, D.C.: U.S. Government Printing Office).
47. Twight, *supra* note 44.
48. *Id.*
49. BOORTZ & LINDER, *supra* note 31, at 24.
50. Twight, *supra* note 44, at 371.
51. *Id.* at 385–86.
52. *Id.* at 389.
53. *Id.* at 390 (alteration in original) (citation omitted).

In the 1980s, Americans blocked the government's attempt to withhold tax from interest income.[54] Withholding tax from earned interest prevents the taxpayer from earning additional interest on the amount withheld.[55] Americans stood up to the government over this new withholding.[56] Yet, why are Americans complacent with the withholding on earned income? Americans simply accept it without any notable public opposition. The American people do not even demand interest on the money that the government, in effect, is borrowing from us until our taxes are due on April 15. Economists estimate that since its inception, withholding has "taken more than $400 billion (calculated in 1995 dollars) in interest from taxpayers."[57] What if taxpayers had the opportunity to invest the money that the government withholds until taxes were due? Commentators offer this illustration: "[I]f in 2002 taxpayers had been allowed to keep their money until it was due—and if they had invested that money in completely safe and secure T-bills—tax-paying Americans would have pocketed nearly *$24 billion* in interest payments."[58] Imagine how much more connected we would be to the tax system if the government paid us interest for the use of our money. Alternatively, if Americans had no system of tax withholding and had to sit down and write one large check to the government on April 15, we would certainly know what taxes were costing us.

A. Nonpayers

One final issue that illustrates taxpayer disconnect is nonpayers. A nonpayer is an individual or couple who has zero or negative income tax liability.[59] In 2013, an estimated 43.3% of Americans will pay no income taxes, up from 41.8% in 2012.[60] Besides the impact of 70 million Americans not contributing to governmental revenue, economists warn of other problems associated with this.[61] There is a strong correlation between nonpayers and government transfer payments—unemployment insurance, Social Security, Medicare, Medicaid, and food stamps.[62] Economists' research indicates that:

> [A] 1 percentage point increase in the share of tax filers who are nonpayers (from 40 percent to 41 percent, for example) is associated with a $10.6 billion per year increase in transfer

54. Twight, *supra* note 44, at 390.
55. *Id.* at 386.
56. *Id.* at 390.
57. Donald Boudreaux & Andrew P. Morriss, *Withholding the Taxpayer Hostage*, THE FREEMAN (Apr. 1, 1999), http://www.fee.org/the_freeman/detail/withholding-the-taxpayer-hostage#respond.
58. BOORTZ & LINDER, *supra* note 31, at 46.
59. Will Freeland, William McBride & Ed Gerrish, *The Fiscal Costs of Nonpayers*, TAX FOUNDATION (Sept. 19, 2012), http://taxfoundation.org/article/fiscal-costs-nonpayers.
60. *Table T13-0228 Tax Units with Zero or Negative Income Tax Liability Under Current Law, 2004–2024*, TAX POLICY CTR. (Aug. 29, 2013), http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3987. Two-thirds of the 43.3% (or roughly 28.9% of the total population), however, paid payroll (Medicare and Social Security) taxes.
61. Freeland et al., *supra* note 59.
62. *Id.*

> payments. Since the number of nonpayers has increased by 20 percentage points over the last two decades, our model indicates that in 2010 alone, over $213 billion in transfer payments are associated with this two decade increase in nonpayers.[63]

The significant rise in nonpayers over the past decade is increasing fiscal illusion.[64] The government benefits are increasing, while the knowledge of the cost of government decreases.[65] "The danger is that if the price of government goes down for enough voters to create a sizable voting block [sic], the overall effect in a majority-rule democracy could be excessive government spending."[66] Expansion of government spending in the face of fiscal illusion contributes to more and more deficit spending and economic decline.[67] One possible solution, or at least a significant contribution to a solution, is comprehensive tax reform.

IV. TAX REFORM

Candidates and politicians have said it hundreds of times: We need tax reform.[68] What does that really mean? More often than not, it means a change in the income tax rates or a change in the breadth of the income tax brackets. For example, in the 2012 Presidential Election, President Obama's tax reform plan called for: (1) increasing the top two tax rates for those making more than $250,000 from 33% and 35% to 36% and 39.6%, respectively; (2) increasing capital gains rates from 15% to 20% on those making more than $250,000; (3) changing the dividend tax rate to match the income tax rate for that group;[69] and (4) reducing the corporate tax rate from 35% to 28%.[70] As 2012 turned to 2013, Congress averted the "fiscal cliff," which refers to the lapse of the George W. Bush era tax cuts, by enacting the American Taxpayer Relief Act of 2012 (ATRA).[71] ATRA represents a compromise between Obama's campaign platform and republicans' tax reform goals. The top tax rate for individuals rose to 39.6%, but only for single filers with taxable income greater than $400,000.[72] The tax rate on

63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. Freeland et al., *supra* note 59.
68. Ashley Parker, *Tax Overhaul Plan Faces Key Hurdles*, N.Y. TIMES, Feb. 26, 2014, at A18, *available at* http://www.nytimes.com/2014/02/26/us/politics/gop-tax-plan-seeks-cuts-in-rates-and-number-of-brackets.html?_r=1. *See* Gregory J. Milman, *Tax Reform Targets Executive Pay, but May Raise Salaries*, WALL ST. J. (Mar. 12, 2014, 3:31 PM), http://blogs.wsj.com/cfo/2014/03/12/tax-reform-targets-executive-pay-but-may-raise-salaries/?KEYWORDS=tax+reform. *See also* Stephanie Condon, *House Republicans Take Aim at IRS, Tax Reform*, CBS NEWS (Feb. 26, 2014, 6:00 AM), http://www.cbsnews.com/news/house-republicans-take-aim-at-irs-tax-reform/.
69. *See* 26 U.S.C. § 1 (West 2013). Currently, the dividend tax rates for all taxpayers are 0% if the individual's income tax rate is 10% or 15%, or it is 15% if the individual's income tax rate exceeds 15%.
70. Patrick Temple-West, *Factbox: Stark Differences in Ryan, Romney, Obama Tax Plans*, REUTERS (Aug. 21, 2012, 11:33 AM), http://www.reuters.com/article/2012/08/21/us-usa-campaigns-taxes-idUSBRE87K0OO20120821.
71. American Taxpayer Relief Act of 2012, PUB. L. NO. 112-240,126 § 2313 (West 2013).
72. *Id.* at § 101(b)(1)(B).

capital gains and dividends for the same high-income taxpayers rose from 15% to 20%.[73] The top rate for estate and gift taxes rose from 35% to 40%.[74] The 2012 campaign platform and the ATRA represent change, not reform. Fundamental tax reform can include tax rate changes, but generally goes beyond that.[75] Tax reform incorporates ideals such as: restructuring the tax base, changing how taxes are administered, collected, and utilized, as well as changing how the tax code is structured.[76]

Do Americans need tax reform? The income tax has basically served our needs since its inception. A brief history of the income tax illustrates how the United States got to the present system. In 1862, Congress enacted the nation's first income tax to raise money to finance the Civil War.[77] This forerunner of our modern day income tax generated $55 million to support the war effort.[78] In 1872, with the war over, Congress repealed the income tax.[79] By 1893, however, the economy was in a severe depression, termed the Panic of 1893.[80] This panic was marked by the Reading Railroad going into receivership and the failure of other railroads and business, which sparked a series of bank failures.[81] Congress reacted to the economic downturn with the Wilson-Gorman Tariff Act, which placed a 2% tax on income above $4000.[82] The following year the Supreme Court of the United States struck down the tax because it was a direct tax on the citizens of the United States and not apportioned among the states according to the Census—a violation of the Constitution.[83] As a result, in 1913, the states ratified the Sixteenth Amendment to the Constitution, which allowed a direct tax on the citizens of the United States and made the income tax a permanent fixture in the United States.[84] The income tax that immediately followed the Sixteenth Amendment, as advertised, was a tax on the "evil and hated rich"—it taxed one-half of one percent

73. *Id.* at § 102(b)(1).

74. *Id.* at § 101(c)(1).

75. *What is Tax Reform?*, WISEGEEK, http://www.wisegeek.com/what-is-tax-reform.htm (last visited Mar. 28, 2014).

76. *Id.*

77. Cynthia G. Fox, *Income Tax Records of the Civil War Years*, PROLOGUE (Winter 1986), *available at* http://www.archives.gov/publications/prologue/1986/winter/civil-war-tax-records.html. The first income tax was moderately progressive, imposing a 3% on annual incomes between $600 and $10000. If an individual earned more than $10000, the rate was 5%.

78. *Id.*

79. *Id.*

80. Charles Hoffman, *The Depression of the Nineties*, 16 J. ECON. HIST. 137, 137 (1956) (discussing the depression of the nineties, including the Panic of 1893).

81. *See id.* at 138; Stephen Salsbury, *The Reading Railroad: History of a Coal Age Empire, Volume 2: The Twentieth Century by James L. Holton*, 118 PENN. MAG. HIST. & BIO. 174, 174 (1994) (reviewing JAMES L. HOLTON, THE READING RAILROAD: HISTORY OF A COAL AGE EMPIRE, VOLUME 2: THE TWENTIETH CENTURY (1992)).

82. *The Income Tax of 1894*, 9 Q. J. ECON. 223, 225–26 (1895), *available at* http://www.jstor.org/stable/1885603.

83. Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 640, 696 (1895) ("'No Capitation, or other direct tax, shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.' Article 1, §9.").

84. U.S. CONST. amend. XVI ("The Congress shall have 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.").

of Americans.[85] In today's dollars, it amounted to a tax on incomes in excess of $250,000.[86] It is not necessary for the purposes of this paper to go into great detail about how the tax burden quickly shifted dramatically from "soaking the rich" to encompassing most working Americans.[87] We know this. The question then becomes: if the income tax has been in existence since 1913 at varying degrees and rates, is tax reform really necessary? In effect, this income tax has gotten the United States this far; why change it now?

A. The Deficit and Debt

The lack of taxpayer awareness and concern that are the trademarks of fiscal illusion and disconnect enable deficit spending and increased debt. In 1984, economist James Buchanan summed up the political nature of the U.S. debt: "The attractiveness of financing spending by debt issue to the elected politicians should be obvious. Borrowing allows spending to be made that will yield immediate political payoffs without the incurring of any immediate political cost."[88] This theory certainly seems to hold true because, if one paid attention during this election, it would be clear that the United States has an enormous budget deficit.[89] A budget deficit occurs when government expenditures exceed its revenues.[90] Imagine sitting down to pay your monthly bills. You add them all up and realize that you have far less in money than you owe. You borrow money to cover that difference. The next month, when you sit down to pay your bills, the same thing happens. Wouldn't you be in a panic if month after month you borrow money just to pay your bills? The government, however, keeps borrowing. How big and how detrimental is this budget deficit to the economy? The Congressional Budget Office (CBO) described it as follows:

> Between 2009 and 2012, the federal government recorded the largest budget deficits relative to the size of the economy since 1946, causing federal debt to soar. Federal debt held by the public is now about 73 percent of the economy's annual output, or gross domestic product (GDP). That percentage is higher than at any point in U.S. history except a brief period around World War II, and it is twice the percentage at the end of 2007. If current laws generally remained in place, federal debt held by the public would decline slightly relative to GDP over the next several years…After that, however, growing deficits would ultimately push debt back

85. BOORTZ & LINDER, *supra* note 31, at 15.
86. *Id.*
87. BOORTZ & LINDER, *supra* note 31, at 16.
88. Andrew T. Young, *Tax-Spend or Fiscal Illusion?* 29 CATO J. 469, 469 (2009) (citing JAMES BUCHANAN, THE DEFICIT AND AMERICAN DEMOCRACY (P.K. Steinman Foundation ed. 1984)).
89. *See* CONGRESSIONAL BUDGET OFFICE, PUB. NO. 4869, THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2024 1 (2014), *available at* http://www.cbo.gov/publication/45010 [hereinafter known as C.B.O. 4869].
90. *Budget Deficit*, INVESTOPEDIA, http://www.investopedia.com/terms/b/budget-deficit.asp (last visited March 21, 2014).

> above its current high level. CBO projects that federal debt held by the public would reach 100 percent of GDP in 2038.[91]

For 2013, the deficit fell to $680 billion, marking the first year below $1 trillion since 2008.[92] But it would be premature to celebrate a deficit reduction. The total debt that the country faces from years of deficit spending exceeds $17 trillion.[93] CBO describes the next decade as follows:

> In CBO's baseline projections, deficits continue to shrink over the next few years, falling to 2.4 percent of GDP by 2015. Deficits are projected to increase later in the coming decade, however, because of the pressures of an aging population, rising health care costs, an expansion of federal subsidies for health insurance, and growing interest payments on federal debt. As a result, federal debt held by the public is projected to remain historically high relative to the size of the economy for the next decade. By 2023, if current laws remain in place, debt will equal 77 percent of GDP and be on an upward path, CBO projects.[94]

CBO's prediction for debt as a percentage of GDP is alarming. GDP, one of the primary indicators of how the United States economy is performing, measures the nation's total output.[95] One measure of the debt burden is the portion of debt held by the public as a percent of GDP.[96] Debt held by the public is the amount the United States government owes to those holding government securities such as Treasury bills and bonds.[97] In 2012, the federal debt held by the public as a percent of GDP was 73%—the largest it has been since the end of World War II.[98] Economists warn that "countries with [public] debt above 90 percent of GDP grow by an average of 1.3 percentage points per year slower than less debt-ridden countries."[99] As discussed above, the United States may not get to that level. However, CBO warns that:

---

91. CONG. BUDGET OFFICE, PUB. NO. 4713, THE 2013 LONG-TERM BUDGET OUTLOOK 1 (2013), *available at* http://www.cbo.gov/publication/44521 [hereinafter known as C.B.O. 4713].
92. CONG. BUDGET OFFICE, PUB. NO. 4649, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023 7 (2014), *available at* http://www.cbo.gov/publication/43907 [hereinafter known as C.B.O. 4649].
93. U.S. NATIONAL DEBT CLOCK: REAL TIME, http://www.usdebtclock.org/ (last visited Nov. 13, 2013).
94. C.B.O. 4649 at 1.
95. *Fiscal Outlook: Understanding the Federal Debt: Budget and Federal Debt*, U.S. GOV'T ACCOUNTABILITY OFFICE, http://www.gao.gov/fiscal_outlook/understanding_federal_debt/interactive_graphic/budget_and_federal_debt?layout=iframe (last visited Mar. 21, 2014).
96. *Fiscal Outlook: Understanding the Federal Debt: Components of Federal Debt*, U.S. GOV'T ACCOUNTABILITY OFFICE, http://www.gao.gov/fiscal_outlook/understanding_federal_debt/interactive_graphic/components_of_federal_debt?layout=iframe (last visited Mar. 21, 2014).
97. *Id.*
98. C.B.O. 4713 at 1.
99. *Hearing on Taxes and the Federal Budget Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 11th Cong. (2010) (statement of Leonard E. Burman, Daniel Patrick Moynihan

> For the 2014–2023 period, deficits in CBO's baseline projections total $7.0 trillion. With such deficits, federal debt would remain above 73 percent of GDP—far higher than the 39 percent average seen over the past four decades. (As recently as the end of 2007, federal debt equaled just 36 percent of GDP.) Moreover, debt would be increasing relative to the size of the economy in the second half of the decade.[100]

The key word above is "projections." We have a fragile economy and nothing is certain. In addition, as with other investments, when risk (in this case ever-increasing debt) increases, investors may demand higher interest rates.[101] Paying higher interest rates slows the growth of the economy.[102] One thing seems clear: the government's current revenue generating tax system no longer supports government spending.[103] According to one expert, "[t]he consequence is that either taxes must increase significantly above historic levels to prevent enormous accumulations of public debt, or that government services, especially those benefiting the elderly, must be cut substantially below current levels."[104]

B. The Cost of Taxes

Critics of tax reform state that "we don't have a taxing problem, we have a spending problem."[105] That is partially true—the government has a spending problem and wastes a significant amount of money.[106] However, we also have a taxing problem.

Perhaps if Americans were aware of tax compliance costs, they would renew the cry for reform. But, most Americans think that their income tax burden is shown on the bottom line of the tax return entitled "total tax."[107] This line on the tax return fails to consider the cost of complying with the tax system. Part of the compliance cost is time. Think about April 15. Think about all of the trouble you

---

Professor of Public Affairs, Maxwell School, Syracuse University), *available at* http://www.taxpolicycenter.org/UploadedPDF/901330_burman_testimony.pdf.

100. C.B.O. 4649 at 1.

101. *Hearing on Taxes and the Federal Budget Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 11th Cong. 2 (2010) (statement of Leonard E. Burman, Daniel Patrick Moynihan Professor of Public Affairs, Maxwell School, Syracuse University).

102. *Id.*

103. *Id.* at 1.

104. *Id.* at 4.

105. Brett Dunlap, *McKinley Hosts Town Hall Event*, THE PARKERSBURG NEWS AND SENTINEL (Aug. 28, 2012), http://www.newsandsentinel.com/page/content.detail/id/564604/McKinley-hosts-town-hall-event.html?nav=5061.

106. *See* Tami Luhby, *Did Obama Really Make Government Bigger?*, CNNMONEY (Jan. 25, 2013, 7:11 AM), http://money.cnn.com/2012/01/25/news/economy/obama_government/index.htm ("Government spending as a share of the economy has hovered around 24% during the Obama administration, several percentage points higher than under President Bush, according to Congressional Budget Office data. It's also elevated from the historical average of 20.7% over the past 40 years.").

107. Kelly Phillips Erb, *Making Sense of Income and Tax Terms*, FORBES (Nov. 13, 2012, 7:47 AM), http://www.forbes.com/sites/kellyphillipserb/2012/11/13/making-sense-of-income-and-tax-terms/ (discussing American confusion with income tax and clarifying what each line in the tax return entails).

have getting your tax return ready. April 15 entails locating receipts, cancelled checks, and financial documents, locating the correct income forms, reading the forms, reading the instructions for the forms, reading about the numerous tax changes, and buying a book to help you understand the tax changes. According to a 2010 study by the National Taxpayer Advocacy Service, taxpayers and businesses spend 6.1 billion hours per year complying with the income tax system.[108] This figure does not include the millions of hours taxpayers spend considering and replying to the 200 million notices sent to taxpayers annually by the Internal Revenue Service (IRS) or the time spent during an audit.[109] One author looked at these hours in a unique way to get the point across:

> If the average life expectancy is [78.49 years], then the [6.1 billion] hours it takes to comply with our tax code in just one year would equal the combined lifespan of [8,872] Americans . . . . It's as if we are throwing away the lives of [8,872] Americans every year, just to make sure we've all complied with the tax code.[110]

The 6.1 billion hours also does not take into account opportunity cost—decreased productivity resulting from countless hours spent by individuals and businesses trying to structure transactions so that they can reduce their tax obligation.[111] "Some have estimated that nearly 80 percent of all business decisions at the highest corporate levels are made only after due consideration of the tax consequences involved."[112] Imagine if businesses made decisions based on what made the most business sense, not what made the most tax sense. Imagine how many jobs businesses could create, how productive taxpayers could be, and how the economy could grow if these 6.1 billion hours were available (or even half of these hours were available).

Another way to look at this is to analyze tax compliance as if it were an industry. Using a standard forty hour workweek and fifty-two weeks a year (with two off for vacation), the cost of covering these 6.1 billion hours adds up to a full-time workforce of over three million people.[113] It would be the largest industry in

108. NAT'L TAXPAYER ADVOC., 2010 ANNUAL REPORT TO CONGRESS VOLUME ONE: MOST SERIOUS PROBLEMS 3 (2010), http://www.irs.gov/pub/tas/2010arcmsp1_taxreform.pdf. *See* NAT'L TAXPAYER ADVOC., 2010 ANNUAL REPORT TO CONGRESS VOLUME 1: EXECUTIVE SUMMARY vii (2010), http://www.irs.gov/pub/tas/execsummary_2010arc.pdf ("Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.").

109. NAT'L TAXPAYER ADVOC., 2010 ANNUAL REPORT TO CONGRESS VOLUME ONE: MOST SERIOUS PROBLEMS 3 (2010), http://www.irs.gov/pub/tas/2010arcmsp1_taxreform.pdf.

110. BOORTZ & LINDER, *supra* note 31, at 43. The figures shown in this article have been updated to reflect the current compliance costs, including life expectancy. *See U.S. Life Expectancy Stagnating*, CBI (June 23, 2012, 1:49 AM), http://www.upi.com/Health_News/2012/06/23/US-life-expectancy-stagnating/UPI-15501340430591/ ("[A]verage life U.S. expectancy for a person born today is 78.49 . . . .").

111. BOORTZ & LINDER, *supra* note 31, at 43.

112. *Id.* at 46.

113. NAT'L TAXPAYER ADVOC., *supra* note 108.

the United States.[114] A recent study indicates that as of 2009, those actually employed in the income tax compliance industry—accountants, tax lawyers, and financial planners—number more than those who "are employed at the five biggest employers among Fortune 500 companies—more than all the workers at Wal-Mart Stores, United Parcel Service, McDonald's, International Business Machines, and Citigroup combined."[115] Economist Arthur Laffer states that, "[w]ithout diminishing in any way the professionalism of tax attorneys, accountants and financial planners, all of these efforts produce nothing other than, well, tax compliance."[116] This, of course, does not include the 86,974 IRS employees with a budget of more than $12 billion working to ensure that the government collects the American taxpayers' money and that the taxpayers comply with the Code.[117] This is yet another sad commentary about how productive America could be with a simpler income tax system.

Besides the exorbitant number of hours eaten up by tax compliance, there is an even greater cost—the dollars associated with compliance. Economists estimate that the total cost to comply with the income tax system is a staggering $431.1 billion annually.[118] Taxpayers spend $31.5 billion of this figure on tax professionals who assist with completing the tax return or on software to help in that endeavor.[119] This also includes the $12.4 billion IRS budget and the costs associated with the 6.1 billion hours spent complying with the Code—$377.9 billion dollars per year.[120] In effect, taxpayers spend $30 in compliance costs for every $100 collected in tax revenue.[121] A unique way to look at this:

> What if your local bank sent you a notice telling you that is was going to start charging you [$30] for every $100 that you deposit, just to cover the bank's cost of complying with banking regulations? Would you keep making deposits there? Of course not….Why then, are we all so willing to tolerate a tax system in which the government takes the first 33 cents out of every dollar

114. *Id.*
115. Arthur B. Laffer, *The 30-Cent Tax Premium*, THE WALL STREET JOURNAL (Apr. 18, 2011, 12:01 AM), http://online.wsj.com/article/SB10001424052748704116404576262761032853554.html.
116. *Id.*
117. INTERNAL REVENUE SERV., SOI TAX STATS - PERSONNEL SUMMARY, BY EMPLOYMENT STATUS, BUDGET ACTIVITY, AND SELECTED TYPE OF PERSONNEL—DATABOOK TABLE 30 (2013), *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Personnel-Summary-by-Employment-Status-Budget-Activity-and-Selected-Type-of-Personnel-Databook-Table-30 (click on 2013); INTERNAL REVENUE SERVICE, FY 2012 BUDGET IN BRIEF INTERNAL REVENUE SERVICE 3 (2013), *available at* http://www.irs.gov/pub/newsroom/budget-in-brief-fy2013.pdf.
118. Arthur B. Laffer, Wayne H. Winegarden & John Childs, *The Economic Burden Caused by Tax Code Complexity*, THE LAFFER CENTER (April 2011), http://www.laffercenter.com/wp-content/uploads/2011/06/2011-Laffer-TaxCodeComplexity.pdf.
119. *Id.*
120. *Id.* at 3.
121. *See id.*

we earn, and then, in effect charges us more to comply with the law?[122]

Compliance costs never make their way into the government to be spent on programs or benefits to taxpayers such as: military defense, highways, or law enforcement.[123] Instead it is $431.1 billion in compliance costs, opportunities lost, and productivity wasted.

C. Why Are Compliance Costs so High?

Why does the income tax system force taxpayers to spend 6.1 billion hours per year complying?[124] Likely, the single biggest issue with the tax system is its complexity. A 2005 survey indicated that 80% of taxpayers surveyed with incomes below $20,000 who filed the simplest of tax forms "found the tax system either very complex or somewhat complex."[125] That figure rose to 100% for taxpayers at $150,000 in income.[126] The survey also found that "[t]he process is so bad that one-third of those surveyed believe that completing the annual tax return is more onerous than actually paying large amounts of money in taxes."[127] In fact, taxpayers find filing a tax return so onerous that about 60% now pay preparers to do it for them.[128]

One reason the tax system is so onerous is the complexity of the forms. For example, I am sitting in my office staring up at the wall where a replica of the 1913 Form 1040 hangs. It is a total of four pages including the instructions.[129] In 2012, Form 1040 was two pages long. The instructions to complete these two pages, however, were 214 pages.[130] In addition, filing Form 1040 often requires the filing of one or more supplemental schedules. Each schedule, of course, has its own set of instructions.[131] Beyond the lengthy instructions, determining qualification for what should be a simple deduction or credit is daunting. "Figuring out whether you

---

122. BOORTZ & LINDER, *supra* note 31, at 42. The 33 cents represents the amount of withholding directly from worker's paychecks for income tax and payroll taxes.

123. Laffer et al., *supra* note 118, at 7.

124. *Id.* at 3.

125. PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 2.

126. *Id.*

127. *Id.*

128. NAT'L TAXPAYER ADVOC., *supra* note 108, at 5.

129. The original Form 1040 can be seen on the IRS website. http://www.irs.go/pub/irs-utl/1913.pdf.

130. Form 1040 Instruction 2013, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/i1040.pdf (last visited Apr. 17, 2014).

131. For example, see schedules A, C, and E. Schedule A, required to itemize deductions, is one page; the instructions are thirteen. *See* 2013 Schedule A Itemized Deductions, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/f1040sa.pdf; 2013 Instructions for Schedule A, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/i1040sca.pdf. Schedule C, required to report business income of an individual, is two pages; the instructions are eleven pages. *See* 2013 Schedule C Profit or Loss from Business, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/f1040sc.pdf; 2013 Instructions for Schedule C, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/i1040sc.pdf. Schedule E, required to report rental income, is two pages; the instructions are ten pages. *See* 2013 Schedule E Supplemental Income and Loss, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/f1040se.pdf; 2013 Instructions for Schedule E, DEP'T OF THE TREASURY INTERNAL REVENUE SERV., http://www.irs.gov/pub/irs-pdf/i1040se.pdf.

can claim the child tax credit, for example, requires the skills of a professional sleuth: You need to complete eight lines on a tax form, perform up to five calculations, and fill out as many as three other forms or schedules."[132] Regardless of income level, figuring out taxes is a burden.

Another reason the tax system is so onerous is the complexity of the tax law itself. An example illustrates this complexity. In 1997, *Money* magazine created a moderately, but not exceptionally, complex tax situation and asked forty-six professionals to calculate the tax liability.[133] *Money* received forty-six returns with forty-six different answers with tax liabilities ranging from $34,420 to $68,192.[134] The actual tax liability was $35,643.[135] Some critics of this argument might say that 1997 was a long time ago and that the situation would not repeat itself. This implies that the Code has gotten simpler. Has it?

According to Commerce Clearing House (CCH), there were 4428 changes to the Code between 2000 and 2010.[136] That is an "average of more than one per day, including an estimated 579 changes in 2010 alone."[137] The Code, in fact, has grown so much that determining its size is difficult.[138] In 2010, the National Taxpayer Advocate indicated that the Code contained 3.8 million words, up from 2.1 million words in 2005 and 1.4 million in 2001.[139] In fact, the Code has tripled since 1975.[140]

In addition to understanding the Code, tax compliance requires familiarity with the Treasury Regulations, administrative guidance, and judicial decisions. The U.S. Treasury Department writes the Regulations, which help to explain the Code provisions.[141] As the Code grows, so do the Regulations, which now stand at more than a foot tall.[142] The CCH Standard Federal Tax Reporter, a leading publication for tax professionals that summarizes administrative guidance and judicial decisions issued under each section of the Code, now comprises twenty-five volumes and takes up nine feet of shelf space.[143]

These complexities fuel questions in taxpayers' minds. Is my tax return right? Did I pay too much? Did I pay too little? Because of these complexities, there is little confidence that Americans really know how much they should be paying in taxes each year. Taking returns to a tax preparer, unfortunately, does not eliminate this issue. "[A]s journalists and tax analysts have repeatedly shown over the years, rarely will two tax preparers working on the same tax return come up with the

132. PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 2.
133. SLEMROD & BAKIJA, *supra* note 16, at 159.
134. *Id.*
135. *Id.*
136. NAT'L TAXPAYER ADVOC., *supra* note 108, at 4. Commerce Clearing House is a leading publisher of tax information.
137. *Id.*
138. *Id.* at 4.
139. *Id.*
140. *Id.*
141. *Id.*
142. NAT'L TAXPAYER ADVOC., *supra* note 108, at 4.
143. *Id.*

same amount of taxes due."[144] The Code should be simple, transparent, and easily understood by taxpayers.

D. Efficiency

In addition to the transparency necessary to curb fiscal illusion and deficit spending, as well as the simplicity necessary to reduce compliance costs, efficiency is another principle of good tax policy. The American Institute of Certified Public Accountants describes the tax system and efficiency as follows: "The tax system should not impede or reduce the productive capacity of the economy."[145] In other words, the tax system should interfere as little as possible with people's economic behavior, i.e., decision making. Of course, any tax system will affect behavior to an extent; however, the goal of a good tax system is to minimize adverse effects.[146] The current tax system is inefficient in several respects. An example will illustrate this point. Think of April 15 again. Poring over income tax forms, looking for deductions and trying to understand if certain tax situations qualify for a deduction is so bothersome to a lot of taxpayers that they go an easier way—they throw out the receipts and stop looking for deductions. "These taxpayers have decided that the cost of claiming the tax deductions that are rightfully theirs is just not worth it."[147] They do not claim any itemized deductions; they file a tax return and claim the standard deduction.[148] As a result, these taxpayers "[send] millions of hard-earned dollars, *which they don't really owe*, to the federal government."[149] In fact, most taxpayers opt to save an hour or two by filing a shorter tax form, rather than filing the longer form and taking the home mortgage interest deduction to which they are entitled.[150] The inefficiency represented by these forgone deductions increases the cost of compliance.

As already mentioned, a tax system is efficient when it promotes economic growth and inefficient when it inhibits such growth. Economist Arthur Laffer explains:

> [I]ndividuals and businesses change their behavior in response to tax policies. Individuals and businesses change the composition of their income, the location of their income, the timing of their income, and the volume of their income in order to minimize the

144. PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 3.

145. AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, *available at* http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx (last visited Oct. 1, 2012).

146. *See* MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE 11–12 (1999).

147. BOORTZ & LINDER, *supra* note 31, at 40.

148. PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 25. The standard deduction is a flat dollar amount set by law that is available to taxpayers to take as a deduction (reduction of income) based on filing status. It is available only to those taxpayers that do not itemize deductions.

149. BOORTZ & LINDER, *supra* note 31, at 41.

150. *Id.*

> effect of the tax codes on their own well-being. Individuals and businesses spend money hiring tax experts to discover ways to reduce the negative impact of taxes. While such actions are perfectly legal, they come with a cost to economic efficiency and growth.[151]

In fact, the inefficiencies may be so great that they discourage work and savings.[152] "When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy."[153] It would be difficult to put a number on the cost of inefficiency in our tax system because it is difficult to measure; it, however, could be the greatest compliance cost of all.

V. CONCLUSION

Americans' disconnect from the tax system results in complacency with its many flaws. No longer do taxpayers demand a system that raises sufficient revenue, is fair, easy to understand and administer, and has low compliance costs. Rather than seeking meaningful tax reform, as Americans once did in this country, taxpayers seem satisfied if the government raises taxes on the rich or on corporations, while lowering taxes on everyone else. Beyond this complacency, Americans are disconnected because they fail to perceive their true tax liabilities. Complexity in the Code, income tax withholding, and tax compliance costs create taxpayers who underestimate their tax burden.[154] In addition, nonpayers fail to contribute to government revenue, misperceive the cost of government, and increase transfer payments.[155]

This disconnect is exacerbating fiscal illusion. When taxpayers misperceive government revenues and are not aware of their true tax liabilities, the cost of government seems to be less expensive than it actually is. As a result, the public's appetite for government expenditures increases, thus providing politicians an incentive to expand the size of government. Evidence of this includes the skyrocketing debt and the more than $1 trillion budget deficit for 2009 through 2012.

In addition to taxpayer disconnect, the tax system itself is flawed. We are spending 6.1 billion hours and more than $431 billion per year on tax compliance.[156] The Code changes an average of once per day; it continues to grow in size and complexity.[157] Tax forms are getting more complicated to understand.

151. Laffer et al., *supra* note 118, at 7.
152. PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 36.
153. *Id.*
154. Laffer et al., *supra* note 118, at 12.
155. *See* Freeland et al., *supra* note 59, at 6.
156. *Id.* at 3.
157. NAT'L TAXPAYER ADVOC., *supra* note 108, at 4.

Unfortunately, all of this complexity still does not yield a tax system that supports the cost of government.[158] Taxpayers need a simplified tax system that is clear, fair, and contributes to economic growth. In short, taxpayers need comprehensive tax reform, not just rate reform, which could contribute to solving these problems and benefit all Americans.

158. Laffer et al., *supra* note 118, at 8.