GRAPHIC DETAIL

A Carnival of Taxation

Taxes are what we pay for civilized society.

—Oliver Wendell Holmes, Jr.

Au contraire.

—Robert Higgs

To determine whether a certain entity is a government, one might first ask: Does it have the power to tax? By this test, for example, the United States of America under the Articles of Confederation (1781–89) was not a government, because the confederation lacked the power to tax, whereas the United States of America under the Constitution (1789–) was a government, because it did possess that power. Critical minds might conjecture that getting the power to tax was, indeed, the principal point of the Framers' suffering through the hot summer of 1787 with the windows closed.

That certain people have the *power* to tax means, of course, that they will hurt you if you refuse to pay. The rebellious farmers of western Pennsylvania learned that lesson the hard way when they wilted under the weight of the armed forces mobilized by President George Washington in 1794. And a multitude of others accepted a similar "offer they couldn't refuse" during the ensuing two centuries. American governments may be lax in many ways, but tax collection is not one of them. In 1993 the Internal Revenue Service alone had 3,621 employees authorized to carry firearms and make arrests (*Statistical Abstract of the United States: 1997*, p. 214). In 1995 the federal courts alone convicted 866 persons of violating tax laws and sentenced 304 of them to prison terms (p. 217). State and local governments also work energetically to instruct their subjects in the causal relationship between paying taxes and remaining at liberty. Unfortunately, the *Statistical Abstract* does not report the number of Americans living in fear of the tax authorities because of offenses real, imagined, or trumped up.

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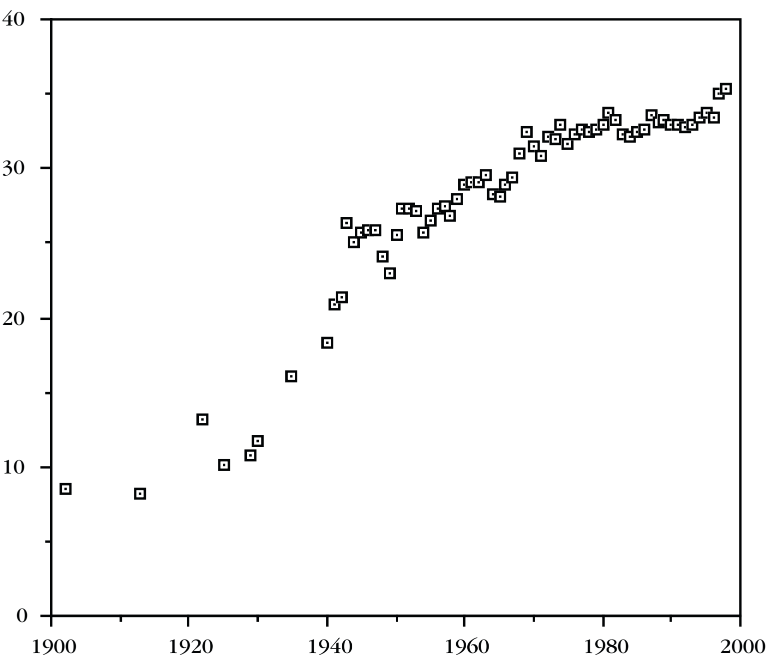
Without doubt, the classic relation of subject and government is the payment of tribute in exchange for protection. All too often, however, the protection received by the taxpayer is exclusively against the violence of the tax taker. A question naturally arises, therefore, as to what distinguishes the government from, say, the Mafia, but that question raises issues much too delicate to be resolved here.

In the past century, Americans have endured nearly continuous political rhetoric about tax cuts, and occasionally taxes have been cut. But taking the long view, one sees that the cuts were relatively trifling and transitory (see figure 1). In an era marked by the rapid growth of national product, taxes have tended to grow far faster. The tax share (including federal, state, and local taxes) of net national product rose from about 8 percent before World War I to more than 35 percent in 1998. As the figure shows, the twentieth-century rise of the tax share followed a logistic curve: the rate of growth was low prior to the 1930s, accelerated during the 1930s and 1940s, then decelerated during the second half of the century. Despite the deceleration, the tax share continued to rise during the postwar era, reaching an all-time high in 1998.

Before the election of Franklin D. Roosevelt, the tax revenues of the state and local governments dwarfed those of the federal government, and the local governments took by far the largest amount. The New Deal and World War II inverted that longstanding fiscal structure. By 1947, federal revenues were three times greater than

Figure 1: Taxes as Percent of Net National Product



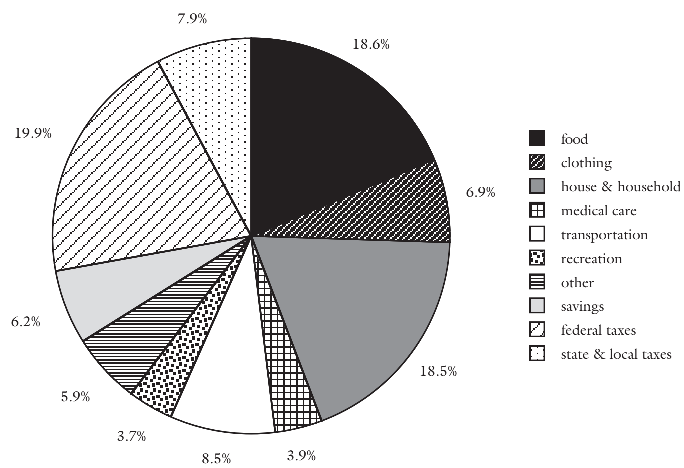
Source: The Tax Foundation (http://www.taxfoundation.org) state and local revenues combined. The feds have remained the big boys on the block ever since. As table 1 shows (see page 437), the federal government currently absorbs two dollars for every dollar taken by state and local governments.

The table also shows the yield of the major forms of tax. At the federal level, individual income taxes bring in the most, followed closely by payroll taxes. Corporate income taxes rank as a distant third, and miscellaneous excises and other taxes round out the total. At the state and local levels, sales and excise taxes yield the most. Property taxes are not far behind, individual income taxes come next, and various other exactions—none of them trivial—add nearly $200 billion to the total.

Table 2 displays snapshot data for 1957, 1977, and 1997, revealing several notable facts (see page 437). First, the median two-income family was already paying a substantial amount of taxes in 1957 (27.8 percent of its total income), but by the time Jimmy Carter took office as president, that family was surrendering a much larger share (36.5 percent) of its much larger income. Looked at another way, the family's nominal income had risen 224 percent, but its nominal tax burden had risen 340 percent. Even though the relative size of the typical tax bite rose much less between 1977 and 1997, the median two-income family continued to lose out to the tax takers, who in the latter year snatched 37.6 percent of the family's income. Figures 2 and 3 show how taxes compared with other major categories of the family budget in 1957 and 1997.

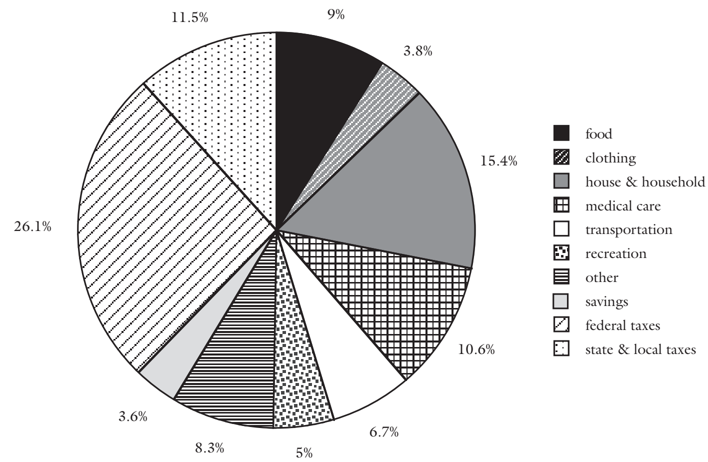
In real dollars, the annual tax burden of the median two-income family increased between 1957 and 1997 by $13,888, or 68 percent, notwithstanding the end of the hugely expensive Cold War. In view of the deterioration of the public schools, the steep increase of crime rates, the crumbling of the public infrastructure, and other

Figure 2: Budget of Median Income Family, 1957



Source: The Tax Foundation (http://www.taxfoundation.org)

Figure 3: Budget of Median Income Family, 1997



Source: The Tax Foundation (http://www.taxfoundation.org)

adverse developments during those four decades, the typical family understandably might ask: What are we getting in exchange for our swollen taxes? However, just as sausage eaters are well advised never to visit a sausage factory, so citizens will surely be more content if they remain largely ignorant of how their governments are disposing of the loot.

Europeans, of course, are not inclined to shed tears for Americans where taxes are concerned. As a rule, European governments take a much larger share of national income than U.S. governments do (see table 3, page 438). Most Europeans also pay a greater amount of tax per capita than Americans do. (Note, however, that the dollar figures in the table are sensitive to the exchange rates used to convert local currency units. Japan, for example, has much lower taxes today, measured in U.S. dollars, than it had in 1994, because of the depreciation of the yen relative to the dollar during the past several years.) Contemplating the extraordinary tax burden borne by the Danes, an American taxpayer might wax Shakespearean, concluding that without a doubt, something is rotten in Denmark.

Still, who can dispute that the governments of the United States constitute the most voracious tax system in the history of mankind? For 1998, according to forecasts by the Tax Foundation, U.S. taxes will total $2,667 billion—almost $10,000 each for the 270 million men, women, and children resident in the country. No other nation-state rakes in an amount even close to the U.S. total. The American revolutionaries, whose tax burden was almost vanishingly small, complained loudly of taxation without representation. If only they could have foreseen the burden of taxation *with* representation.

ROBERT HIGGS

Table 1: Taxes by Type and Level of Government, 1998
(in billions of dollars)

	Federal	State & Local	Total
Individual Income Taxes	792.6	169.2	961.8
Social Insurance Taxes	682.2	91.2	773.4
Sales & Excise Taxes	83.0	272.8	355.8
Property Taxes	0	221.3	221.3
Corporate Income Taxes	226.4	40.3	266.7
Other Business Taxes	0	41.5	41.5
All Other Taxes	21.8	24.9	46.7
Total	1,806.0	861.2	2,667.2

Source: The Tax Foundation (http://www.taxfoundation.org)

Table 2: Tax Facts for the Median Two-Income Family

	1957	1977	1997
Median Family Income	$5,776	$18,704	$54,910
Federal Income Tax	$511	$2,102	$4,942
Payroll Tax			
Employee Portion	$95	$965	$4,033
Employer Portion	$95	$965	$4,033
Total Federal Taxes	$1,167	$4,975	$15,408
State & Local Taxes	$464	$2,205	$6,761
Total Taxes	$1,630	$7,180	$22,169
After-tax Income	$4,240	$12,489	$36,774
Taxes as Percentage of Total Income	27.8%	36.5%	37.6%
Inflation-adjusted Total Taxes (1997$)	$8,281	$17,050	$22,169

Source: The Tax Foundation (http://www.taxfoundation.org)

Note: The burden of federal and state corporate income taxes is included. After-tax income does not deduct employer share of payroll taxes because the burden of the payroll tax is assumed to reduce income before the "gross" seen on paychecks. Total taxes as a percentage of income is calculated by adding the employer's share of the payroll tax to the median family income.

Table 3: Tax Revenues in 28 Countries, 1994

Country	Total Taxes (billions $)	Taxes per Capita ($)	Tax Revenue as Percent of GDP
Australia	100	5,589	29.9
Austria	85	10,569	42.8
Belgium	106	10,500	46.6
Canada	201	6,858	36.1
Czech Republic	17	1,648	47.3
Denmark	75	14,460	51.6
Finland	46	9,051	47.3
France	586	10,129	44.1
Germany	803	12,197	39.3
Greece	33	3,169	42.5
Hungary	17	1,648	41.0
Iceland	2	7,191	30.9
Ireland	19	5,451	37.5
Italy	424	7,416	41.7
Japan	1,304	10,434	27.8
Luxembourg	6	16,271	45.0
Mexico	71	764	18.8
Netherlands	154	9,983	45.9
New Zealand	19	5,434	37.0
Norway	51	11,706	41.2
Poland	40	1,040	43.2
Portugal	29	2,902	33.0
Spain	173	4,410	35.8
Sweden	101	11,481	51.0
Switzerland	87	12,464	33.9
Turkey	29	480	22.2
United Kingdom	348	5,968	34.1
United States	1,885	7,234	27.6

Source: U.S. Bureau of the Census, *Statistical Abstract of the United States: 1997* (117th ed.). Washington, D.C.: U.S. Government Printing Office, 1997, p. 844.

Tax Reform

MILTON FRIEDMAN

Two principles are basic to every discussion of tax reform.

First, tax reform consists of more than changes in those items that are called taxes. The real cost of government—the total tax burden—equals what government spends plus the cost to the public of complying with government mandates and regulations and of calculating, paying, and taking measures to avoid taxes. Currently, this burden, at federal, state, and local levels combined, exceeds half of national income: 40 percent in direct spending and more than 10 percent in indirect costs. Anything that reduces that real cost—lower government spending, elimination of costly regulations on individuals or businesses, simplification of explicit taxes—is a tax reform.

Second, essentially every tax affects incentives by altering the rate of exchange between various activities—between work in the market and at home (e.g., painting your house yourself or hiring a painter), between work and leisure, between one vocation and another, between buying a product or service from one seller or another, and so on in infinite variety. In short, there is no such thing as a neutral tax. But the lower the tax rate, the broader the base, and the more equal the tax rates, the less distortion it introduces. On these grounds, our present corporate and individual income taxes must surely rate as among the most misshapen monstrosities that ingenious tax-gathers have ever created.

Discussion of fundamental tax reform has recently centered on two proposals: House Majority Leader Dick Armey's flat-rate income tax and House Ways and Means Chairman Bill Archer's flat-rate retail sales tax. Both would greatly simplify the tax system and reduce the cost of tax compliance to taxpayers and of tax collection to the government. Both would eliminate double taxation from the corporate tax and the individual tax, reduce the bias against saving, eliminate the marriage tax, level the playing field for income from diverse sources, and reduce the disincentive of high marginal rates to innovation and enterprise.

Though each has advantages and disadvantages, the differences between the two are trivial compared with the superiority of either to our present system. Unfortunately, neither has a chance of being enacted by Congress, because their greatest economic merit is a political demerit. Neither performs one major function of the present tax system: enabling legislators (and presidents) to raise campaign funds by inserting or removing loopholes in our present obscenely complicated code.

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Accordingly, it is worth considering less radical, more incremental reforms. Of the many such, two seem to me to deserve special attention.

• *End real bracket creep.* "Bracket creep" became a household term in the 1970s, when galloping inflation was pushing people into higher income-tax brackets. Such inflation-induced bracket creep was eliminated in 1981, when income-tax brackets were indexed for inflation. However, bracket creep remains in a different form as a result of rising real income. Since President Clinton moved into the White House, federal tax receipts have risen by 42 percent, though national income has risen by only 30 percent, thanks partly to the Clinton tax increase in 1993 but mostly to real bracket creep.

A solution: Index tax brackets to the rise in per capita nominal (i.e., dollar) income, and not merely to the rise in prices. One further step would complete the 1981 reform: Index for inflation (a) the base for capital gains and (b) interest payments and receipts.

• *Privatize Social Security.* The payroll tax is arguably the worst of our bad taxes. It should be eliminated as part of the privatization of Social Security. Contrary to much talk, there is no rational obstacle to immediate and complete privatization of Social Security. The impression to the contrary arises from the need to convert what is now an unfunded liability into a funded liability. But that accounting change does not alter the real government debt, which is a multiple of the figures conventionally cited.

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