



## A Missed Opportunity?

### Fixing the Debt Crisis Could Have Begun a Major Rework of Our Badly Broken Tax System

By: Jeffrey Ferguson

Our economy is sick; and, it has been sick for quite some time now. For weeks this summer we heard on almost a daily basis from the President, the Speaker, the Majority Leader of the Senate and assorted others how this debt ceiling had to be addressed. For the Democrats, it mostly meant raising the debt ceiling. For Republicans, it meant cutting spending. The Democrats and the President told us that we faced armageddon if we didn't raise the ceiling. They reiterated *ad nauseum* that the rich don't pay enough in the way of taxes and through them lies the solution to the problem. The Republicans said that without meaningful spending cuts they would not support any measure put forward. They also knew that they fell prey in the past to promised spending cuts (3 dollars in spending reductions for every dollar tax increase) during the Reagan years that never happened. Name-calling, threats, scare tactics and bullying were part of the daily events which largely did nothing but disgust the public with both sides of the aisle. Anyway, we kind of got a deal done which gets us past current issues on spending and the debt ceiling. But, it is only a short-term fix, not one that can last for long.

While the President and his acolytes issued daily diatribes emphasizing class warfare, the Republicans might have missed a wonderful opportunity to discuss the ills of the current tax system and move us on a path to fixing what even **The Economist** has termed "its absurdly complicated tax system".<sup>[1]</sup> We have a federal tax system where approximately 47% of all tax filers pay no income tax. At first

glance, you believe that it is only the bottom tier who pay no taxes and the burden has shifted to the middle and upper income earners who then pay the majority of the taxes. True, the upper five per cent pay the largest amount of taxes (about 60% of the total according to the National Taxpayers Union), but there are a number in each tax quintile who pay nothing in federal income taxes. As cited by Bruce Bartlett in a recent **New York Times** article, those who earned below \$16,812 paid no taxes by statute. But, about 3/5's of those in the middle quintile and 7.3% in the fourth quintile also paid no federal income taxes. On top of this, we had 78,000 filers who had incomes between \$211k and \$533k who paid no federal taxes; and, 24,000 households with incomes between \$533k and \$2.2m and no tax liability. There were even 3,000 tax filers who had income above \$2.2m who paid no federal taxes.<sup>[2]</sup> The middle and upper income non-payers occurred because of tax credits instituted and codified by Congress as well as income derived from either capital gains and/or tax-free municipal bonds. In essence, we have designed a tax system with leakage legally built into it. You could be kind and say that this is an unintended consequence of Congress' perpetual tinkering with the system. Or, you could own up to the issues of nonpayment at the middle and upper ends and fix the situation.

On top of the legal leakage from the tax system, we have the growth of the underground economy. Our underground economy which includes both legal and illegal

activities has been estimated to be as high as 13% of GDP.[3] This means that our underground economy i.e. the cash-and-carry part of the economy, could be as much as \$1.8 trillion. None of this money today is captured by our tax system.

Polls and shared focus groups tell us the public recognizes that we have a spending problem at the federal level. This has gotten us into a place where both our standing and esteem in the world as well as the credit worthiness of the U.S. are being called into question. Beyond our spending problem, we also have a revenue problem that needs fixing. This relates to the fact that our tax system emphasizes the wrong things. We tax salaries and wages, savings and investments. We don't tax consumption. We have a government that spends untold hours enforcing the tax system to gain compliance when we could implement a simpler, easier to understand and police system where we impose a national tax on all consumption. If we say that the underground economy is "only" a trillion dollars annually, a 1% sales tax on all purchases would bring an additional \$10 billion into the system, money that is outside of the system today. If we believe that this is unduly harsh on the bottom quintile and perhaps the second quintile, we could have a tax credit for them granted at the time of annual filing; or, we could exempt food purchases from the consumption tax. As far as the wealthy are concerned, they are the ones who spend more. A national consumption tax would capture their spending so that no one escapes without paying something in taxes. For those who don't think this is progressive enough, who spends more

money, the rich or the poor? Who buys luxury items and takes more trips? Who buys more "stuff" and purchases more services? Those who spend more would be contributing more tax dollars to the system.

When we implement this 1% consumption tax, we should couple this with a reduction in the tax rates of our current system so that this is not an extra tax, but a more logical way to collect revenue. As several Presidential candidates have said, the time is ripe for reducing and simplifying our tax rates and collections. My guess is that this small tax on consumption would generate much more revenue while reducing the cost of compliance. If done well, it would serve as the basis for moving our entire tax system over to taxing consumption and fully eliminating the complicated and hardly intelligible system we currently have.

Polls and studies have shown that the greater majority of the people believe that everyone should pay something in taxes, even if it is a token amount. The Republicans in Congress have had a great opportunity to refute the class warfare talk and begin a discussion of how we can fundamentally bring more revenue into the government by having everyone participate in paying taxes while lowering rates. This is an opportunity that they need to seize. This is a much more "fair and balanced" approach, one that people could actually feel good about.

*Dr. Jeffrey Ferguson is Exec. Vice-President of the Harbour League. He can be reached at [jwfergus5@aol.com](mailto:jwfergus5@aol.com).*

---

[1] *Turning Japanese. The Economist*, July 31, 2011. P. 9

[2] Bartlett, Bruce. *Who Doesn't Pay Federal Income Taxes(Legally)*. **The New York Times**. June 28,2011

[3] Rahn, Richard W. *New Underground Economy*. **The Washington Times**. December 9, 2009