INNOVATIONS IN TAX THINKING: APPLYING HISTORY AND CREATIVITY TO KANSAS TAX POLICY

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Throughout history there have been taxes. As Supreme Court Justice Oliver Wendell Holmes famously said in 1904, “Taxes are what we pay for civilized society.”¹ From the recorded writings of the earliest civilizations to the front page of today’s newspapers, taxes have been core to human existence. Governments require revenue. In the earliest civilizations governments raised revenue to fight wars and defend their citizens. Taxes were used to build roads, ports, and fortresses. As the world economy expanded, taxes were used to promote economic development, build factories, and encourage commerce. As social needs evolved over the last two decades, taxes have been used to provide for the poor and the needy, for education, and to improve the quality of life for a nation’s citizenry.

Regardless of the spending agenda, governments all need revenue. From the first civilizations to today’s modern government, the history of taxation has followed similar patterns and governments throughout history have faced similar challenges. What to tax? Should taxes be levied on property, income, or consumption? How to measure and determine the amount of tax to be paid? How

to administer and collect tax? Should tax be direct to the citizen or indirect and collected at the source? How to find a balance in the fairness of tax? And how to deal with the inevitable strategies citizens develop to avoid tax? Should citizens self-report their tax liabilities with government systems to audit those reports? Or should government invest in the infrastructure required to collect taxes at the point of source?

This thesis will explore taxes: the history, the newest ideas, the abuses, and the reasons why tax policy today has become so cumbersome and legalistic that it takes thousands of pages to explain all the complexities of our tax system. Changes to any area of our modern tax code have ripple effects that influence, benefit, or harm entire constituencies. Around the world, groups cry out for reform but are at a loss as to how to accomplish reform. Some call for higher taxes while others demand reprieve from what is already considered a repressive tax burden. There are taxes on property, sales, income, imports, exports and just about anything else governments can devise to tax. At the same time, government’s are issuing enormous tax breaks and exempting entire sectors of the world economy from tax liability. Meanwhile, we slog along without ever addressing the fundamentals of the system itself.

Government tax policies are like an old car with a thousand joint owners. One part of the car can’t be remodeled without impacting the other parts of the car. A new transmission disrupts the carburetor or the fuel system or the spark plugs. In the meantime, governments borrow enormous sums of money to keep the old car
Some of the owners pay more and more to help fund the car while others ride along and pay nothing. Eventually, the burden of maintaining this old car becomes enormous, debts exceed the value of the car, and owners, who can’t agree on what new car to purchase or what repairs to make, end up walking because the car won’t operate.

Perhaps the global tax frustration was best summarized by Sydney Smith in 1820:

We can inform Brother Jonathan what is the inevitable consequence of being too fond of glory. Taxes upon every article which enters the mouth or covers the back or is placed under the foot. Taxes upon everything which it is pleasant to see, hear, feel, smell or taste. Taxes upon warmth, light and locomotion. Taxes on everything on earth or under the earth, on everything that comes from abroad or is grown at home. Taxes on the raw material, taxes on every fresh value that is added to it by the industry of man. Taxes on the sauces which pamper man’s appetite and the drug which restores him to health; on the ermine which decorates the judge, and the rope which hangs the criminal; on the poor man’s salt and the rich man’s spice; on the brass nails of the coffin and the ribbons of the bride; at bed or board, couchant or levant, we must pay. The schoolboy whips his taxed top; the beardless youth manages his taxed horse with a taxed bridle, on a taxed road, and the dying Englishman, pouring his medicine, which has paid seven per cent, into a spoon which has paid fifteen per cent, flings himself back upon a chintz bed, which has paid twenty-two per cent, and expires in the arms of an apothecary who has paid a license of one hundred pounds for the privilege of putting him to death. His whole property is then immediately taxed from two to ten per cent, besides the probate judge’s fees demanded for buying him in the chancel; his virtues are handed down to posterity on taxed marble, and he will then be gathered to his fathers to be taxed no more.²

This paper asks the very simple question “If we had to do it all over again, would we do it the same way?” It’s an important question because it impacts every person. This paper is not a commentary on government spending priorities. Each nation of the world makes that determination for itself. The reality, however, is that many governments, including our own, spend beyond what the tax system collects. The only outcome for that system is to raise taxes or continue borrowing to the point where supporting the debt becomes unsustainable. This issue of debt, in particular, has dire long term consequences. If for no other reason than the mounting global debt crisis, questions of taxes and tax policy must be explored.

Is it possible to create a new tax methodology which meets the spending requirements of government without creating new debt or new tax burdens on the citizenry? Indeed, could debt be retired at the same time we reduce the burdens of taxation and increase spending on programs which governments require and citizens demand? Instead of constantly changing either the inputs (taxes) or the outputs (spending), what if the system itself could be reformed so that tax payers feel no additional burdens while beneficiaries receive no cuts? Do we dare to even imagine a system where balance and fairness are achieved for everyone?

This concept will be explored using the State of Kansas as a platform for discussing innovations in methodology. Kansas serves as an excellent platform because it’s small enough in size and scale that changes to the tax code can be reasonably and easily measured. The United States federal system is too large in scope and complexity, but the Kansas landscape lends itself to cutting, pasting, and
experimentation. Benjamin Franklin said that “nothing is certain except for death and taxes.”

While there is little to be done about the former, perhaps it’s time for some fresh thinking on the subject of the latter. It’s also possible, that Kansas, as a smaller state where genuine reform is actually possible, could serve as a starting point for new thinking on taxation. That, of course, would require some courageous legislating by the elected officials of Kansas, but perhaps the time has come for just such courage.

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CHAPTER I

A BRIEF HISTORY OF TAXATION

There is no known civilization which has not had a tax. The Sumerians were the first civilization with recorded history. Located along the fertile plain between the Tigris and Euphrates rivers in modern Iraq some 6,000 years ago, this earliest of civilizations recorded the collection of tax.¹ These early taxes were used to fund a terrible war. “Everything was taxed. Even the dead could not be buried unless a tax was paid.”² A Sumerian proverb is even recorded on an early clay tablet from this lost civilization, “You can have a Lord, you can have a King, but the man to fear is the tax collector.”³

In the 1700’s, Adam Smith wrote a variety of important works on free market capitalism. His famous work, The Wealth of Nations, included the four canons of taxation. To this day the canons remain important to tax thinking:

(1) The subjects of every State ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities—that is, in proportion to the revenue which they respectively enjoy under the protection of the State.

(2) The tax which each individual is bound to pay ought to be certain and not arbitrary. The form of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person.


²Ibid., 2.

³Ibid., 3.
(3) Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.

(4) Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.4

Whether we cite the Sumerians of ancient times, Adam Smith of the 1700’s, or today’s headlines, a number of truths have always existed with regard to taxes. Citizens, as a rule, always want to pay less taxes. If given a choice between paying higher taxes or lower taxes, citizens choose the latter. Citizens are often in favor of someone else paying higher taxes, but when it comes to tax burdens, individuals and companies alike, are always in favor of their portion being less.

Fairness throughout history has always been an issue. Whatever the tax mechanism devised, the group most affected by the tax undoubtedly takes issue with it. As governments devise new strategies to create fairness, citizens seek ways to minimize or reduce the amount of tax they pay. Tax avoidance or tax evasion are inevitable results of any tax.

As a result of these fundamental truths, governments all face a similar cycle in their taxing policies. Taxes are levied, individuals cry foul and seek ways to minimize the tax, governments respond with new laws to close loopholes in attempts to maintain a fairness to the administration of the tax, and new laws are created to enforce the tax. If the taxes get too repressive or the government too heavy handed in its enforcement, citizens will find a way to rebel. In ancient times,  

rebellion often took the form of assassinating the tax assessor. The United States Revolutionary War was a result of taxation without representation. In the modern era, companies and individuals rebel against tax systems by creating overseas tax havens or using a variety of legal and sometimes illegal tax strategies to circumvent the system.

The goal of any successful government is to find the right balance in which a vibrant civilization can exist without creating such burdens as the citizens either choose to go elsewhere or rise up in rebellion. That balance is also impacted by the spending decisions of the government. The more robust the spending the higher the tax burden required to support it. The issue of balance is also influenced by how efficiently a government executes spending priorities and the role to which corruption and inefficiency frustrate the tax paying citizens. Perhaps Will Rogers said it best, “People want just taxes more than they want lower taxes.”

In ancient times, individuals had few rights and tax policies were determined by individuals and governments under the right of absolute law. In some cases, the application of tax policy was benevolent and in other instances the enforcement of tax policy was burdensome. As the rule of law developed, and along with it court systems to enforce the laws, so too did the rights of the individual to question and challenge those laws. Taxes inherently have an arbitrary element. The value of someone’s property, the value of goods and services, and the interpretation of law are all subject to disagreement. As previously discussed,

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individuals and companies always seek ways to lower their tax burdens.

Governments, in turn, modify laws to eliminate loopholes in pursuit of the ever-elusive fairness and to root out tax avoidance or evasion. This problem is dramatically compounded when governments use tax policy for other purposes. Governments throughout history have used taxes to encourage or discourage certain activities. For example, governments often exempt churches from paying taxes. This modification of tax code encouraged the formation of churches and temples which governments viewed as in the best interest of their communities.

Governments encourage certain types of trade or the formation of certain industries by issuing tax breaks to companies and individuals engaged in certain economic activity. These activities complicate tax policy and encourage companies and individuals to lobby for changes to tax code solely to benefit their interests. In simpler terms, when taxes are subject to negotiation, there is a benefit to negotiating.

In the earliest of times, taxes were largely collected in the form of tributes. What began as voluntary offerings gradually changed over time to compulsory fees. These fees evolved into primitive poll taxes (a tax on every individual, also referred to as a capitation tax) and then simple, indirect taxes on goods and services.⁶

As wealth began to develop, however, and along with it the needs of government, so too did the need to evolve the method of taxation into a system which more fairly measured an individual’s ability to pay. Economic classes

formed along with the development of private property. The simple poll tax became inadequate as the inequality of wealth led to an inequality of tax burden. Wealthy owners of private property paid the same poll tax as those who had no property. As a result, it became necessary to determine a new test which measured one’s ability to pay based on his or her wealth.\(^7\)

Property tax evolved as the method of measurement by which taxes were levied. Property tax was levied on land owners, and the first real estate property tax was created. “Gradually, as primitive industry and commerce develop, various forms of personal property come into prominence and are added to the tax lists, until finally the two are fused together in order to form the first general property tax, which is universally found in this stage of economic development. Property becomes the only possible general test of faculty in taxation because it is the specific mark of distinction between classes and between individuals within each class.”\(^8\)

There are a number of problems which immediately arise in the implementation of a tax on property, particularly as economies grew in complexity. There is a gap between property and product. A piece of land may have a specific valuation which may or may not adequately reflect the yield of the products derived from that property. Two pieces of similar land may yield completely different harvests based on farming method, drought, or bad luck. If two farmers pay tax

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\(^7\)Ibid., 5-8.

\(^8\)Ibid., 6.
based on land production, one may go broke during a period of poor harvests.

Similarly, if two home owners desire to rent their properties, one may be successful while the other fails to find a suitable tenant and thus goes broke due to an inability to pay tax on the property. Conversely, if the property tax is applied to the yield of a harvest or the rents collected from a tenant, the government takes the risk that it may collect no tax and therefore suffer a shortfall to its coffers.

As labor incomes evolved, there existed a significant gap between property owners and those with rich salaried positions but little to no property. As lucrative professions evolved such as lawyers or doctors or engineers, the burden of taxation remained solely on those who owned property. Reliance on property as the pure measure of ability to pay exempts from the tax rolls those individuals who achieve wealth without property ownership.

Property tax failed to adequately account for indebtedness. A farmer, for example, may own $10,000 worth of land but also have $10,000 worth of debt. Early property tax systems did not take this into account. Property owners paid tax on the value of their assets without considering debt payments. Strategies which accounted for indebtedness only yielded fraud, land speculation, and an imbalance whereby either the farmer paid on the entire value of the asset or the government sacrificed its revenue in favor of the payer’s debt.

In ancient times, land was primarily used for agricultural purposes and could be reasonably valued. As economies matured and wealth accumulated, land was often used for non-productive purposes of enjoyment. Valuing all property for
its production value failed to take into account the actual use of the property being taxed.

The variety of uses of property, land as well as personal property, led to a system by which some were grossly overassessed while others found ways to escape taxation completely. As a result, the measure of property as a fair and universal taxation method became increasingly arbitrary.  

As early civilizations evolved, property tax coupled with indirect taxes on goods and services such as the sale of tobacco or alcohol and import and export duties on trade comprised the vast majority of state’s revenue. Each civilization, however, had its own nuances and issues which evolved in its administration of tax policy.

Ancient Egypt

The Egyptians, by all accounts, had a relatively successful system of taxation. “The Egyptians taxed just about everything: sales, slaves, foreigners, imports, exports, businesses. Agriculture production was taxed at a hefty twenty percent. This was not just a harvest tax, it included home gardens and crafts—income from every conceivable source exactly like our income tax.”

The system was successful, however, due to the benevolent administration of the tax by the pharaohs. The tax collectors, called scribes, were taught to act kindly toward the poor and defenseless. One ancient text instructed scribes: “If a

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10Adams, *For Good and Evil*, 7.
poor farmer is in arrears with his taxes, remit two-thirds of them.”

This practice of benevolence during hard times was a common practice and was originally called “philanthropa” from which the word philanthropy is derived. The pharaohs were also mindful of the dangers of corruption among their scribes and maintained a system of surveillance of scribes to ensure integrity among their tax collectors.

The great shortcoming of the Egyptian tax system occurred when temples and priests were given tax exempt status. Enormous sections of land fell under temple control and were thus exempt from tax, including valuable agricultural lands. Lands and buildings owned by the temples became a refuge for people fleeing the tax collecting scribes. This right of asylia (assylum) survives today when citizens of one country flee to another seeking refuge from taxation or persecution. Tax exemption remains to this day for many churches and is often as controversial today as it was in ancient Egypt.

Confucius and Ancient China

The tax policy of ancient China was heavily influenced by Confucius. An agrarian economy, Confucian doctrine called for a tax on the land to form the foundations of the state. This land tax or single tax was ten percent. The Confucian doctrine evolved over time to include the Well-Field Tax System which

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11Ibid., 8.
12Ibid., 10.
13Ibid., 14.
was a modification of the ten percent tax guideline. In the Well-Field System, a parcel of land was divided into nine equal parcels of approximately 100 acres per parcel. Eight of the nine parcels were given one each to an individual family to farm. The ninth parcel, located in the center of the other eight, was called public land. The eight families on the surrounding parcels would work together as a community to farm parcel nine. The proceeds of the crops grown on the ninth parcel were given to the state to constitute its ten percent share of the collective.\textsuperscript{15}

In the more populated areas, people were required to pay ten percent of their earnings. As explained by the Confucian philosopher Mencius, “I would ask you, in the remoter districts, observing the nine squares division, to reserve one division to be cultivated on the system of mutual aid, and in the more central parts of the kingdom, to require the people to pay a tenth of their produce.”\textsuperscript{16} As Confucius and Mencius both believed that a tax on the land was adequate to support the state, they were adamantly opposed to other taxes and to the harsh implementation of tax policy. Further, they believed that taxes on trade, imports and exports, would discourage economic development.

 Ancient Greece

The intellectual achievements of the Greeks are well documented and were equally applied to their administration of tax policy. “To the Greeks, the badge of liberty was indirect taxation. The individual was not taxed directly; what was taxed

\textsuperscript{15}Adams, \textit{For Good and Evil}, 48.

\textsuperscript{16}Miles Meander Dawson, \textit{The Ethics of Confucius} (New York: Putnam, 1915), 206.
were some commercial activity such as a sale, import, or use of a public facility such as a road, a bridge, a sea lane, or a harbor. The taxes were justified because money was needed to cover the costs of maintaining these facilities.”

The Greeks also had taxes on auctions, slaves, real estate sales, and lodging at inns. There was also a tax on foreigners who traveled to Greece to conduct trade.

Unlike the Chinese and Egyptians, however, who advised benevolence and harmony, the Greeks were harsh in their administration of taxes. “Tax evaders were taxed ten times the amount of the evaded tax. Foreigners faced the additional penalty of confiscation. Informers were encouraged for enforcement and they received a reward of fifty percent of the penalty.”

These harsh methods gave rise to local tyrants who eventually resorted to direct taxes to raise funds. These direct taxes included a poll tax on all citizens as well as a ten percent harvest tax. These taxes were unpopular and gave rise to widespread confiscations and imprisonments. Tyrants attempted to keep their subjects in good humor with lavish spending, but their lives were often short. The assassination of tyrants was considered a virtuous act.

A notable and successful period in Greece’s tax history occurred during the administration of Aristides the Just. After the Greek victory at Marathon, Aristides was appointed to oversee the Greek tax system. The famous biographer Plutarch

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17 Adams, *For Good and Evil*, 55.
18 Ibid.
19 Ibid.
20 Ibid.
recorded this period as a time when Greek citizens were taxed fairly according to their ability and worth. Taxation was based on fairness and proportion. These ideals remains to this day as example of a just tax system.\textsuperscript{21}

\textbf{Delos and the First Tax Haven}

In the 2nd century B.C. the Rhodian Empire on the Island of Rhodes was a great commercial power. It was a natural stopover in the Eastern Mediterranean and trade from Rome, Greece and from the east all passed through Rhodes. The Rhodians collected a two percent tax on all trade which flowed through its ports. Rhodes emerged as a commercial giant and used its wealth to keep the sea lanes free from pirates. Rome considered Rhodes its ally, but when war broke out between Rome and Macedonia, the Romans were offended by the neutral position taken by Rhodes in the conflict. Rather than punish Rhodes through military action, the Romans established a tax free port of their own on the island of Delos. Tax revenue in Rhodes declined by eighty five percent in the first year and within a few short years their status as a commercial giant was lost.\textsuperscript{22} Without delivering a single military blow, the Romans, through tax policy, had devastated Rhodes.

\textbf{Rome and Tax Evasion}

The history of taxation in the Roman empire is filled with periods of reasonable and fair policy as well as periods of absolute tyranny. One particularly noteworthy period of its long history is found toward the end of the fall of the

\textsuperscript{21}\textit{Ibid.}, 60.

Roman empire. During the reign of Emperor Diocletian (245-311 AD) a number of reforms greatly enlarged both the size of the military and the size of government. The result was an increased tax burden required to fund and continually support this larger infrastructure. Wealthy citizens and members of the Senate successfully bribed or lobbied to eliminate themselves from the burden of paying taxes and therefore the burden fell wholly on the farmers, the middle class, and the poor.

“The rich no longer shared their wealth with the community. The process of redistribution reversed itself. Furthermore, the race and struggle for tax evasion produced a class of corrupt senators whose wealth was based on their ability to abuse the tax system and corrupt public officials.”

In order to enforce tax policy, citizens were tortured and children encouraged to inform on their parents. Additionally, Emperor Constantin created a law in 332 AD which required farmers to share tax burdens with other farmers. If a farmer failed to pay his tax or abandoned his land, the other surrounding land owners inherited the responsibility of paying that individual’s taxes.

Large landowners and the wealthy class repeatedly lobbied the government and were often granted tax amnesty or simply bribed local tax assessors to obtain low rates. During this time, taxes on Senators were also abolished including sales tax and inheritance tax. The wealthy purchased Senate seats and by doing so enjoyed complete tax amnesty. As the tax burdens on farmers became unbearable

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23 Adams, For Good and Evil, 121.

they simply transferred their land ownership to a wealthy landowner who paid no
tax and were thus alleviated of their tax burden.25

The results were disastrous for the Roman government. Revenues were
inadequate to fund the state and further taxes were required. As taxes went up,
revenue continued to decline. “In the end, there was no money left to pay the army,
build forts or ships, or protect the frontier. The barbarian invasions, which were the
final blow to the Roman state in the fifth century, were simply the culmination of
three centuries of deterioration in the fiscal capacity of the state to support itself
and fund an army for its defense. Indeed, many Romans welcomed the barbarians
as saviors from the onerous tax burden.”26

The Rise of the Income Tax

During the middle ages, France was the first important country to develop
an income tax. The tax was directly levied on individuals and was referred to as
the taille or tallage. “The tallage was more or less arbitrary feudal imposition upon
the king’s tenants, calculated primarily according to the amount of land, but
modified to some extent by general considerations of ability to pay.”27 This tax
survived in France until the French Revolution, but over time was fraught with
abuse as whole classes of the population secured exemptions. In 1697, the tax was
modified to impose different rates on individuals according to their social status.
The system called capitation or capitation graduée initially had twenty two

25Adams, For Good and Evil, 121-123.
27Seligman, The Income Tax, 49.
different rate classes. By 1701, it had transformed into a tax on individual incomes
with different graduated rate classes.\textsuperscript{28}

Florence had an income tax for a short time beginning in 1451. Florence
was a thriving commercial and industrial center where wealth was accumulated
from the earnings of commerce rather than from the rent of land. As a result,
property was no longer the best index to measure ability to pay. “From the very
outset, however, the political conditions were unfavorable to efficient
administration. In the struggle with the Medici, the assessment of the income tax
became a favorite weapon of whatever party happened to be in power; and at no
other time in the world’s history except, perhaps, in the later centuries of the
decaying Roman Empire, was there such an orgy of corruption and
maladministration.”\textsuperscript{29} The entire system was based on the arbitrary whims of the
taxing authorities and was short lived. The two earliest examples of income tax,
France and Florence, both provide great examples of the difficulty in applying
fairness and how easily systems are corrupted when the taxing authority is
inefficient and corrupt in administration of its own policy.

The first income tax in England was the result of wars with France. Until
the late 18th century, revenue was derived almost exclusively from customs and
excises. A tax was collected on land but over the years that revenue stream had
shrunk to a small proportion of overall revenue. “In 1792, just before the outbreak

\textsuperscript{28} Ibid., 50.

\textsuperscript{29} Ibid., 46.
of the French war, out of a total tax revenue of about seventeen and a quarter millions sterling, the land tax yielded only two millions, and houses and establishments only one and one-quarter millions. Almost the entire remainder came from customs and excises. Taxes on articles of food and drink were responsible for nine millions.\textsuperscript{30} The additional revenue required to conduct a war with France was simply unavailable. In 1798, parliament passed the Aid and Contribution Act which consisted of three categories of graduated tax rates based on wealth and income. In his arguments in favor of the tax, William Pitt successfully swayed the parliament that an income tax was necessary and that it should tax all incomes alike from whatever source derived.\textsuperscript{31} This all inclusive view of income is an important evolution in tax thinking which remains to this day.

It is not important to this paper to review further the evolution of the British income tax system. It is interesting to note, however, that our United States income tax system is a direct descendent of the British system which began in 1798. Throughout the 1800’s, Britain continuously reformed its system and by 1908 had developed it into a system of schedules which remain in use today. These schedules were designed to categorize income by source so that tax rates could be determined for various types of income and so that all incomes, regardless of source, could be taxed. By 1908, schedules had been created to account for land, houses, other property, occupation of land, income from government securities, and

\textsuperscript{30}Ibid., 60.

\textsuperscript{31}Ibid., 72-74.
income from various professions and corporate interests. Over the course of a century, the efficient execution and evolution of the British income tax system effectively turned public sentiment from disdain for the tax to recognition of its important role as a reliable and necessary funding source for English livelihood.  

It is impossible to ignore the relationship between war and taxes. Wars are expensive. The cost of arming, equipping, feeding, training, and supporting an army is an expense which nations throughout history have been ill-prepared to fund. The United States is no exception to this principle and with the outbreak of the Civil War in 1861, the first income tax in the United States was levied. The original tax proposal called for a tax on land owners and farmers. This notion was quickly dismissed as too onerous a tax for land owners to bear and was replaced with a call for an income tax.

There were many who stood in opposition to an income tax, but the funding requirements of the government were dire. As a result, the Act of 1862 was passed into law. “The income duty consisted of a tax of three percent upon the annual gains, profits or incomes of any person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries or from any profession, trade, employment or vocation carried on in the United States or elsewhere, or from any source whatever, to the extent that the income exceed six hundred dollars.” For those with incomes in excess of ten thousand dollars the rate

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32Ibid., 213-220.
was increased to five percent.\textsuperscript{33} As the war progressed the need for additional funding was apparent. A new tax act was proposed in 1864 raising the tax rate to five percent on incomes up to ten thousand dollars, seven and a half percent on incomes up to twenty five thousand dollars and ten percent levied on incomes above twenty five thousand dollars.\textsuperscript{34}

The importance of the Act of 1864 was the advancement of the graduated income tax based on wealth and income. In the United States of 2016, there is enormous debate on the issue of fairness and whether the wealthy ought to be required to pay a higher percentage of tax. While this issue is hotly contested today, it was first, and with equal passion on both sides, debated in 1864. Opponents of the Act of 1864 argued that higher taxes on the wealthy were simply unfair. “It seems to me,” wrote Thaddeus Stevens, “that it is a strange way to punish men because they are rich. I think the principle of taxing a man who is worth twenty thousand dollars more in proportion to his wealth is an unjust one. If he is worth over a million dollars, we might as well provide that the government shall take the surplus.”\textsuperscript{35} Justin Smith Morrill went on to say, “Experience shows that people who are taxed unequally on their incomes regard themselves as being unjustly treated, and seek all manner of ways and means to evade it. This

\textsuperscript{33}Ibid., 437-438.
\textsuperscript{34}Ibid., 440.
\textsuperscript{35}Ibid.
inequality is in fact no less than a confiscation of property, because one man happens to have a little more money than another.”

In favor of the graduated tax was William Fessenden who agreed that the proposed income tax was discriminatory. He also believed “that those having very large incomes can afford, and perhaps better afford than those who have smaller ones, to pay a tax, and a larger tax, the discriminating tax if you please.” With a number of amendments, the tax passed. The income tax existed beyond the Civil War but was ultimately allowed by statute, and after heated debate in the Congress, to expire in 1872.

By the 1890’s, wheat farmers in the west and cotton growers in the south had fallen on hard times. At the same, enormous wealth was amassed in the industrial and financial centers of the east. The farmers, who constituted the majority of the middle class as well as a large voting population, were restless and frustrated as state and local taxes weighed on them. At the same time, tax policies benefited the wealthy in the east and the complaints of the agricultural class grew loud and deep. After much debate, a new income tax was imposed on January 1, 1895. This tax, almost to the word, was a reinstitution of the previously abandoned Civil War income tax.

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36 Ibid., 441.

37 Ibid., 442.

38 Ibid., 456-467.

39 Ibid., 493-495.
Over the next twenty years, many legal challenges were raised with regard to income taxes and violations of Constitutional provisions against direct taxation and apportionment. Specifically noted are the following:

Article I, Section 2, Clause 3: Representatives and direct taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers...[1].

Article I, Section 8, Clause 1: The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

Article I, Section 9, Clause 4: No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken. of the Constitution.40

These legal challenges were ultimately resolved with the adoption of the 16th amendment on February 3, 1913. The 16th amendment allows the Congress to levy an income tax without apportioning it among the states or basing it on the United States Census.41 With the adoption of this amendment, income tax was forever adopted as a pillar of the United States tax code.

Sales Tax

Sales tax is a pay-at-the-source tax collected by retailers when consumer goods are sold. Although taxes on consumption have existed since ancient times, it is a relatively new tax in United States history. Tax on retail sales gained popularity with state governments during the Great Depression of the 1930’s. West

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41Ibid.
Virginia implemented the first sales tax in 1921. By the end of the 1930’s more than two dozen states had adopted a sales tax. Today, statewide sales tax is collected in every state except Alaska, Delaware, Montana, New Hampshire, and Oregon.42

Before the imposition of sales taxes, state income had been historically derived from taxes levied on property. As previously discussed, property taxes have a number of inherent shortcomings. In American property tax history the property tax has always been *ad valorem*, meaning a tax on value, rather than on some characteristic of the property such as number of windows or yield from the most recent harvest.43

*Ad valorem* property tax has many advantages for a state government. Namely, as the tax base and the economy grow, property values rise and the state collects more revenue. The disadvantage, however, is that the value of property is largely hypothetical. An assessment is made of what the property is worth, but the actual value is only known if a willing buyer purchases the property. Tax officials estimate the value based on the price of comparable sales and an estimate of the materials used in the construction process. “Any such technique of estimation opens room for error and disagreement—or for deliberate manipulation and favoritism. That is one reason why political thinkers as astute as James Madison

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and Alexander Hamilton thought that real estate values were a ‘chimerical’ basis for taxation.”

The other significant weakness of the ad valorem property tax system is with the assessor. Assessors have historically been locally elected officials or political appointees. The politicizing of the position and discretion afforded the assessor often led to favoritism and unfairly rewarded or punished certain constituencies. The most favored constituency was often homeowners. This large block of voters often received favorable tax treatment by assessors. In many cases, the assessor was a known member of the community and did not want to be perceived as too harsh in establishing values on property of individuals personally known to the assessor. As a result, fractional assessment, or the paying of tax on only a portion of the actual value of the property, was often standard practice in many communities. Additionally, assessors typically used data from the previous year’s assessment as a baseline which may or may not have accurately reflected changes in the marketplace.

This system proved unfair not only to property owners, particularly those who lived in the wrong residential neighborhoods, but was also unfair to business owners who typically paid a greater fraction of the true value of their property. From the perspective of the state that collects the tax, this system simply does not produce the required revenue needed to meet the rapidly growing financial needs of

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44Ibid., 7.

45Ibid.
local government. The weaknesses of the ad valorem property tax system remain to this day and in some cases have become more problematic as communities are motivated to compete with each other to attract new businesses, new housing developments, and state and federal aid.46

The problems of the property tax system were dire during the Great Depression. Up to the Depression, citizens had benefited from this system as tax value often lagged behind the actual value of property. Citizens were afforded an informal tax privilege. “But during the Great Depression, this same custom imposed an informal tax penalty: as the real values of their homes and businesses sank, their tax bills did not. Property taxes not only failed to sink, they even rose, because more and more people were crowding onto the county relief rolls, and more and more students were staying in public schools longer in order to avoid the dismal labor market.”47 Taxpayers responded with protests and local property owners’ associations threatened governments with tax strikes. As more and more taxpayers fell behind or simply couldn’t make required tax payments, the financial situation for state and local governments turned desperate.48

Given the gravity of the situation, and with local and state governments on the verge of bankruptcy, the sales tax emerged as a new and desperately needed source of revenue. A century ago, state and local governments obtained nearly eighty percent of their tax revenue from property tax. The introduction of the sales

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46Ibid., 28-29.

47Ibid., 29.

48Ibid.
tax has changed that figure dramatically. Today, state and local governments obtain, on average, thirty five percent of their funding from property tax, thirty four percent from sales tax, and twenty three percent from individual and corporate income tax.  

As has often been the case throughout history, crisis leads to new taxes. In this case, it was not war but the Great Depression which led to the rise of sales tax as a new mechanism for government funding. And, as also is typically the case, once a tax is created it is rarely abandoned.

Value Added Tax

A value added tax (VAT) is an indirect type of consumption tax added on to purchases for goods and services. A tax is collected at every step in the production chain. For example, when a television is made the manufacturer is charged a tax on all the supplies they purchase for producing the television which is then passed on to the consumer. Once the product reaches the shelf, the consumer pays the accumulated tax which has accrued through the manufacturing process. Value added tax is thus a giant sales tax.

Value added taxes have been levied in Europe since the 1970’s. The original idea for a VAT tax originated in France in the 1950’s. The European Economic Community requires its members to levy a VAT on all but essential products such as food or medicines. VAT rates vary from country to country in the 

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EEC, but typically represent an increase of about twenty to twenty five percent on purchased items which are not exempt from the tax.\textsuperscript{51}

Many Americans have called for a VAT or national sales tax as a new source of government revenue. In fact, the United States is the only country in the thirty four member Organization for Economic Cooperation and Development that does not impose a VAT tax. Proponents argue that a VAT tax would raise much needed revenue and be relatively simple to implement and enforce. The opponents fear that VAT will introduce a slippery slope to dramatically higher rates of taxation. Changing the VAT rate would serve as a simple mechanism for the federal government to easily raise revenues in a system many believe is already repressive. Additionally, opponents fear that if the federal government establishes an enormous source of new revenue, it will simply be spent to implement and enhance social welfare programs.\textsuperscript{52}

Summary

This brief history by no means accounts for the thousands of pages of written history on the subject of taxation. It is instructive, however, in that common themes repeat themselves throughout history. Citizens, in general, have always recognized the need for government. The necessity of infrastructure, security, economic development, and needs of the citizens require governments to


generate revenue to provide these basic essentials. Compulsory contributions to state revenue (taxes) have always been levied to fund these needs.

While the need for taxes has never been in dispute, there has always existed a tension between tax payers and the governments they support. That tension is a balance between reasonableness and tyranny. Out of balance in favor of the tax payers resorts in revenue shortfalls. Conversely, when the balance favors government, nations equally suffer under the burden of oppressively high taxes. The lessons of history teach us that balanced and just systems stand the test of time. The great challenge is achieving this desired state.
Governments are always in search of new and innovative ways to approach the issue of taxes. Some innovations are reflective of changing times, the implementation of new technologies for example. Others reflect the changing demands of our global environmental climate. Taxes, for example, on carbon emissions or methane production are designed to limit, through taxation, the production of pollutants to the environment. Other innovations, however, are simply aimed at identifying new revenue streams to fund the needs of government. Core taxes around the world remain based on property, income, sales, and duties on imports and exports, but this chapter will explore some of the new ideas and approaches with regard to taxation as well as some of the modern ways individuals and companies have found to evade or avoid paying taxes. Many of these ideas are whimsical or leftover from strange interpretations of tax law, but others form the core of important debates taking place in legislatures around the world which would lead to meaningful change in the way taxes are levied.

There are literally thousands of strange tax laws. Many of these taxes were implemented to raise additional revenues while others were established to promote social change. For example, England has a tax on televisions. If you own a tv in
your home, you are required to pay an annual television license fee. The income generated form this tax is used to fund program content created by the BBC.¹

The Hubei province in central China imposes a smoking quota on local officials of 230,000 total packs of cigarettes to boost tax revenues. The edict imposes fines on officials who fail to meet their smoking quota or are caught smoking rival brands of cigarettes. “The move, which flies in the face of national anti-smoking policies set in Beijing, is aimed at boosting tax revenue and protecting local manufacturers from outside competition from China’s 100 cigarette makers. China has 350 million smokers, about a million of whom die each year from smoking-related illnesses. Despite anti-smoking campaigns, cigarette taxes form a major component of China’s annual tax-take at the local level.”² In order to boost culture and the arts, Ireland offers income tax exemptions to artists who demonstrate cultural merit through their artwork. If the work is deemed to enhance the quality of individual or social life, the artist can file for an exemption from the income derived from the work. Similarly, Britain offers tax breaks for films which are recognized as “culturally British.”³ Peter the Great had a tax on beards in 1672. The tax was aimed at encouraging people to appear clean shaven. Canada offers tax breaks to companies that put toys in children’s cereal. And bribes were a


recognized tax deduction in Germany until 2002. The list of strange tax laws is literally endless.

The United States is certainly no exception. New York City places a special tax on sliced bagels. Maine has taxes on blueberries. Iowa, Pennsylvania, and New Jersey exempt sales tax on pumpkins, but only if they are to be eaten and not carved. In Oregon, double amputees get a $50 tax credit. Colorado taxes straws and cup lids as they are considered nonessential food items. In New Mexico, people over 100 are tax exempt. Tennessee taxes litigation to discourage frivolous lawsuits. Texas imposes a special $5 tax on establishments that host live nude shows if alcohol is consumed on the premises. The tax is comically referred to as a “pole tax”. Kansas recently determined that hot air balloon rides are exempt from sales tax because they are considered air transportation. Tethered balloon rides, however, are considered an amusement and thus subject to sales tax.

Tax laws are frequently the subject of humor and there are thousands of them on the books of tax entities all over the world. Other ideas, however, are always surfacing and many of them represent interesting and potentially important changes to the taxes governments levy and to the tax policies pursued.

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4Ibid.

5E-file, "Strange and Unusual Taxes Throughout History.”
India and the Global Sales Tax (GST)

For many years, India imposed a convoluted system which imposed sales tax on all transactions at all levels of the manufacturing and consumer process. For example, if company A purchased something it paid sales tax. Company A marked up the price to account for the sales tax paid. If Company B bought from Company A, it paid the higher marked up sales price plus an additional sales tax on the full price of the purchased item. Company B accordingly marked up the sales price and Company C, purchasing from Company B, then paid that higher price charged by Company B plus an additional sales tax on the full purchase price of the item.

This system of escalating tax at each level, literally a tax on a tax, resulted in high prices to the consumer and encouraged inflation. A Value Added Tax (VAT) system was imposed which gave a tax credit to each company in the chain as it produced goods and services. The problem of tax on tax remained, however, because two different tax policies existed in India. The VAT tax was levied by state governments while the central government levied separate excise and service taxes. A manufacturer claimed relief from state tax using the modified VAT system, but could not claim relief from the taxes of the central government. As a result, the system, while improved, remained inflexible and the burden of taxation continued to encourage inflation and higher prices.\(^6\)

In order to improve the efficiency of the system, the Indian Parliament (Lok Sabha) passed a new law in 2015 which created a new system referred to as the

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\(^6\) Palkash Asawa, “How will the Goods and Services Tax (GST) work in India?”, Quora, February 25, 2016.
Goods and Services Tax (GST). The new system is scheduled for implementation on April 1, 2016 and represents the biggest tax reform in India since 1947.\(^7\)

“The main function of the GST is to transform India into a uniform market by breaking the current fiscal barrier between states. Thus the GST will facilitate a uniform tax levied on goods and services across the country. Currently, the indirect tax system in India is complicated with overlapping taxes levied by the Centre and the State separately.”\(^8\) The GST will continue to have a dual Central and State structure, but taxes such as excise duty, service, central sales tax, VAT, and entry tax will all be subsumed by the GST under a single umbrella. By simplifying the system, India expects a climate of improved tax compliance while at the same providing tax relief to the consumer and achieving an overall decline in the cost of goods.\(^9\)

The reforms in India are important for several reasons. First, the old system highlighted the problems of tax compliance in cumbersome and inefficient tax systems. As Adam Smith stated in the 1700’s, taxes have to be understandable and simple to maximize compliance. Secondly, India serves as an important reminder that when tax systems are overly burdensome, individuals and companies will find ways to circumvent or work around the tax. Lastly, India stands as an important example that tax reform on a large scale is achievable.

\(^7\)KC Archana, “What is the GST Bill? What does it mean to you and me?”, *IndiaToday*, November 28, 2015.

\(^8\)Ibid.

\(^9\)Ibid.
Environmental Tax Policy

The desire to reduce greenhouse gas emissions has lead to a wave of new tax strategies around the globe. The implementation of taxes and tax incentives, particularly on energy use, is seen by many as an effective way to protect the ozone layer, local air quality, and water supplies. Green taxes (also called ‘environmental taxes’ or ‘pollution taxes’) are excise taxes on environmental pollutants or on goods whose use produces such pollutants. “Economic theory suggests that taxes on polluting emissions will reduce environmental harm in the least costly manner, by encouraging changes in behavior by those firms and households that can reduce their pollution at the lowest cost. In practice, green taxes, even indirect ones, on proxies for emissions or on related goods, have rarely been imposed. Some examples can be found in Europe, but virtually none in the United States.”

The most innovative tax idea in this area is likely the Danish Cow Flatulence Tax. Cows produce a variety of gasses including methane. “Though carbon dioxide is the first gas that comes to mind when we think of greenhouse emissions, pound for pound, methane is more than 20 times more powerful in terms of its global warming potential. Methane doesn’t linger in the atmosphere quite as long as CO2, and it’s not produced industrially in anywhere near the same quantity, but it does its damage all the same — and livestock toots out a surprisingly large share of it.”

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One study estimated that the average cow produces the equivalent of 4 tons of carbon dioxide per year while the average car produces around 2.7 tons. The study further estimated that globally, cows account for approximately 6% of total annual greenhouse gas emissions. Denmark has established ambitious goals aimed at reducing their output of greenhouse gases. The result was the creation of the cow flatulence tax which levies a fee of $110.00 USD per cow to offset damage caused to the environment and to encourage overall reductions in the Danish carbon footprint.\textsuperscript{12}

Japan and the \textit{Furusato Nozei}

Like many countries in the world, Japan suffers from rural-urban migration. Citizens relocate to find better jobs and in most countries those jobs are found in the major cities. For decades, Japan has experienced a migration from small, rural cities and towns to major metropolitan areas like Tokyo and Osaka. Rural communities are impacted by the loss of qualified workers and consequently by the tax revenue those workers produce. In 2007, Japanese Prime Minister Shinzo Abe introduced a plan referred to as “Regional Revitalization.” One element of that plan is a program called “\textit{Furusato Nozei}” which in Japanese means “hometown tax”. The program offers tax breaks to individuals who make donations to their hometown. It’s a voluntary program and is treated like a charitable deduction

\textsuperscript{12}Kluger, “Silence the Cows, Save the Planet.”
designed to encourage citizens to financially support rural, struggling communities in Japan.\textsuperscript{13}

As the program evolved, rural communities implemented the practice of sending thank you gifts to donors. Kamishihoro, Hokkaido, for example, sends local produce such as beef, potatoes, or cans of honey.\textsuperscript{14} Some communities send local seafood specialities while others have sent electronics such as iPads and laptops as thank you gifts. “Taxpayers who donate money to Hirado get a nice deduction and a shipment of slipper lobsters, spiral-shelled mollusks and oysters. Don’t like seafood? Hirado has hundreds of other thank-you gifts, like a monthly vegetable delivery, a fold-up electric bike or a wedding photo shoot with formal wear and hotel stay included. Donors — 36,000 in one year — now outnumber residents.”\textsuperscript{15}

The elaborate thank you gifts have sparked controversy in Japan as concerns are raised that communities are spending too much of the donations they receive purchasing gifts. The reason for the explosion in gifts, both in quantity and in quality, is because the program is indifferent to which hometown an individual elects to support. Japanese citizens are free to donate to any hometown which participates in the program regardless of their place of birth. Hometowns offer elaborate gifts because they are actively competing against other towns for a piece

\textsuperscript{13}Tomohiro Osaki, “Home ‘tax’ donation system catching on,” \textit{The Japan Times}, October 20, 2014.

\textsuperscript{14}Ibid.

of the ever growing pie of money flowing form the metropolitan areas back into rural Japan. In 2008, the program generated 6 billion yen in revenue. In 2014, that number exceeded 14 billion yen, and the government recently raised the limit so donors can give more, up to 20% of their municipal tax bill.\textsuperscript{16}

As communities compete for revenue, additional creative ideas are being generated. Takamachi in the Niigota Prefecture, for example, recently created a website so donors could direct their funds into programs they want to support. The community not only raises revenue, but allows the donors to participate in local governance by directing exactly where the donation will be spent. These programs allow supporters to give directly to causes like community child care or computers for school children.\textsuperscript{17}

The top recipient of the program in 2014 was the fishing village of Hirado. Once a thriving city, the population has dropped by half since the 1950’s. The thriving trade industry is gone and has been replaced by a handful of aging and mostly empty hotels. “While Hirado began accepting donations soon after the program began in 2008, it only recently started to earn serious money. Taking cues from online shopping, it set up a website where donors can choose gifts and a point system to claim rewards. It takes a donation of 10,000 yen, or $84, to get a seafood

\textsuperscript{16}Sable, “In Japan, you get a tax break and a side of lobster and beef.”

\textsuperscript{17}Osaki, “Home ‘tax’ donation system catching on.”
The town earned 1.46 billion yen in donations in its latest fiscal year, which ended in March, or about $12 million — 7 percent of its annual budget.”

The program has been very successful for donors as well. Between the tax deduction and the elaborate gifts from the local communities, many donors discover that very little actual out of pocket expense is incurred. The only frustrated parties in the hometown tax strategy are the major metropolitan areas which suffer from the loss of revenue. Proponents, however, maintain that funds would go to these communities anyway in the form of government subsidies. The *furusato nozei* program encourages participation, individual involvement, connection with rural Japan, and makes the tax paying process fun and rewarding.

**Corporate Inversion and Source Taxes**

One of the challenges of the modern world is the mobility of individuals and companies. At least from the government’s point of view, it’s difficult to levy taxes on companies when they move to other countries. There are similar challenges when citizens move from one city or state to another or leave a country entirely. The freedom of movement wasn’t so easy in ancient times, but in today’s global world with international banking, the internet, and non-stop flights it’s relatively easy to relocate a business to another country. In the United States, businesses and individuals have recognized the taxing authority of the territory in which the income was produced. For example, if a company has operations in multiple states, tax is paid at the rate levied by the state in which the income was

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18Sable, “In Japan, you get a tax break and a side of lobster and beef.”
actually produced. Similarly, if a company or an individual earns money outside
the United States, a tax is paid to the foreign country where it was earned. While
the Internal Revenue Service (IRS) has always required companies and individuals
to declare foreign income, it was not considered taxable in the United States until
the earnings returned to the United States. In other words, companies paid foreign
taxes on the money earned, but were not required to pay tax on that income in the
United States if it was earned abroad.

In recent years, however, the IRS has ramped up worldwide enforcement of
the foreign source policy. The IRS now requires companies and individuals to
declare all foreign assets including foreign bank accounts. The IRS is on a global
hunt in search of Americans using foreign countries as tax havens or to hide assets,
but is also demanding and enforcing a policy that taxes be paid on all income
regardless of country of origin.19

Americans who live abroad have been especially impacted because they pay
tax in their foreign country of residence, but now additionally pay tax to the United
States, their home of citizenship. The issue of double taxation is causing a record
number of Americans to renounce their citizenship in order to avoid the burden of
U.S. taxes. Not surprisingly, the United States government recently raised the fee
to renounce citizenship from $450 to $2,350.20

19Robert W. Wood, “Reverse Immigration: Americans Renounce Citizenship in Record
Numbers,” Forbes, October 26, 2015.

20Ibid.
There are also record numbers of United States companies moving abroad to avoid U.S. taxes. This tax strategy is called corporate inversion and has been in use since the 1980’s, but has increased in practice in recent years. Corporate inversion occurs when a U.S. company purchases or merges with a foreign company. Once the purchase or merger is complete, a country of domicile is declared and the company is no longer subject to U.S. tax law. *The Economist* explains as follows:

Pulling off a successful inversion requires only a modest sleight of hand. When company A (based in America, say) acquires company B (based in Ireland) the managers of the combined A+B entity get to choose a domicile. If they choose the United States, they are in effect choosing to pay relatively high American corporate rates—up to 39%—on all the overseas profits they repatriate; unusually, the IRS taxes income on a global basis. If they choose Ireland instead, they will have to pay a much lower tax rate (12.5%) on profits generated in Ireland, but the crucial bit is that they will pay only the local rate on whatever profits are generated in foreign subsidiaries—because Ireland, like most other countries, taxes on a strictly territorial basis. That means paying, for example, 39% on profits generated within the United States, 20% in Britain, or 0% in Bermuda. A third option is to choose a neutral country, such as Britain or the Netherlands which, like most of the world, also have lower rates and a territorial system. Few global companies would choose to stay in America given that choice, though plenty remain based there, often for publicity reasons. Walgreen’s bosses abandoned plans to move to Europe last year, but only after calls for a consumer boycott. The IRS managed to tighten some rules in September, which seems to have made it slightly harder for other companies to invert.21

As the IRS and the United States government both scramble to stop companies from moving abroad, the United States finds itself once again

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repeating history and the lessons learned by so many other governments before: companies and individuals will always seek ways to avoid, evade, and find ways to pay lower taxes.

Elected Officials and the Expanding Tax Code

The United States tax code is 187 times longer today than it was a century ago. When the income tax was permanently adopted in 1913, the tax code only grew from 400 to 504 pages. Even after the “New Deal” was enacted by President Franklin Roosevelt during the Great Depression, the tax code was still under 1,000 pages. The U.S. tax code today is 74,608 pages long. Most of that growth has occurred in the past thirty years. The tax code was 26,300 pages in 1984. While the tax code has expanded, so too have the numbers and types of taxes which Americans pay and the number of programs the government supports. Programs, the size of government, and the U.S. tax code grow hand in hand.

One of the reasons for this explosion in the size of the U.S. tax code is found in an inherent problem with elected officials in a democracy. That problem is the fundamental trend of elected officials to expand government. Drawing on my own experiences as an elected official, I think it fair to say that humans, by nature, are typically compassionate and, if given a choice, will generally choose to help rather than to harm. I recognize this is a broad statement but among elected officials, whose elected office is earned by

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winning votes from fellow citizens, this desire to be helpful is very real because it is a core requirement to public service. The desire to be helpful may even be exaggerated among elected officials as their livelihood and electability is a direct reflection of their popularity with the electorate. Elected officials are far more likely to pander, cater, and work for the benefit of constituents than they are to enact policies which are painful or harmful to their communities. Unpopularity is rarely a trait that gets elected officials re-elected. This is not a criticism of elected officials, but merely an observation which is helpful to understanding why the number of programs continues to rise as well as the taxes required to fund those programs.

This desire to be helpful, over time, leads to larger government. The growth of government manifests itself in two ways. First, in good times, when governments experience an increase in revenue, there is often an expansion in programs and spending. Bad economic times, however, also often lead to an increase in programs because the needs of citizens often increase during difficult times. There is never a shortage of proposed government spending programs or opportunities for new spending. Existing programs can always be expanded, infrastructure improved, and new programs created to meet some crisis or concern among the citizens.

Secondly, once programs are created they are rarely abandoned. It is much easier to spend money and create new programs than to cut spending and end programs. For example, if a government enacts a program to
provide free meals, it is reasonable to expect that citizens will use and
derive a benefit from that program. Canceling that program at some future
time has dire consequences to the citizens who have come to rely upon it.
The same is true for companies and individuals who receive tax amnesty or
tax exemptions. If that exemption is removed, it becomes a tax increase and
is financially painful for the individuals or companies affected.

Additionally, when programs are implemented, governments must
create the infrastructure needed to support the program. Agencies are
created to administer the programs. Office space is identified and
employees hired to oversee the programs. These newly created agencies are
then responsible for writing the governing rules of the program and
marketing and explaining the program to those who either benefit or are
regulated by it. This is common sense and inherent to all governments.

The problem, however, that arises for elected officials is that once
agencies are created, like programs, they are difficult to abolish. Agencies
develop their own fiefdoms within government. Agencies can become
politically powerful within government and abolishing such an agency is
often impossible, particularly when doing so would result in unemployment
for some or all of the employees of the agency.

An example of this phenomenon is the regulation of water in the
State of Kansas. As Kansas is an agricultural state, water is of critical
importance. During the dust bowl years of the 1930’s in particular, water
management was crucial. But there existed a fundamental distrust of the agencies at the time responsible for water management. Farmers feared that preferential treatment might be afforded to some farmers over others. The legislature responded to this fear by creating multiple agencies to oversee water. The agencies created as well as the tradition of multiple agency management, which has proved a lasting legacy to this day.

Kansas water management today consists of the following: The Kansas Water Office which coordinates water planning. The Kansas Department of Agriculture, Division of Water Resources, governs how water is allocated. The Kansas Department of Health and the Environment is responsible for measuring water quality. The Kansas Department of Agriculture, Division of Conservation, administers programs to improve water quality. The Kansas Corporation Commission oversees adequate water services and sets rates for water usage. The Kansas Department of Wildlife, Parks and Tourism manages the conditions of rivers and streams. The Kansas Geological Survey provides educational programs on the use and conservation of water. The Kansas Department of Commerce promotes business, commerce, and industry as related to water resources. The Kansas Rural Water Association provides technical assistance to small cities and rural water districts to enhance public health. Local groundwater management districts provide administration for water usage for irrigation.

And local County Soil and Water Conservation Districts are responsible for conservation of water.24

All these agencies exist in Kansas. Each requires annual funding and employs workers in the execution of their designated functions. Common sense would certainly question the necessity of all these agencies and highlights the challenges of abolishing agencies, particularly those that by tradition and history have long existed.

Certainly there are exceptions to the general statement that governments get larger over time and cutting programs and agencies is politically difficult. Governments have cut programs and spending when financial restrictions demanded it, but as a general rule it is reasonable to understand why governments are more likely to grow in size and scope than to shrink. It is the nature of the elected officials who serve to develop new programs, and as societal demands increase, our ‘helpful’ elected officials meet those demands through new programs and taxes to fund those programs.

Lobbyists, the Courts, and Tax Gamesmanship

The U.S. tax code is also expanding due to all the objectives, beyond the mere raising of revenue, that government tries to orchestrate through tax policy. “Over the decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy

hybrid vehicles, turn corn into gasoline, purchase health insurance, buy a home, replace that home’s windows, adopt children, put them in daycare, purchase school supplies, go to college, invest in historic buildings, spend more on research, and the list goes on. One way for the government to engineer economic and social activity is through tax incentives. Recalling Adam Smith and his canons for taxation reminds us that taxes must be ‘certain and not arbitrary.’ The problem with a tax code filled with exemptions is that it is far from certain and in need of interpretation by the courts. The U.S. tax code is more than 74,000 pages in length because it contains, in addition to the statues themselves, thousands of pages of collected court cases on each subject of the tax code. Laws which are uncertain are resolved by the courts, hence the need for thousands of pages of court interpretation and opinion of the tax code.

A government engaged in tax policies designed to manipulate economic and social activity encourages companies and individuals to lobby the government so that tax policies are beneficial and not harmful to their interests. In simpler terms, if there is an advantage to be gained by the taxpayer because the government is willing to hand out tax advantages, then conditions are ripe for lobbying.

Appropriating wealth without producing it is called ‘rent-seeking.’ Rent seeking is the practice of spending your own resources to acquire someone else’s surplus. Companies hire lobbyists to sway public policy to their benefit. The

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25 Russell, “Look at how many pages are in the federal tax code.”

26 Adams, For Good and Evil, 2.

lobbyist does not produce anything of value but rather seeks to allocate some
resource, in this case favored tax treatment, to the benefit their client and reduce
their tax burden. If company A receives a tax incentive from the government then
compny A will pay less in taxes. The government, however, doesn’t decrease
spending and so the revenue forfeited to company A must be made up by Company
B by either imposing a higher tax or creating a new tax. A better explanation is
provided by David Marotta:

Imagine a thriving sea trade in which ships carrying cargo
receive a 20 percent profit on the value of the goods. Now
imagine the first pirate who arms his boat with cannons and
rent-seeks the profit. The pirates are not producing any value of
their own but are spending their own resources to capture the
surplus of the shipping trade. If the pirate ship captures just one
in every hundred ship, the average profit for the traders will
drop to 19 percent. Meanwhile, the pirate is seizing a 100
percent profit. There is incentive to join the rent-seeking pirate
trade. By the time ten pirates are competing for plunder, the
profit of honest merchants has dropped to just 10 percent. At 20
pirates, there would be no profit remaining and no incentive to
engage in the shipping trade.28

Rent-seeking does not encourage production. It is simply trying to gain for
yourself at someone else’s expense. It is no surprise then that lobbying for special
tax treatments is big business. Whirlpool, a manufacturer of appliances, recently
secured lucrative tax credits worth an estimated $120 million dollars for making
high-efficiency products. They spent $1.8 million in lobbying fees over the

previous two years. The return on investment for Whirlpool is 6,700 percent and
total tax expense for the company falls to zero.\textsuperscript{29}

As previously stated, this paper is not about government spending.
Members of Congress and the President have perhaps identified some
environmental benefit that justifies special tax treatment for Whirlpool. There may
also exist a number of other factors in the Whirlpool exemption that are of interest
to Congress, perhaps including job creation or job retention. Perhaps the company
was threatening to relocate their business outside of the United States.

Nonetheless, the $120 million given as a credit to Whirlpool has to be paid by
someone. The budget for government spending did not decrease by that amount.
And herein lies the frustration for the American taxpayer. Some pay more in taxes
while others pay less or no tax at all. The criteria by which that determination is
made is not always clear and certain: it may have been arbitrary. It may have
more to do with the negotiating skill of the lobbyist than the equitable and fair
application of the law, or in some cases, with simply changing the law to achieved
the desired benefit. New taxes are created or increased to fund the constant
shortfall which arises from what David Marotta refers to as “government legislated
rent-seeking.”\textsuperscript{30} All of this points to reasons why the U.S. tax code is 74,000 pages
in length and growing. An environment that encourages tax policy gamesmanship
requires constant changes to the rules and new interpretations of those rules. The

\textsuperscript{29}Christopher Rowland, “Tax Lobbyists help businesses reap windfalls,” \textit{The Boston Globe},
March 17, 2013.

\textsuperscript{30}Marotta, “What is Rent-Seeking Behavior?”
issue of fairness is frustrating to many Americans, particularly those whose tax burdens increase to offset the tax amnesties awarded by the government.

Fair Tax and Flat Tax

Americans disagree on a wide range of issues; Republican or Democrat alike, there is a great deal of disagreement. The complexity of our tax system, however, and reforming the U.S. tax code is one area where everyone is in general agreement. All Americans recognize that the tax code has become hopelessly convoluted. There are so many exclusions, exemptions, and workarounds that companies and individuals with the best accountants and lobbyists come out ahead. As described by Rick Newman, “Inefficiencies require higher tax rates than necessary while generating far less revenue than the government actually needs. There’s one other gloomy consequence of a convoluted tax system: It makes Americans distrustful of government and less likely to support measures which might actually make things better.”

Recalling again my time as an elected official in Kansas, I realize meaningful reform of any program was only accomplished when it was done on a grand scale. Nipping around the edges of programs rarely resulted in significant change because the affected constituency would fight tooth and nail to protect and defend any elements of a program which benefitted them, but by reforming programs in their entirety, all constituents are impacted, positively and negatively.


32Ibid.
If everyone loses a little to gain a lot then there is reasonable framework for significant reform.

Currently, there are two ideas being circulated at the federal level aimed at massive overhaul of our current tax system: the flat tax and the fair tax. Bear in mind that federal revenues in the United States are largely derived from income tax and payroll tax. There is no national sales tax or national property tax; therefore, reforms of the existing system focus on income tax. The current income tax system in the U.S. is a progressive tax, meaning the rate of tax increases as income increases and is then offset by exemptions, tax credits, and tax deductions to determine the effective tax rate. Proponents of the progressive tax like it because it raises revenue by taxing based on the ability to pay: the higher the income, the higher the rate of tax. Opponents of the progressive tax dislike it because it treats everyone differently and those at the top pay significantly more as a percentage of their income. Since 2003, the top 1% of taxpayers in the United States have consistently paid more in federal income tax than the bottom 90%.  

A Flat Tax is a consistent tax rate applied to all tax brackets. Russia has had a flat tax with a rate of 13% since 2001. Senator Ted Cruz and Dr. Ben Carson both include flat tax in their current presidential campaign platforms. Flat tax is a popular idea because it achieves fairness; everyone pays the same percentage. A flat tax would also eliminate or dramatically reduce the need for the IRS. Flat taxes

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are also supported by business because gains from dividends, distributions, capital gains and other income are generally exempt from this tax which should encourage investment and savings.\textsuperscript{35}

Opponents of the flat tax argue that it impacts taxpayers disproportionately because the basic costs of living do not change with income. The cost of milk, bread and gasoline affect everyone equally. Therefore, a 10\% flat tax on a low income household creates a significant hardship. Some flat tax proposals, like the one from Senator Rand Paul, give exemptions and deductions for low income households which quickly changes the flat tax back to a progressive tax system. There is also concern that flat tax programs simply would not generate enough revenue to fund current spending. As a result, there would have to be significant cuts in government spending or large increases in the national debt.\textsuperscript{36}

The Fair Tax proposal is a dramatic departure from the current progressive income tax because it does not tax income at all. The Fair Tax would replace all income tax, including payroll taxes, with a single consumption tax. The tax, as proposed, would be 30\% on purchases of all goods and services. Such a national sales tax concept is popular because it eliminates all income tax and treats all citizens equally based on the consumption of goods and services which are entirely within the control of the consumer. Everyone would be subject to the tax, even those engaged in illegal activities as they also purchase goods and services. It


\textsuperscript{36}Ibid.
would also be possible to eliminate the IRS because retailers would be required to remit collected taxes directly to the treasury.

The opponents of the Fair Tax argue that it is a regressive tax since people have to purchase basic necessities regardless of their income or quality of life. The argument is also made that it will create an undue burden on retailers, many of whom do not currently collect sales tax. The biggest problem with the Fair Tax, as pointed out by Len Burman, is that “very high-income households spend only a fraction of their income, while low- and middle-income people spend all or most of what they make. A sales tax, by design, exempts a large share of income at the top.”

Summary

This chapter explored a variety of subjects. The core problem, however, for all governments of the world, is managing the balance between tax revenue and providing programs which meet the requirements of the nation. This was true for the ancient Sumerians and every government which has existed since. The challenge which threatens governments today is that debt has become the mechanism by which the equation is balanced. When spending exceeds revenues, governments turn to debt to make up the shortfall. The larger the debt, the more governments spend to support that debt which creates additional shortfalls requiring new or increased taxes. Taxes go up, debts increase, and new programs

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continue to be created which require additional debt. As taxes increase, citizens look for new ways to reduce their tax burden and governments are forced to create new laws to ensure compliance. Tax policies are more complex, lobbying and tax gamesmanship create winners and losers, the courts offer more and more opinions, taxpayer frustration rises, and the end result is a frustrating cyclone in which fairness evades everyone.

Whether on the side of more spending or less spending, higher taxes or lower taxes, the innovation required is to the tax system itself. The original premise of this thesis asked the question, “If we had to do it all over again…” Having laid the groundwork, Chapter 3 will delve into that very subject.
CHAPTER 3

REFORMING KANSAS AND
A ‘SIMPLE’ TAX SYSTEM

Kansas, like most states, utilizes a system primarily based on taxes levied from property, income, and sales. The entire annual budget for the State of Kansas for fiscal year 2017 is $16.1 billion. The majority of the budget is funded by grants from the federal government to support various federal programs and priorities. Of the overall $16.1 billion budget, the State of Kansas estimates revenue and spending from taxes to account for approximately $6.4 billion of the total budget.\(^1\) Of the $6.4 billion in state tax revenue anticipated for fiscal year 2017, the State estimates that $2.995 billion will come from income tax and $3.226 billion from sales tax, liquor tax, cigarette tax and a variety of other miscellaneous excise taxes to comprise the bulk of state revenue.\(^2\) In addition to state taxes, local units of government in Kansas including counties, cities, and townships levy an additional $5.1 billion in taxes to support local government. The bulk of local tax revenue is raised through property taxes.

The History of Taxation in Kansas

The history and tradition of taxing property in Kansas deserves some discussion. The first territorial taxes were levied in Kansas in 1855 and included a tax on all property, real and personal, and a $.50 flat rate poll tax on free male


persons between the ages of 21 and 55 years of age. Counties were permitted to add a county levy so long as it did not exceed the territorial tax by more than 100 percent. The local Sheriff was the collector of tax revenue and maintained a tax book which included procedures for demanding payment as well as guidelines for seizing and selling goods for nonpayment of taxes.

The early territorial tax in Kansas was levied to provide for basic administration, maintain law and order, develop road systems, establish schools and prisons, and to record and protect land titles. Property, in the early days of the Kansas territory, was the only measurable asset that could be taxed on a large enough scale to generate meaningful revenue. There were no mechanisms in place for taxing income or infrastructure nor was there a large enough volume of goods and services purchased to warrant any form of consumption tax.

Assessments were made on the value of land and taxes were collected accordingly. Taxes on personal property in the old Kansas territory were based on a system of ‘self-assessment.’ Property owners filed an affidavit stating the value of their property. The affidavit was co-signed by a disinterested resident of the same ward or town vouching for the accuracy of the affidavit. It was the responsibility of the local assessor to verify the accuracy of the property values listed on the affidavit.

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4Ibid., 67.

5Ibid., 53-69.
Kansas became a state on January 29, 1861. The structure of government consisted of a state government, a county government in each of the 105 counties of the state, and cities and townships within each of those counties. In 1861, logistical challenges made it necessary to form many entities of government so that local services could be provided. As an agricultural state, Kansas founded cities and townships in areas of the state convenient to the needs of the local farmer. As local taxes were collected, it was the responsibility of a locally elected board of supervisors to determine the amount of money needed and the allocation of those funds, particularly for school purposes.

Early Kansas suffered from the challenges of implementing and managing a property tax system. Defining taxable property, property ownership, the valuation of property, the proper jurisdiction to oversee taxation, collection, and distribution, were all complex problems in a newly created state without any of the modern benefits of communication or infrastructure to support the system. The problems were increased by decisions of the Legislature in the 1870’s to issue exemptions for certain property as well as the constant struggle to determine the value of intangible personal property.

From the outset, citizens expressed great dissatisfaction with the system. “Almost every governor from the beginning of statehood until the end of the

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8Ibid., 88-90.
century denounced the tax or its administration. The state auditor’s reports often contained even longer and more detailed criticism, and sometimes the state treasurer joined in with a word or two denouncing some aspect of the tax.”

In 1872, F. W. Giles published a 40-page report expressing frustration with the current system after the Kansas supreme court failed to provide remedy to taxpayers whose property was overassessed. “He noted that assessors have little data on which to base a decision. There are few sales and the assessor can only call to mind the price he has quoted a real or imaginary inquirer for his own farm.” Giles went on in his report to present great variations and abrupt fluctuations in the average value per acre among townships throughout the counties.

Court challenges to the property tax law increased, additional studies were commissioned, and citizens continued loud and forceful condemnation. By the early 1900’s, numerous reports had concluded that property in Kansas was poorly and unfairly assessed. The largest problem of the system was that assessments were competitive from county to county and assessors were under enormous pressure from fellow citizens to undervalue property to keep tax burdens low.

The shortfalls of property tax systems have been well documented in this thesis and Kansas is no exception. However, the system devised in the 1850’s remains largely in use today. There have been improvements to the assessment

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9Ibid., 113.
10Ibid.
11Ibid., 124.
process over the years, enforcement greatly enhanced, improvements to administration through technology, and abolition of the old ‘self-assessment’ protocol. The fundamental system, however, including local assessment and taxation by cities, counties, and townships, is still in practice. Income is a better measure of ability to pay and sales tax is easier and cheaper to administer. Unfortunately, the property tax system still exists in Kansas because there is simply no other tax capable of financing local government. Among many smaller counties and cities in Kansas, there is little to no sales tax base and many have little income tax base. Given those circumstances, the elimination of the property tax would require the state to assume responsibility for funding local units of government that currently rely on property tax. “Local governments financed from state funds would have little incentive to operate economically and would lobby hard to maintain or increase their share of revenue. Local governments entirely dependent on state grants will, in the long run, have little autonomy.”

Real and personal property in Kansas had a combined assessed value of $31 billion for tax year 2014. Statewide, local units of government collected $4.1 billion in revenues from property tax in 2014, the latest year for which complete data is available. 46% or $1.89 billion of collected property tax revenues went directly to local school districts.

Ibid., 210-211.

In addition to property tax, a statewide income tax was levied in Kansas beginning in 1933 as a result of changes to the State Constitution. The tax rate is progressive based on income earned. From 1933-1956, the income tax rate ranged between 1% and 4% of federally adjusted gross income. The top rate of 4% was applied to individuals with incomes above $25,000. From 1977-1987, the top rate was 9%.\textsuperscript{14} The current top income tax rate in Kansas today is 4.6%.

In 1963, the state imposed a privilege tax on banks, savings and loan associations, and trust companies, in lieu of an existing 5 mill intangibles tax.\textsuperscript{15} The privilege tax rate is 2.25% on the first $25,000 of income. Banks pay 2.125% on income in excess of $25,000 while savings and loans and trust companies pay 2.25% on incomes in excess of $25,000.\textsuperscript{16} The tradition of taxing banks and savings and loans at separate rates from other businesses, as well as referring to it as a privilege tax, is a strange anomaly in Kansas tax policy.

For tax year 2013, the State of Kansas issued income tax credits totaling $172 million. Tax credits were issued for more than forty programs for activities such as alternative fuel use, agritourism, business and job development, film production, historic preservation, and venture capital investing. The largest income tax credit, by far, is a state extension of the federal Earned Income Tax credit which

\begin{itemize}
  \item\textsuperscript{14} Chris Courtwright and April Holman, \textit{Kansas Tax Facts} 7th Ed. (Topeka, KS: Kansas Legislative Research, 2000), 41.
  \item\textsuperscript{15} Ibid., 46.
\end{itemize}
provides income tax refunds for low to moderate income households. This program accounted for $85 million of the total tax credits issued in 2013.\textsuperscript{17}

The first sales tax in Kansas was adopted in 1937 as part of the ‘Retailer Sales Tax Act’. The law was expanded in 1970 to authorize local units of government to also levy a sales tax. As of July 1, 2015, the state sales tax rate in Kansas is 6.5\% with local units of government authorized to levy an additional sales tax from 0\%-5\%.\textsuperscript{18} All local sales taxes are collected and distributed by the State. The State of Kansas generated $2.54 billion in statewide sales tax revenue in 2015. Local sales tax in counties and cities accounted for an additional $1.03 billion.\textsuperscript{19}

Beginning in the 1970’s, Kansas awarded a variety of sales tax exemptions which remain in effect today. The following list of sales tax exemptions is not all inclusive but simply an illustration of the expansiveness of the exemptions awarded:

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  \item 1977-all labor services
  \item 1979-services received from electric, gas, and water utilities
  \item 1980-used farm machinery, equipment, parts, and repair
  \item 1985-used mobile homes
  \item 1987-40\% of the price of new mobile homes
  \item 1988-manufacturing machinery and equipment
    \begin{itemize}
      \item new farm machinery, seeds, and tree seedlings
      \item drill bits and explosives for the oil and gas industry
    \end{itemize}
  \item 1987-2009-sales tax exemptions for certain activities
\end{itemize}

\textsuperscript{17}Kansas Annual Report 2015, 30-33.


\textsuperscript{19}Kansas Annual Report 2015, 35-47.
of not-for-profits or whole exemptions for specific not-for-profit agencies\(^{20}\)

Between 1985 and 2009, sales tax exemptions grew from 30 to almost 100. The estimated cost of sales tax exemptions for tax year 2009 was $4.2 billion. Of this total, $3.4 billion was found by the Kansas Legislative Division of Post Audit to be necessary and unavoidable. These exemptions eliminate issues of double taxation associated with manufacturing and motor fuels and also exempt all purchases by government agencies. The remaining $800 million in exemptions have been awarded to specific organizations or activities. In many instances, these exemptions provide questionable benefit to the state and in other cases, according to state auditors, create unfair competitive advantages for some organizations and businesses over others.\(^{21}\)

The State has recognized the need to reconsider these tax exemptions as well as develop new strategies aimed at broadening the overall tax base. In 2005, the Special Committee on Assessment and Taxation was tasked with an analysis of State and local tax policy, which included discussions of the tax mix, concerns about mill levy increases in rural areas, tax base erosion, growing State and local debt, and a declining elasticity of State General Fund tax receipts due to growing earmarks and a general shift towards service based industry. After numerous hearings and reports from the Department of Revenue, the Committee


recommended additional studies of tax base erosion. The 2006 Special Committee on Assessment and Taxation was tasked with reviewing the latest Department of Revenue research on erosion of sales and property tax bases. The Committee conducted numerous hearings and then strongly recommended additional studies of unfair competitive advantages afforded through exemptions. The 2007 Special Committee on Assessment and Taxation again reviewed sales tax exemptions and strongly recommended the Legislature consider establishing objective standards for granting sales tax exemptions. These results, humorous in their indecisiveness, highlight the challenges of tax reform.

The Brownback Tax Experiment

The current Governor of Kansas is Sam Brownback (R). He was elected to office in 2010 with a pledge to cut taxes. The Governor’s tax advisor was Arthur Laffer, a Reagan-era supply side economist who encouraged the Governor to dramatically cut income taxes. He argued that such a move would lead to an economic explosion in Kansas with large increases in both new businesses and new jobs. In 2012, Kansas enacted the largest tax cut in state history. The State repealed its top individual income tax bracket of 6.45 percent and lowered its other two brackets of 3.5 percent and 6.25 percent to 3 percent and 4.6 percent, respectively. More significantly, the state exempted from taxation all income earned by limited liability companies and S-Corporations; in other words, income tax on

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22Performance Audit Report, 11.
pass through entities. Brownback, after signing the tax cuts in 2012, pledged the cuts would act as a “…shot of adrenaline into the heart of the Kansas economy.”

The tax cuts were expected to cost the State $800 million in revenue. The tax package was sold, however, as a way to boost the economy and spur investment and job creation. It was believed the $800 million in lost revenue would be quickly recaptured through business and job creation. “Arthur Laffer, who developed the Kansas tax cut plan, practically guaranteed success. But it didn’t work. The Kansas economy is stagnating, the deficit has grown, and the state’s bond ratings have been embarrassingly downgraded.”

In 2013, the State estimated revenues of $6.4 billion, but actual revenues fell short by $73.1 million. In 2014, the State lowered revenue estimates to $5.9 billion. Actual revenue again fell short by nearly $300 million. The gap widened further in 2015 as the state’s finances became further strained. In the first quarter of 2016, the Governor announced budget cuts to education of $53 million while at the same time borrowing money from state highway funds and delaying payments into the state pension fund to fill gaps in the budget resulting from revenue shortfalls. The State of Kansas today is in financial crisis. The State is

24 Ibid.
constitutionally banned from borrowing money to fund the state budget. As a result, options are limited. Borrowing from the Highway Fund or withholding money from the state employee pension fund are short term solutions, but at some point those funds will either need to be restored or the State will be forced to cut much needed highway projects or make further cuts to education. With such grim forecasts, there must be a sense of urgency to introduce meaningful reform to the system of taxation in Kansas.

Successful Tax Systems

In order to reform Kansas tax policy, it’s instructive to consider the successful tax policies of other governments. There are places in the world where tax policy functions more effectively, business is encouraged to flourish, citizens feel fairly and reasonably taxed, and the government successfully provides for the needs of the citizens. The nation of Estonia from the former Soviet Union provides such an example. According to the International Tax Competitiveness Index, Estonia has the most competitive tax system in the world. Estonia has a flat income tax rate of 21%. Businesses, however, only pay tax on distributed profits. If a company makes $100 profit, but retains the earnings in the company, it is not taxable. Tax is only collected in the event the company distributes profits to its owners and shareholders. In that instance, it is taxed at a flat rate of 21%. Estonia also has a 100% tax exemption on foreign earned income. This provides enormous
incentives for foreign companies to invest in Estonia as profits earned are free from taxation.  

Estonia also has a neutral tax stance on property values. The property tax in Estonia is based only on the value of the land. There is no additional property tax levied on the structures on the land, therefore, businesses may build new facilities or expand structures without facing a higher property tax bill. Additionally, there are no estate taxes, transfer taxes, wealth taxes, or taxes on financial transactions. Estonia has also been on the forefront of tax filing technology. While many countries and states require pages and pages of tax documents to file, Estonians file their taxes online, and it takes only a matter of minutes for the average citizen to file.

New Zealand is another nation recognized globally for having fair tax policies which are simple and easy to understand. New Zealand has a flat business tax rate of 28%. Personal income tax rates range from 10.5% to a top rate of 33% based on income earned. There is also a simple, flat Goods and Services Tax (GST) of 15% on most items purchased. The GST is simple compared to other countries that utilize a Value Added Tax with confusing levels of taxation at different levels for different products and services. What makes New Zealand’s system appealing is its simplicity. There are no inheritance taxes, general capital

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29 Ibid.
gains taxes, cumbersome local or state taxes apart from a levy on property, no payroll tax, social security tax, or taxes on health care.\textsuperscript{30}

Many of the tax reforms undertaken by countries are not always directly applicable to Kansas. Many of these strategies would be more effectively implemented by our federal government, but in their simplicity they are instructive as reforms to Kansas tax policy are considered.

Reforming Kansas Tax Policy

As the monumental task of reforming Kansas tax policy is undertaken, it’s important to begin with some key lessons from history. Fairness is the most important element of tax policy. In most instances, fairness is more important than the tax rate itself. If individuals or businesses of similar circumstance pay varying rates, it only serves to promote dissatisfaction and frustration among taxpayers.

Taxes also have to be easily understood. Convoluted systems of tax breaks, tax credits and special exemptions not only frustrate taxpayers, they also call into question the credibility and effectiveness of the government itself.

Tax policies must also be business friendly. No government can survive long term without a thriving economy. In this modern time, it is simply too easy for businesses to relocate. The competition for good firms is ongoing, and if a state has unfavorable tax policies for business, businesses will simply go elsewhere. While many in Kansas favor higher and higher taxes on business, this is simply impractical. As history has taught us, everyone desires to pay less in taxes if given

the option. If that option is as easy as crossing a state line, there is little benefit to
tax policies that are overly burdensome to business.

Tax policy also has to be broad in scope. When tax exemptions are given,
someone else has to pick up the tab. Over time, this effect narrows the tax base.
As exemptions grow, the burden on those who pay tax continually rises to account
for those who are exempt. If fairness is restored, the tax base gets wider. As
participation increases, the overall average burden to the individual taxpayer is
decreased. In other words, the more people paying into a system, the less everyone
is required to pay.

Lastly, reform must be done on a grand scale. If done piecemeal, as history
has shown, it’s nearly impossible to accomplish significant reform. Where taxes
are concerned, it’s often easier to abolish a program entirely than to carve out
individual winners and losers within the program. Based on these fundamental
rules, here are proposed changes to existing Kansas tax policy which will both
restore fairness and solve the State’s financial crisis.

**Income Tax:** Income is the most accurate way of assessing ability to pay.
Current income tax rates in Kansas vary widely from 0% for Limited Liability
Companies and S-Corporations to 7% on companies with earnings in excess of
$50,000. There are two rates for personal income tax: 2.3% on lower incomes and
4.6% on incomes in excess of $30,000 for married couples filing jointly or $15,000
for individuals.³¹ Additionally, as previously discussed, a separate income tax

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³¹ Kansas Department of Commerce, Taxes and Incentives, http://kansascommerce.com,
(accessed March 10, 2016).
referred to as the ‘privilege tax’ is assessed on banks, savings and loans, and trust institutions. There are also a wide variety of convoluted income tax exemptions for job creation, business expansion and investment.

Kansas tax policy would be greatly simplified by implementing a flat income tax of 4% on all incomes, business and individual, while at the same time eliminating the complex system of tax credits associated with job creation and investment. The implementation of a flat income tax would not only simplify the current system, but increase compliance. In addition, the privilege tax should be abolished and institutions which currently pay the privilege tax revert to the simple 4% flat tax. The current federal tax system, which utilizes the widely accepted adjusted gross income calculation, could be easily used and applied for purposes of calculating the 4% flat rate tax in Kansas. If legislators deemed it appropriate, an exemption on households earnings less than $30,000 per year could be maintained without much adverse effect to overall state revenue.

A flat income tax in Kansas responds well to the issue of fairness. Income is an acceptable measurement of ability to pay, and taxing all individuals and entities at the same rate provides the fair and balanced approach required. Such a change in policy would also greatly enhance revenue for the state as the current 0% rate on Limited Liability Companies and S-Corporations would be repealed so that all business entities would be treated equally. This change to a more balanced approach would do much to improve the current financial crisis in the state.
Four percent is the correct flat tax amount for Kansas for one primary reason: it’s lower than other surrounding states. Colorado has a flat personal and corporate income tax rate of 4.63%. The top individual and corporate tax rates in Oklahoma are 5.0% and 6.0%. Nebraska has a top individual tax rate of 6.84% and a top corporate tax rate of 7.0%. Missouri has top rates of 6.84% on personal incomes and and 6.25% on corporate incomes. A lower income tax rate in Kansas should not only minimize corporate flight, but may well serve to encourage businesses and individuals to relocate to the state. Governor Brownback was correct in recognizing that income tax rates in Kansas needed to be lowered, but incorrect in thinking that income tax rates needed to be zero. A just system of flat taxation, coupled with rates lower than the bordering states, is adequate to stimulate economic development and maintain fiscal responsibility.

**Sales Tax:** As is the case with current income tax policy, the state sales tax has become wholly out of balance based on the expansive number of exemptions granted by the State Legislature. So many sectors of the Kansas economy are exempt from paying sales tax, most notably agriculture, oil and gas, labor services, utilities, and many charities, that it requires a heavier burden on all other taxpayers to account for the shortfall. These exemptions should be repealed to return the sales tax to a broader, more equal footing. Repealing these exemptions is politically difficult for the legislature as noted in the numerous attempts at reform in recent years. The legislature would be wise to put these exemptions,

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collectively, on a statewide ballot and allow the citizens in one loud voice to repeal them in total. Such a move would resolve the issue without requiring the legislature to make difficult, politically awkward choices.

Eliminating these exemptions would generate significant revenue for state and local units of government. Increased sales tax revenue would also allow the state to reduce the overall state sales tax rate, currently at 6.5%. If sales tax rates declined, it’s reasonable to assume that consumer spending would increase for the average Kansan, particularly on such larger ticket items such as automobiles and expensive household appliances.

Lastly, it should be noted that Kansans pay sales tax on groceries. 6.5% sales tax on groceries is one of the highest tax rates in the country and poses a significant burden on low and middle class families. Leveling the playing field would not only allow the state to lower sales tax rates, but also create a reasonable financial cushion so that tax on basic necessities, like groceries, could be abated to the benefit of all Kansans. Regardless of income, all citizens purchase groceries and would benefit in more or less equal terms by the elimination of this tax.

Property Tax: Property tax is the oldest tax in Kansas and likely the most detested. It remains in use because no other mechanism has been discovered for providing funds to local units of government. The tax itself, however, as pointed out by Glenn H. Fisher, “…is so flagrantly inequitable that its retention can only be explained through ignorance or inertia.”

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Local state assessors determine the value of all property in the state on January 1 of each year. Those valuations, absent any actual sale transaction, are based on an estimate of similar properties or comparable sales of similar properties. These values vary widely from county to county. Once a total valuation of all property within a taxing jurisdiction is determined, the local government sets the tax rate or mill levy against the value of the property. Different types of property have different classifications and differing fractional assessment rates. The inconsistencies in the system have created an environment where valuations are constantly challenged and appealed. The real problem of the system is that local units of government determine the tax revenue required and assign valuations to ensure adequate tax revenues are collected. If assessed valuation decreases, then the mill levy is increased to make up the shortfall. Conversely, if valuations rise, the mill levy is decreased and local government generates the same amount in tax revenue. By all accounts, it’s a shell game using approximate valuations to derive a desired revenue outcome. The issue is one of fairness. One homeowner may challenge the valuation of his or her property and receive tax relief while another homeowner pays more to make up the difference. By practice, the system has become institutionalized, but the fundamental unfairness of it remains a challenge.

The system is further complicated by the enormous number of property tax exemptions. Kansas Statute 79-201 states that “…all property owned by religious, educational, literary, scientific, benevolent, alumni associations, veterans organizations or for charitable purposes, parsonages, community service
organizations providing humanitarian service; electric generating property using renewable technology; landfill gas and production are exempt from all property or ad valorem taxes levied under the laws of the State of Kansas.”34 In addition to state exemptions, local units of government issue exemptions to businesses to encourage them to relocate to their city or county. This is particularly true in metropolitan Kansas City where suburban cities routinely use tax exemptions to compete against one another to attract new business.

The only reasonable solution to the property tax dilemma is to abolish it entirely. The challenge of replacing the system, however, is daunting. Property tax in Kansas accounts for $4.1 billion in revenue for local units of government. The property tax, along with about $1 billion of local sales tax revenue, accounts for nearly 100% of the budget for local units of government.35

If this system must exist, the only reasonable modification is to the assessment process. If the arbitrariness of valuation is the biggest frustration, then the simple solution is to lock in current assessed values. Appraisers should take the average appraised value of a property over the last five years and fix that as the value of the property. The locked in valuation incorporates today’s arbitrariness, but alleviates the annual frustration and fluctuation in value going forward. Over time, the actual value of property will likely increase, but the tax value would remain constant. In other words, a home worth $100,000 today might be worth


35Kansas Annual Report 2015, 73.
$200,000 on the open market ten years from now. For tax purposes, however, the home remains valued at $100,000. Even after the home is sold to a new buyer, regardless of the actual purchase price, the home remains valued at $100,000 for tax purposes. The tax value of the property is now disassociated from the real value. The local government will likely raise the mill levy over time to generate more revenue, but integrity is restored because the government can’t use valuation to derive additional revenue. Values have become fixed, therefore, government must transparently raise taxes and can no longer hide behind the veil of increased valuation.

New construction, whether commercial or residential, would be valued similarly to other buildings or homes within the same geographic area. By way of example: a homeowner spends $300,000 to build a new home in a neighborhood where tax valuations average $100,000 per home, the new home is worth $300,000, but for tax purposes is valued at $100,000 to remain consistent with other homes in the neighborhood.

This approach to property tax assessment is a modification of the Estonian property tax policy. Recall that Estonia taxes the land, but not the structures built upon the land. Similarly, this proposal sets the tax value of the property at 2016 levels, and therefore, for commercial and residential owners alike, there are no longer disincentives to improving property. Home remodeling and expansion of existing commercial real estate is not punished by increased property taxes.
Furthermore, there would be tremendous incentive for new construction in blighted areas due to the lower tax valuations on property in those neighborhoods.

Another important step toward simplifying the property tax system would be a reduction in the number of property classifications. The current system is designed to account for every possible type and use of property, and each has a different tax rate. The process should be simplified by utilizing five classifications of property: commercial, residential, agricultural, land not used for agricultural purposes, and exempt (limited to church buildings, schools and educational buildings, and governmental property). Reducing the number of classifications and fixing property values at 2016 levels would not only simplify the system, but should generate enormous savings for state and local government.

In addition to fixing values on real property, the tax on personal property should be abolished completely. Real estate accounts for over 90% of the assessed valuation of property in the state.\textsuperscript{36} The revenue collected by taxing personal property is simply not worth the enormous investment of time and resources it takes to collect. Adam Smith reminds us in his fourth canon that governments should not undertake taxes unless the revenue obtained is worth the expense to the state. Taxing personal property in Kansas no longer fits that criteria.

Lastly, in the interest of fairness, the state should eliminate property tax exemptions for all property not used directly for religious, educational, or governmental purposes. Requiring charities to pay property tax is a difficult

\textsuperscript{36}Kansas Annual Report 2015, 71.
challenge politically, but charities should be supported by donations from interested citizens who receive a tax deduction for their gifts, not by the state at the expense of other taxpayers who are forced to pay higher rates to account for the shortfall. The same principle is true for all other entities that receive property tax exemptions from state or local units of government. The goal of any tax system should be equality and fairness.

The Kansas Simple Tax

If the State of Kansas were a new state and we had to do it all over again perhaps there would be an easier, better way to achieve the desired results. Taxes on liquor, cigarettes, fuel, personal and commercial vehicles account for $1.2 billion in annual revenue. Assuming those taxes remain in place, as well as the myriad of other small taxes on this and that, the state would need approximately $10.3 billion in annual revenue to fund current obligations. This number includes $5.2 billion required by State government plus an additional $5.1 billion that counties, cities, and townships require to provide local services.

The Kansas Simple Tax is a two tax system: a flat tax on income and a simple progressive poll tax. The flat tax on income would be set at 4% for all individuals and businesses alike. The first $25,000 of income should be exempt to provide a safety net for taxpayers on the lower end of the income scale but should be equally applied to everyone to maintain fairness. All income above $25,000

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should be taxed equally at 4%. The federal tax calculation for ‘adjusted gross income’ should be used as the baseline.

The total income for individuals in Kansas in 2015 was approximately $76 billion filed by 1,469,265 tax returns. Corporate income tax and the privilege tax generated an additional $500 million in tax revenue.\(^{38}\) Corporate tax revenue is more difficult to estimate given the uncertain fluctuations in the economy, but it’s reasonable to estimate that a 4% flat tax on all incomes would generate approximately $5 billion in revenue to the state, $4 billion from individual tax returns and an additional $1 billion from businesses, particularly as the current 0% tax on Limited Liability Companies and S-Corporations is increased to the 4% level.

If income tax generates $5 billion in revenue for the state, a balance of $5.3 billion remains to maintain funding at existing levels. As of July 1, 2015 the United States Census reported a total population in Kansas of 2,911,641.\(^ {39}\) The average Kansan generates $876 per year in sales tax revenue for the state and pays an additional $1,437 in real/personal property tax.\(^ {40}\)

The Kansas Simple Tax abolishes sales tax and property tax completely. Revenue from those tax programs is replaced by a simple progressive poll tax paid by every individual based on household income earned. In 2015, 42.37% of

\(^{38}\)Kansas Annual Report 2015, 22.


\(^{40}\)Kansas Annual Report 2015, 13.
Kansas households, representing 1,233,370 Kansans, had incomes of $25,000 per year or less. 1.46% of Kansas households, or 42,510 Kansans, had incomes in excess of $250,000. All other taxpayers, obviously, fall somewhere in the range between.

The Simple Tax rates for Kansans would be as follows:

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Rate per person</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $25,000</td>
<td>$400 per person</td>
</tr>
<tr>
<td>$25,000 to $50,000</td>
<td>$1,000 per person</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>$1,700 per person</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>$2,500 per person</td>
</tr>
<tr>
<td>$100,000-$250,000</td>
<td>$3,400 per person</td>
</tr>
<tr>
<td>More than $250,000</td>
<td>$4,500 per person</td>
</tr>
</tbody>
</table>

The per person rate applies to all individuals within a household. In other words, if a married couple, filing jointly, has income of $100,000, then the husband and wife, and each of their children within the household, would pay $2,500 per person. Children pay the same rate as the adult that claimed them on their federal tax return. The rates are proportional because it’s reasonable to assume that individuals with higher incomes generally purchase more goods and services, eat out more frequently, own more property, and live in more expensive homes. Based on 2015 data, this simple tax on individuals would generate approximately $3.7 billion in revenue.

The Kansas Simple Tax for business follows the same methodology but is based on number of employees. There are 1,140,300 private sector employees in

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41 Kansas Annual Report 2015, 22.
the State of Kansas as of February, 2016. In order to achieve the $1.6 billion in revenue required from this group of taxpayers to meet state and local funding requirements, businesses would have to contribute an average of $1,500 per employee. This would create an enormous burden on small business unless the rates were similarly proportioned based on the adjusted gross income of the business. Business income data in Kansas is not publicly available, but by way of example, the business simple tax rates might be as follows:

<table>
<thead>
<tr>
<th>Business Adjusted Gross Income</th>
<th>Tax Rate per Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $25,000</td>
<td>$100 per employee</td>
</tr>
<tr>
<td>$25,000 to $100,000</td>
<td>$300 per employee</td>
</tr>
<tr>
<td>$100,000-$500,000</td>
<td>$500 per employee</td>
</tr>
<tr>
<td>$500,000-$2 million</td>
<td>$1,000 per employee</td>
</tr>
<tr>
<td>$2 million-$5 million</td>
<td>$2,000 per employee</td>
</tr>
<tr>
<td>$5 million-$10 million</td>
<td>$3,500 per employee</td>
</tr>
<tr>
<td>more than $10 million</td>
<td>$5,000 per employee</td>
</tr>
</tbody>
</table>

On the surface, these rates might appear harmful to the business climate and perhaps discourage job creation. Realize, however, that these rates are in lieu of sales and property tax currently paid by these businesses. The small farmer, with a handful of employees, benefits enormously by the elimination of property tax. Large manufacturers with thousands of employees also benefit by not paying property tax on the facilities and equipment used in the manufacturing process or sales tax on equipment required. Similarly, small retailers and restauranteurs benefit by not charging or remitting sales tax and by realizing an increase in consumer spending as a result of the eliminated sales tax. Although difficult to

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calculate, the elimination of the sales tax should also result in an increase in out-of-state shoppers coming to Kansas to buy goods and services. Lastly, repealing property tax and sales tax creates enormous savings for state and local units of governments as the infrastructure and employees required to support these programs would no longer be required.

Perhaps the greatest benefit of repealing sales tax and property tax is that if there is no tax, there are no exemptions. The playing field is leveled and a just and fair system of taxation is restored. The simple tax is also consistent with maintaining the autonomy of local units of government. Taxes can be collected by the state and easily remitted to the tax jurisdiction where the individual taxpayer or individual business is located. This policy also encourages a practice which does not exist in Kansas today, the direct incentive for cities and counties to attract more people. Just as the Japanese Hometown Tax encourages struggling communities to invest in themselves, local communities in Kansas might invest to improve their attractiveness to new residents.

The implementation of the Kansas Simple Tax also allows for a much simpler, online tax filing process. A Kansas taxpayer could access an online portal and enter three pieces of data: Social Security Number or Federal Taxpayer Number; adjusted gross income from the federal tax return; and, in the case of a business, the number of employees in the business. The state could easily include vehicle data on the portal and through this system greatly simplify the process for vehicle registration and renewal. Tax filing would be simple and streamlined and
accomplished in a matter of minutes. But, above all, the Kanas Simple Tax would be fair.

Summary

There is a good reason Kansas has not attempted significant tax reform in decades. Tax policy is complex and tax paying is an emotional and significant issue for all taxpayers. The Kansas Simple Tax is a fair, balanced, easily understood approach to funding government at the state and local levels. If we had to do it all over again, it would certainly be preferable to our current convoluted system.

Of course the recommendations offered here are by no means exhaustive. Experts may well question the methodology, look for shortfalls in both the data and the conclusions, and anticipate a whole host of unintended consequences. My hope, however, is that this thesis will at least generate conversation in Kansas and encourage our elected officials to consider genuine reform as an alternative to continually trying to fix a broken system. I recognize this is innovative tax thinking and changes to any system pose challenges which are potentially difficult and painful. But a just and fair system should be our goal above all else. Kansas has a long tradition of progressive, forward thinking. Perhaps the time is right to reimagine the tax system.


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