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On Power and the Use of Coercion

The Income Tax: A Century Is Enough

by Chris Edwards

Alexander Hamilton won in the end. As Treasury Secretary in the 1790s he championed an array of "internal" taxes to supplement federal revenues from import tariffs. Thomas Jefferson despised Hamilton's internal taxes as an assault on liberty, and when elected in 1800 he made sure that they were abolished.

The Jeffersonian view held sway for decades, but by the late 19th century the growth in government and concerns about high tariffs led to calls for new revenue sources. The first income tax was imposed to fund the Civil War and lasted until 1872. Another income tax was imposed in 1894, but it was struck down by the Supreme Court as unconstitutional.

At the turn of the 20th century, the rise of Progressivism and the Democrat opposition to high tariffs generated support for an income tax. President William Howard Taft proposed a Constitutional Amendment for an income tax in 1909. It was passed by the House and Senate, and then ratified by the states in early 1913. Congress got to work on legislation, and the modern income tax was signed into law by President Woodrow Wilson exactly 100 years ago today, October 3, 1913.

That's when the problems started. The 16th Amendment allowed for "taxes on incomes, from whatever source derived," but it did not define how "income" should be measured. It turned out that defining "income" is a tricky matter, and liberal and conservative economists and policymakers have never agreed on how to do it. The many economic interest groups affected by the tax have different views as well. The result of all the disagreement is that we've had a constantly changing and increasingly complex tax code.

The number of pages of federal tax rules soared from 400 in 1913 to 73,954 today, according to CCH Inc. Unlike a product in the marketplace that improves over time — like the century-old automobile — the government's income tax has become ever more inefficient and damaging. After 100 years, it is a bigger challenge than ever to create a simple, pro-growth structure for federal taxation.

The key problem is that liberals have favored an expansive definition of income

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The Income Tax: A Century Is Enough by Chris Edwards (continued from page 1)

that is anti-growth and punishing to savers and investors. The liberal "Haig-Simons" income has been the starting point for our income tax, and it includes all labor income, capital income, and even various non-cash items such as the implicit rent from owning a home. It also includes the accrued value of all capital gains, whether the gains are realized or not.

That is a very impractical base for taxation. Taxpayers with little cash-flow, for example, cannot afford to pay an annual capital gains tax on their accrued, but not realized, gains. As a result of such impracticalities, policymakers have adopted a plethora of ad hoc rules to fix the Haig-Simons income tax base, which further increases complexity.

Another problem with the Haig-Simons income tax is that it penalizes frugal people and rewards the spendthrift. That's because earnings are taxed a second time when saved, but immediate consumption does not face a further tax. This makes no sense because savers are the chief benefactors of economic growth because their money flows to the nation's new and expanding businesses.

Fiscal conservatives have fought back over the decades with an alternative view of the proper federal tax base. In the early years of the income tax, economist Irving Fisher argued that "income" is best measured by the flow of services consumed from existing capital. Thus it should not include changes in the value of capital (capital gains) nor additions to capital (savings). Fisher argued that Haig-Simons income erroneously mixed current income with additions to capital, creating a complex and distorted mess of the tax code.

Fisher was right. In recent decades conservatives and libertarians have championed consumption-based taxation, which is basically the tax structure that Fisher envisioned. The Steve Forbes and Dick Armey flat taxes, for example, have consumption bases. Under such a base, savings and investment would not be double-taxed, and thus economic growth would be maximized.

Perhaps the greatest recent champion of tax reform was former Princeton economist David Bradford. He made powerful arguments that consumption-based taxation would be much simpler than the current income tax. Some of the most complex parts of the income tax, such as capital gains and depreciation rules, would disappear under the flat tax. Consumption taxes have more coherent tax bases than income taxes, and thus would not require all the ad hoc rules.

We haven't succeeded in

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Gasoline Taxes: Funding Roads or Pork?

by Jonathan Williams

According to the American Petroleum Institute, federal, state, and local taxes average 48.8 cents per gallon of unleaded gasoline and 54.4 cents per gallon of diesel. As drivers face that burden each time they fill up at the pump, it is necessary for lawmakers to show that these funds are being used prudently.

For the past 100 years, American motorists have been enamored with better roadways, and the benefits of increased personal mobility cannot be overstated. Gasoline taxes provided the vast majority of funding required to bring the United States into the automobile age and to build the interstate highway system. For generations, Americans thought of gasoline taxes as the price of mobility in America; however, with increasing mismanagement of gasoline tax funds at the state and federal level, drivers no longer see the connection between gasoline taxes at the pump and spending to build and maintain transportation infrastructure.

Gasoline taxes in America were levied upon the premise that they would serve as a user fee for roads. If the benefit principle is to work, governments must ensure gasoline tax dollars are spent to build and maintain roads for the benefit of users who pay the gasoline tax.

Unfortunately, gasoline taxes have unquestionably departed from their historical justification, rooted in the benefit principle of taxation. The Council's Task Force on Tax and Fiscal Policy adopted model language to correct this problem (see "A Constitutional Amendment Restricting the Use of Vehicle Fees and Taxes for Highway Purposes"). According to previous research, at least 20 states divert gasoline-tax revenue to fund numerous general fund projects. In addition, state gasoline-tax revenue, which could have been used for road construction and maintenance, has been instead used for the following:

- Administration of mobile home titling,
- Aid to public schools,
- Improvement of recreational snowmobiling,
- Eradication of the fruit fly and other emergencies,
- Recreational boating activities, freshwater fisheries management and research,
- Boating and boating facilities, seafood and salt water sports fishing, and
- Conservation activities to prevent or reduce soil, wildlife, and habitat loss.

The recent acceleration away from the benefit principle is detrimental to sound tax policy, quality public roads, and the overall integrity of government "trust funds." If benefit-principle taxation is to survive as the foremost source of road funding, lawmakers must insist on more oversight to ensure revenue from gasoline tax user fees do not support bridges to nowhere or attempts to eradicate the fruit fly. Instead, these user fees should be used to build the roads of the 21st century and to provide a fair and equitable transportation system for all American motorists. For additional information, please see "Paying at the Pump: Gasoline Taxes in America" at www.taxfoundation.org.

Jonathan Williams is Director of the American Legislative Exchange Council's Task Force on Tax and Fiscal Policy as well as the Center for State Fiscal Reform.

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The Obamacare Train Wreck

by Richard A. Epstein

It is now common knowledge that the bugs in the Obamacare website have been embedded in the system from the start. For the past two weeks, not only have many individuals found it impossible to access the website, but they are often frozen in place once they pass through the initial portal. The problems will just get worse. The current law requires extensive communications between enrollees and their chosen insurance carriers, as well as massive interaction with both federal and state organizations. As a result, web traffic builds up behind bottlenecks and leads to massive frustration. As I warned last May, watching Obamacare unravel is a painful business.

The Bright Side of Bad News

Health and Human Services Secretary Kathleen Sebelius has tried to put a positive gloss on the messy situation with the dubious observation that the system glitches are due to heavy consumer demand. Her statement subtly implies that the nation's alleged need for the program is the cause of its momentary glitches. She claims that things are "getting better by the day." Not so. The government site was not built for heavy traffic, nor was it tested before going live. It is no mean feat to try to fix a balky computer system on the fly.

As a result of these problems, calls to delay the implementation of the individual mandate are now reaching a fever pitch, such as Peggy Noonan's to delay the individual mandate a year. The bugs need to be worked out before ordinary people are slapped with fines for failing to enroll in the derelict system before the penalty deadline now set for March 31, 2014.

Thus far, the Obama Administration has been mum on the sources and extent of the difficulties. But make no mistake about it: they reflect the broader structural weaknesses of the program, which were hidden from view by the disastrous launch. Nonetheless, the system's basic design is flawed, and its gaffes will become only more apparent as implementation moves forward.

Republicans are howling to repeal and defund Obamacare. As a policy matter, that is surely the correct move. But as a political matter, the prompt repeal of Obamacare is just not going to happen over the uncompromising opposition of a Democrat President and a Democrat Senate. So, if the first-best solution is not possible, more modest fixes for Obamacare are in order until Republicans start winning elections. Here are three areas of the law to change: the employer mandate for employees who work 30 hours-per-week; the coverage rules; and the medical loss ratio.

Part-Time Employment

As of January 1, 2014, Obamacare's employer mandate kicks in with respect to employees who work thirty or more hours per week for a single employer. Just finding out who falls on which side of that line is no easy task. Much employment is seasonal, which could make it difficult to classify individual employees on one side of the line or the other without a close examination of their working history, which then has to be updated on a periodic basis.

But the larger difficulty is structural. As Andrew Puzder recently argued in *The Wall Street Journal*, the closer we come to implementation of the employer mandate, the stronger the pressure becomes for employers to hire part-timers who unambiguously work less than 30 hours per week. It will not happen in all cases. But in some significant fraction of cases it will be cheaper for a firm to hire more workers on a part-time base than fewer workers on a full time basis.

Alternatively, some employers will find it more efficient to hire fewer high-skilled workers with overtime payments in order to minimize the mandate's burden. Both of these Obamacare-driven strategies are inefficient because neither would be adopted in a tax-free world, with higher optimal output.

The administration wanted to keep the hours exemption low in order to reduce the number of employers who would avoid the mandate. What they did instead was to put the cart before the horse. In the effort to force-feed the healthcare market, they managed to cast a major pall over a struggling labor market. It is far better to expand labor markets in ways that create more wealth instead of restricting them for the sake of a botched employer mandate.

Obamacare's Coverage Rules

A second major problem with Obamacare is how it sets healthcare rates in individual markets. The administration's insistence that these be called "exchanges" or "markets" belies their coercive and confused nature. An open exchange is one that allows companies that meet certain minimum standards of probity and financial responsibility to sell their goods or services on terms and conditions that they choose to offer: think eBay. But none of that is tolerated on the Obamacare exchanges, as all parties are rigorously scripted to the kinds of services they can offer and the prices that they can charge.

In this case, the first problem is that the set of minimum benefits under the various plans is defined so generously that people will have to pay for services that they would never chose to acquire in a voluntary market. The clear implication is that the higher coverage generates social losses, not social gains. The inclusion of exotic items (e.g. habilitative care) not only raises the price of access, but it also makes it harder to get sensible benchmark pricing in what was, until the advent of the ACA, a non-existent market. Cutting back on these benefits should go a long way to controlling some of the price issues that have surfaced with the initial quotes, and bring healthcare costs into greater alignment.

Under the current system, too many people make a beeline for coverage in the hopes of receiving huge subsidies — subsidies large enough to lure them away from private plans for which they pay market rates. That migration undermines private insurance companies that currently serve these people. It also requires cross-subsidies from healthier individuals to pick up the slack built into the system. The required revenues will not come from direct government payments, but only from other plan participants, namely younger enrollees now forced to pay above-market rates to supply the subsidy — if they chose to participate, which they often won't.

This form of community rating has pronounced effects. Under the ACA, the maximum allowable rate differential is three-fold between a young person and a senior, but the market differential is about five-fold. Under those circumstances, the young person is likely to resist even movie-star exhortations to enroll in a plan that offers a net negative.

That tendency will increase because of the generous accommodations Obamacare makes for applicants with preexisting conditions. Most insurance plans design their enrollment and premium strategies to combat the constant risk of adverse selection. People have private information about their healthcare status, and thus are more likely to purchase healthcare at standard group rates when aware of their own precarious healthcare position.

Most traditional plans use various devices to control the risk of adverse selection. These include an individual disclosure, which allows firms to raise prices or exclude customers. With group plans, it is commonplace to require a minimum level of employee participation to prevent individual opportunism. But Obamacare goes in the exact opposite direction and requires insurers to enroll parties who know of their increased risk.

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The Obamacare Train Wreck by Richard Epstein (continued from page 5)

There is today a huge public ground swell that insists that no one should be excluded from healthcare on the grounds of their preexisting conditions. Nothing in the short run can stop that dynamic. But it is at least possible to slow down its effects. Thus, if open enrollment is allowed at any time, at least require all persons who enroll to remain in the plan for a year so that the insurer can earn back some of the money that it loses thanks to these strategic enrollments.

There is a limit to the size and quantity of subsidies that can be required. Pushing the balance back may well make access to the exchanges a more attractive proposition for those who right now are likely to stay out. Even if some community rating system is sacrosanct, its size is not. Tapering down on the program is a sensible mid-level strategy. The blunt truth is that the Republicans have to win elections in order to force a fundamental overhaul.

The Medical Loss Ratio

As currently constituted, the ACA imposes extensive restrictions on the way in which insurance companies spend their premium dollars. In an ordinary business environment, the savvy firm is always making trade-offs at the margin between its medical and administrative expenses. Finding the right combination lets firms compete effectively in the marketplace. There is, moreover, no single ratio that works for all firms: much depends on the composition of its insured, the nature of its specialization, the local regulatory environment, and many other factors.

The medical loss ratio pays scant attention to these differences and limits the amount of "administrative expenses" that can be spent to 20 percent of individual plans and 15 percent of small group plans. Since 2012, firms that do not meet their respective targets have been required to issue rebates to their customers.

This boneheaded system is yet another example of how Obamacare forces private insurance companies to incur costly administrative expenses in order to deliver inferior services to their customers. This system is based on the peculiar belief that government agencies know, in the abstract, which expenses count as administrative, and how much they can be. It also assumes that governments should force firms into predetermined paths even though businesses, facing competitive pressures, have a far better grasp of how their cost structures should operate. These requirements are a back-handed form of price regulation, which should and could be eliminated right now without gutting the core of Obamacare.

Getting from Here to There

Repealing Obamacare should be a high priority for the Republicans if they can win national elections. But they can only get there if they play the short-term game well. The usual three imperatives for healthcare are to ensure access and quality while controlling price. I know of no top-down administrative system that can begin to reach those three goals. The efforts to force access and mandate quality are not only counterproductive, but they will also drive up prices in ways that undermine both access and quality.

The only viable counterstrategy treats deregulation as the first line of attack on the inefficiencies of the current system. Reduce costs and avoid regulatory nightmares, and access to care will rise as rates decline and quality of care improves. Once this is done, targeting subsidies at certain individuals to allow them to purchase healthcare plans that the market offers, such as the Healthy Indiana plan, without taking over management of the system, will result in greater access without compromising quality.

Playing hardball is a losing strategy. The Republicans will never get their turn unless they use today's computer glitches and enrollment delays as a platform on which to propose modest market-enhancing reforms. This might give the public the confidence in the GOP's ability to work on more substantial reforms down the road.

Richard A. Epstein is the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution. He researches and writes on a broad range of constitutional, economic, historical, and philosophical subjects.

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Remembering Senator Rod Grams by John Hendrickson

In October former Minnesota Senator Rod Grams lost his battle with cancer. Senator Grams served as a journalist and a small business owner before being elected to the United States House of Representatives. Grams won election to the Senate in the historic midterm elections of 1994 — famous for Newt Gingrich's Contract With America — which resulted in the Republican Party capturing control of Congress and bringing a more conservative direction to public policy.

Rod Grams was unique because he ran as a conservative and won in Minnesota, which is a progressive/liberal state. Grams believed in limited government and free enterprise. He was pro-life and defended traditional values. Grams correctly saw the dangers of too much government regulation on businesses and the problem of high taxation. He stood for constitutional limited government. One of his major legislative achievements was the $500 per-child tax credit.

Senator Grams understood that if the federal government followed a fiscal policy of low taxation and limited regulation it would lead to economic growth. He also was a champion for limited government by supporting reductions in government spending. Senator Grams understood the need to preserve entitlement programs such as Social Security, but also the reality that these programs needed to be reformed for younger generations. Therefore, he proposed "individual investment accounts as a part of Social Security."[1] In regard to national defense he stood for a strong American defense, while protecting national interests. Grams also served as a Congressional delegate to the United Nations.

During his term Grams established "one of the most conservative voting records," which is interesting in comparison to Minnesota's other Senator, Paul Wellstone, who was the leading champion of progressivism in the Senate.[2] During the 2000 election Senator Grams stood for reelection, but was defeated by Mark Dayton, who currently serves as Minnesota's Governor.

Grams continued his public service after his time in the Senate by continuing to fight for conservative principles and candidates. In 2006 he ran against Representative James Oberstar in the 8th Congressional District, and although he lost that election he was part of the historic Republican victory of Chip Cravaack, who defeated Oberstar in the 2010 election. Grams served as Representative Cravaack's Chief of Staff to help him with the transition.

Senator Rod Grams will be remembered for his record of service, kindness, and for being a champion of conservative policies and values. As for myself, in 1994 Senator Grams' campaign introduced me to politics and to the virtue of conservative principles. I will never forget Rod Grams and I wish we could have his leadership in the Senate today to help solve the great fiscal crisis that will determine the future of our republic.

Endnotes:

[1]Michael Barone and Grant Ujifus, *The Almanac of American Politics: 2000*, National Journal, Washington, D.C., 1999, p. 870.

[2]Ibid., p. 869

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The Income Tax:
A Century Is Enough

by Chris Edwards
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scrapping the income tax yet, but fiscal conservatives have moved the system more toward a consumption base. Provisions such as 401(k)s and Individual Retirement Accounts, for example, help to reduce the punitive treatment of savings under the income tax.

But much more needs to be done. Thomas Jefferson noted of internal taxes that they "covered our land with officers and opened our doors to their intrusions." That's certainly true of the income tax. Indeed, Jefferson would be horrified by the power of today's IRS to break down our doors and seize our property, and he surely would have led a revolt on seeing the powers added to the IRS under Obamacare.

The Jeffersonian goal of abolishing internal taxes seems distant, but we can make the federal tax system much simpler, more efficient, and respectful of limited government. After a century, it's time to scrap the income tax and replace it with a consumption-based flat tax.

Chris Edwards is Director of Tax Policy Studies at the Cato Institute. He is also editor of www.DownsizingGovernment.org. This article appeared in the Daily Caller *on October 3, 2013, and is reprinted with permission from the Cato Institute.*

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