

# Inside the Federal Hurting Machine

by James L. Payne

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If politicians give someone \$1,000, press reports emphasize the wonder of the gift and explain how it has eased suffering and restored hope. But when politicians take away \$1,000 in taxes — even from the same person! — it is a nonevent. The prevailing assumption is that when government is handing out money, its subsidies and payments are desperately needed, and serve a vital national purpose. When government is taking in money, even from the same people it has just subsidized, the cash being collected is seen as limp and lifeless, a surplus wealth of taxpayers who have no good use for it.

The underlying cause of this remarkable lapse in reasoning is the popular urge for wishful thinking. With the exception of a few crusty reactionaries, people want to believe in government. They want to see it as a source of hope and help, an agency that can

give them college educations, art museums, pensions, and free medical care more or less out of thin air. To remind them that they will be forced to pay every single penny these things cost, and much, more, is a cruel party pooper. So when it comes time to examine the injuries of taxation, people stick cotton in their ears and turn the TV to full volume.

But no government spending program can be justified unless its benefits exceed the costs of taxing people to pay for it. Policy makers who approve spending programs without knowing about the costs of taxation behave irrationally and may well be doing enormous harm to the country.

## Compliance costs

To begin our exploration, we need to distinguish between two types of costs: the cost of taxes, and the cost of the tax system. The taxes are the monies taken from the public, to be spent by government. While politicians make great efforts to hide, distort, or forget about this figure, at least it is known and documented. Anyone can look it up in a standard reference book. For

this reason, we shall not dwell upon it here.

The burdens of the tax system, on the other hand, are almost entirely unnoticed and unreported. These are the direct and indirect costs of operating the system that forces people to pay taxes. After all, the money that government collects and spends does not fly into the Treasury on wings of its own. Citizens have to be prodded, and all this prodding, and dealing with the prodding, costs the American people more dearly than anyone has realized.

One of the main burdens of the tax system is the compliance cost: the time and energy people spend keeping records, studying tax instructions, making calculations, and filling out forms and schedules. The most complete study we have of this burden was carried out by the Arthur D. Little Company at the behest of the IRS itself (which had been forced to commission the study by the 1980 Paperwork Reduction Act). The Little study found that, in 1985, businesses and individuals were spending 5.4 *billion* hours on federal tax compliance activities. This corresponds to 2,900,000 people — the entire

work force of the state of Indiana — working *all year* long on federal tax compliance activities. The cost of this work amounts to 24% of all federal taxes collected.

This carefully documented figure (which is supported by several other academic studies) has been ignored in Washington. Instead of working to reduce the paperwork burden, tax administrators and Congressmen keep adding to it with a steady flow of laws and regulations. Economist Joel Slemrod found that in the 1980s, especially as a result of the 1986 tax act, tax compliance burdens for individuals increased 26%; the increase for businesses was undoubtedly even greater.

A number of scholars have tried to tell congressional tax managers they are sowing disaster. Economist Richard Vedder put it this way, to a Congressional committee in 1984: “If an enemy power bent on destroying our nation were somehow given the opportunity to devise our tax code with a goal of sapping the nation of its economic vitality . . . it could do little better than adopt our current Internal Revenue Code.” Law professor Richard Doernberg flatly declares, “The United States now has the most complex tax laws in the history of civilization.”

### **Forgone production costs**

The high cost of compliance is not the greatest burden of the tax system. An even larger drain is the economic disincentive cost. Ever since Adam Smith, scholars have known that taxation hurts the economy. It denies workers, entrepreneurs, and investors some of the fruits of their creative activity and therefore discourages their contributions. Recently, economists have begun making calculations about the size of the economic loss caused by the tax system. One estimate for the entire tax sys-

tem, by Charles L. Ballard of Michigan State and his colleagues, published in the *American Economic Review* in 1985, put the disincentive effect at 33.2%. That is, to raise an additional \$100 in taxes causes a loss of \$33.20 in lost production on top of the \$100 in taxes paid. Another study, reported in 1990 by Harvard economists Dale W. Jorgenson and Kun-Young Yun, put the disincentive cost for the tax system even higher, at 38.3% of tax revenues raised.

America saw a small illustration of how the disincentive effect operates when Congress put a tax on pleasure boats in 1990: A strong export industry was almost destroyed and thousands of workers lost their jobs. In 1993, Congress recognized its error and repealed the tax. Unfortunately, Congress hasn't gone further and recognized that all its taxes go on destroying jobs day after day. They add to the cost of doing business and therefore cause scores of thousands of businesses to fail and discourage scores of thousands of other possible businesses from ever being started.

### **Noncompliance costs**

Another burden of the tax system is enforcement — the cost of dealing with those who don't comply with the tax code. Taxation, we need to remind ourselves, is based on force and the threat of force. At first glance,

this makes it seem an efficient way of raising money. Generations of eager spenders have embraced it with just this hope in mind: the threat of force should make the money flow in automatically.

What they overlook is that human beings resent being forced to do things against their will. This contrary streak leads them to resist tax collectors. The result is that instead of a smooth hum of money pouring effortlessly into the Treasury, taxation turns into a costly, and often tragic, guerrilla war. To compel the population to conform to its demands, the government has to operate a burdensome enforcement program.

The reader might find it instructive to try to guess how many levies the IRS issues each year. A levy is an order directed to entities like banks and employers forcing them to send the taxpayer's money to the government—a routine IRS seizure of property without due process of law. For the individuals involved, a levy is a personal catastrophe. Funds have been seized, credit destroyed, financial plans and dreams wrecked, and businesses shuttered. How many of these devastating enforcement episodes are necessary to make the tax system work?

Raised in a culture of spending that fosters the illusion of government as a beneficent cornucopia, Americans suppose this

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number is trivially small. In fact, it is a national scandal. For 1992, the IRS reports issuing 3,253,000 levies. Because of double-counting and IRS clerical errors, this figure overstates the number of human beings affected; a correction for these distortions reduces this figure by half, to about 1.6 million people affected. This is still a sizeable chunk of humanity, more than the entire population of Nebraska.

This avalanche of levies constitutes only a small fraction of all enforcement actions. To keep the money flowing into the Treasury, the IRS also issues liens, which freeze taxpayer assets (1.5 million); sends out under-reporter notices, which allege taxpayer underpayment of taxes (3.8 million), and non-filing notices, which allege a taxpayer failure to file a tax return (1.5 million); conducts personal audits of taxpayers (1.0 million), and mail audits and service center corrections (0.5 million); and imposes some nine million filing and payment penalties. In addition, it pursues about 6,000 criminal prosecutions, trying to jail people for failing to adhere to the tax code.

Naturally, the human beings caught in these snares struggle, expending enormous time and energy trying to keep their funds and prove the IRS wrong. In the under-reporter program, for example (where over *half* of the IRS accusations turn out to be wrong), I have estimated that Americans spend 30 million hours yearly reacting to the worrisome brown envelopes: studying the notices, examining tax law, reviewing tax data, discussing their cases with friends and advisors, and composing letters of protest. The level of tax litigation — the audit appeals, court cases, and tax rulings — is running at 195,000 cases a year.

According to my calculations, the monetary cost to the American public of dealing with

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city or divorce. That the money is being raised in a good cause does not lessen the human pain. Consider the 1988 suicide of Alex Council. The victim of an erroneous IRS lien that ruined him financially, he shot himself and left a suicide note instructing his wife to use his insurance money to pursue the legal case against the IRS — which she eventually won.

### Tax avoidance and evasion costs

To function efficiently, a tax system needs citizen cooperation. Unfortunately, by relying on force, the tax system undermines its claim to taxpayer goodwill. Instead of happily cooperating with tax collectors, citizens scheme to confound them.

In the United States, high tax rates and the impossibly complex tax code have made tax evasion and avoidance a major industry. Unfortunately, it is a completely unproductive industry, feeding and housing no one. It is merely the wasteful struggling of human beings trying to avoid the exactions of government.

Some citizens avoid taxes by taking their economic activity underground. I estimate there are at least 2 million people with significant potential tax liabilities who are driven underground by the tax system (another 2 million have gone underground as a result of immigration and drug laws). In attempting to avoid taxation, they have reduced their own productivity and therefore that of the

need. To avoid estate taxes, millions of people hire lawyers to devise and administer estate tax shelters. Highly skilled legal professionals work week in and week out drawing up grantor retained income trusts, generation-skipping trusts, and so on. Another class of skilled professionals is busy exploiting the tax avoidance potential of foreign tax havens, while yet another group manages the massive paperwork that makes possible retirement tax shelters. All told, by my estimate, the nation wasted some \$19 billion in tax avoidance and evasion activities in 1985 — a figure that has probably about doubled since then.

### Adding up the costs

When all the burdens are added together, what is the monetary cost of the U.S. federal tax system? According to my calculations, in 1985, the burden was \$363 billion. In dynamic terms, the burden is *65% of the taxes collected*. This figure represents the only attempt anyone has made to estimate the cost of the tax system. Studies have been made of some of the sub-costs, but no one else has been prompted to add the numbers together to calculate a total cost.

The absence of other estimates is remarkable because, as we noted at the beginning, it is impossible to make rational decisions about government spending programs unless the costs of raising the money are factored in.

Economists should have noticed, for example, that their theories about the social benefit of government subsidies are meaningless unless tax system costs are known. It's like trying to calculate whether a plane can fly without knowing its weight.

One excuse that policy makers might give for not considering the costs of taxation is the assumption that these costs are fixed. In order to raise the first dollar of taxes, this argument would go, the entire \$363 billion burden noted above is incurred. Therefore additional tax dollars raised for additional spending programs entail no further costs. However, the costs in the tax system don't work this way. The majority of the costs not only increase with the tax rate, but they do so *exponentially*.

The disincentive cost, as it is calculated by economists, is tied to the square of the tax rate: *double* the money you try to raise and you *quadruple* the cost in lost production, people thrown out of work, and so on. Most of the costs associated with enforcement, evasion, and avoidance also go up exponentially with the tax rate. As more money is at stake, it pays taxpayers to work harder to keep tax collectors from getting it. Even compliance costs are variable. When taxes are raised to pay for more spending programs, tax avoidance goes up, which in turn prompts the tax authority to issue more regulations to prevent it. The result is a more complex tax system and higher compliance costs.

The overall picture, then, is that tax system costs increase along with the level of taxes. The 65% figure noted above is a marginal cost figure: if taxes are raised another \$100 million to pay for another spending program, an additional \$65 million cost will be imposed on the economy.

We return to our point: *why*

*have policy makers ignored these costs?* The answer appears to be the powerful social convention against weighing the *costs* of taxation. Legislators and their publics want to believe in government as a helping machine, and it spoils the illusion to be told that it is, at the same time, a hurting machine.

Consider how programs to create jobs are discussed in Washington. Common sense tells us that any government spending program designed to create jobs must also cause unemployment. After all, the taxes imposed to pay for it drain money away from investors who would have opened new businesses, and from consumers who would have employed workers through their purchases. When we add to this common sense analysis our knowledge of the costs of the tax system, it becomes clear that *a jobs-creation program could well destroy more jobs than it creates*. Therefore, anyone pro-

posing a jobs-creation program ought to give Congress two figures: the number of jobs the program hopes to create, and the number of jobs the taxation to pay for the program is expected to destroy.

This, of course, is never done, because telling the whole truth would make the project look foolish. Journalists would question the sanity of a President who proposed to create jobs by destroying them.

#### **Affordable health care?**

Take another issue: government provision of medical care. The responsible policy maker would have to point out that government is not a something-for-nothing machine. It cannot pay for health care unless it first takes money away from the citizens it wants to help. Furthermore, it can never return to them the full value of their contributions. The administrative overhead — the bureaucracy, the pa-

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perwork, the overcharging, the fraud, the disputes over benefits — are bound to consume a large fraction of resources devoted to the spending program, probably around half of the funds. In addition to this waste, there is the 65% cost of raising the money through the tax system.

Hence, the overall arithmetic for a government health care system would look something like this: To raise \$100 in taxes to fund the system costs an additional \$65, and then government administration and waste consume about half of that \$100, or \$50. So for an initial \$165 total burden, the citizen will get \$50 worth of medical care out of the system. This is the bedrock statistic that Washington's health care analysts should be telling the American people: A government health care system is going to cost the average person *three times as much as paying medical bills out of his own pocket.*

Alas, no one mentions any such figure. Legislators, eager to appear well-intentioned, ignore

the down side of their proposals. That makes as much sense as counting benefits but never costs. Less excuse can be found for the silence of the technical specialists, the thousands of experts working for Washington's alphabet soup of research agencies, the OMB, the GAO, the CBO, and so on. These professionals are paid huge sums of taxpayer money to find out about policies and inform the country about their true costs. Yet no one in any of these agencies has compiled any estimate of the overhead cost of tax-and-spend programs.

Ignoring the costs of taxation has gone on long enough. It's time to put aside our childish faith in government and take a frank, careful look at the human costs of its optimistic endeavors.

**What Does a \$1 Billion Federal Program Cost?**

The budgeted price tag: **\$1,000,000,000**

- Plus, additional tax system costs:
- Compliance (24.4%): **244,300,000**
- Forgone production (35%): **350,400,000**
- Enforcement (1.97%): **19,700,000**
- Avoidance/ evasion (2.9%) **29,600,000**
- IRS budget (0.61%) **6,100,000**

**True Total Cost to Fund a \$1 Billion Federal Program: \$1.65 Billion.**

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