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How Do Tax Laws Reflect American Values?

William J. Wilkins

The American tax system is complicated and often confusing. Federal, state, and local governments all hold powers of taxation fundamental to their operation, producing sources of revenue for government services. There are many different types of taxes: sales taxes, property taxes, estate taxes, payroll taxes, licensing and fees, and the type most people think of first— income taxes. In addition to the federal income tax, most states also tax income of their residents and non-resident workers. Taxes have been shaping American history since its beginning—provoking revolution, inspiring representative government, financing war and major domestic initiatives, building modern society, and influencing individual behavior. In a recent interview with Tiffany Willey, tax lawyer and expert William J. Wilkins explained how established tax laws reflect American values and public policy priorities.

How does American tax law reflect our values?

In the United States, the tax systems of the various levels of government reflect familiar American social values—some of long standing and some that reflect more modern commercial and cultural developments. Some aspects are the obvious encouragements in the tax system for activities such as charitable giving and home ownership. On a broader level, however, our tax system reflects the pluralism and diversity of our society; our skepticism of concentrated government power; the importance of property ownership and hard work; respect for the rule of law; our transformation into a modern commercial economy; and our basic sense of fairness.

How does our tax system reflect respect for the rule of law?

Our tax system is consistent with respect for the rule of law—being a government of laws and not of men. The tax collector only has such discretion as interpretation of the duly enacted tax laws provide—and even that discretion is subject to review by the courts. Congress often takes the opportunity to change tax laws in response to IRS interpretations and court decisions. In the end, it is the legislative process that decides how we are taxed, which reflects our particular form of self-government and our skepticism of concentrated power.

What is the role of federalism—the relationship between the federal and state governments — in our tax system? Are there instances where the states have greater taxing powers than the federal government?

Many of the great debates and decisions of the founding fathers dealt with balancing the roles of the states with the role of the federal government. The federal, state, county, and city governments all exercise taxing powers, which presents a similar set of balancing issues. States generally have broad taxing powers, and the federal government often takes voluntary steps to accommodate and defer to state taxing powers. For example, the federal government has so far declined to collect property taxes such as real estate taxes, leaving these taxes to state and local governments. The same is generally true of sales taxes. Where federal and state taxes overlap, the federal system typically defers in some way to the state system. For example, income and estate or inheritance taxes are imposed at the federal level and are also often imposed at the state level. In the case of such an overlap, the federal tax system permits a taxpayer to reduce his or her federal tax based on the amount of state tax paid. State tax systems do not provide any similar relief based on federal tax paid.

Can state governments impose any taxes they wish? Are there legal or other constraints on their taxing authority?

As a matter of constitutional law, the states are forbidden from imposing taxes that place undue burdens on interstate commerce—one of the important goals of the Constitution being to assure open borders among the states. As a result, states know that efforts to impose differential tax burdens based on whether or not the taxpayer is based inside the state are subject to constitutional challenge. There are also basic jurisdictional bars that require a minimum level of in-state activity before an out-of-state person can be subject to state taxation. These rules are likely to evolve in response to changes in the economy, but the basic principle will continue to be that a state cannot tax a person who does not in some way access the customers, facilities, or other aspects of the state's economy and infrastructure.

We live in a mobile society. What happens, for instance, if someone lives in one state, but works in another? How are they taxed by these states?
There are systems to coordinate among states. For example, where an individual works in one state, but lives in another state, the individual normally files a return in both states, but uses a tax credit system so that the same income is only taxed once. Under this approach, the worker's income is taxed first by the state where the individual works. Then the worker's state of residence collects additional tax on the same income only if the residence state's income tax rate is higher than the job state's rate. If the state of residence has the same or lower tax rates as the state of employment, the residence state will collect no tax on the worker's income. In addition, multistate organizations seek to coordinate definitions of taxable income and items subject to sales taxation, so that multistate businesses are subject to similar rules from state to state. These coordination efforts usually fail to achieve complete coordination, but there is increasing consensus on the most significant issues.

Who shapes the tax legislative policy in the United States? How does this compare to other countries?
In a parliamentary form of government, the executive would largely dictate the content of tax laws, because he would control both the executive and legislative officers. Accordingly, in many European governments, a tax proposal made by the treasury or tax authorities is normally enacted in very much the form originally proposed. In the United States, on the other hand, the president's party often lacks control of one or both Houses of Congress; and in any case, each House contains significant resources for studying, proposing, and amending tax legislation. As a result, the tax legislative process usually involves significant consultation among powerful, independent players. The U.S. Treasury Department and IRS are almost never able to dictate detailed results.

Taxes have never been popular, but which have been particularly controversial among Americans?
Our tax system reflects our history and tradition favoring private property and an economy dominated by capitalism. Taxes that are collected in "lumps"—upon a property owner's death, upon the sale of property, or with an annual assessment based on property value—have been among the most controversial of all American taxes. Sensitivity to the wealth-destroying aspects of these "lumpy" taxes has led governments at all levels to consider and adopt extensive relief measures from time to time.

ENRICHMENT ACTIVITIES

Tiffany Willey

1. Our current federal income tax system is typically characterized as "progressive." Refer students to the definition in Wilkins's interview. Have them research income tax systems in other countries. How do they compare to the United States? Then ask them to research tax reform proposals, including introducing a "proportional" or "flat" tax. Finally, ask students to answer the question, "Is the current federal income tax system fair? Why or why not?"

2. Have students examine how their school is funded through taxes. What portion comes from local property, state, or federal sources? Have them research school funding in other states and communities. Ask them to consider if their school's funding is adequate. Is it fair? Should it be changed? Why? How?

3. There are many federal income tax credits and other exemptions available to American taxpayers. Ask students to find out more about them. Why do they think they are included in the tax laws? What values do they promote? Ask students if the promoted values are worthwhile.

4. The federal government's right of taxation is described in the Constitution. Ask students to read through the articles of the Constitution and find clauses that deal with taxation. What do they say?

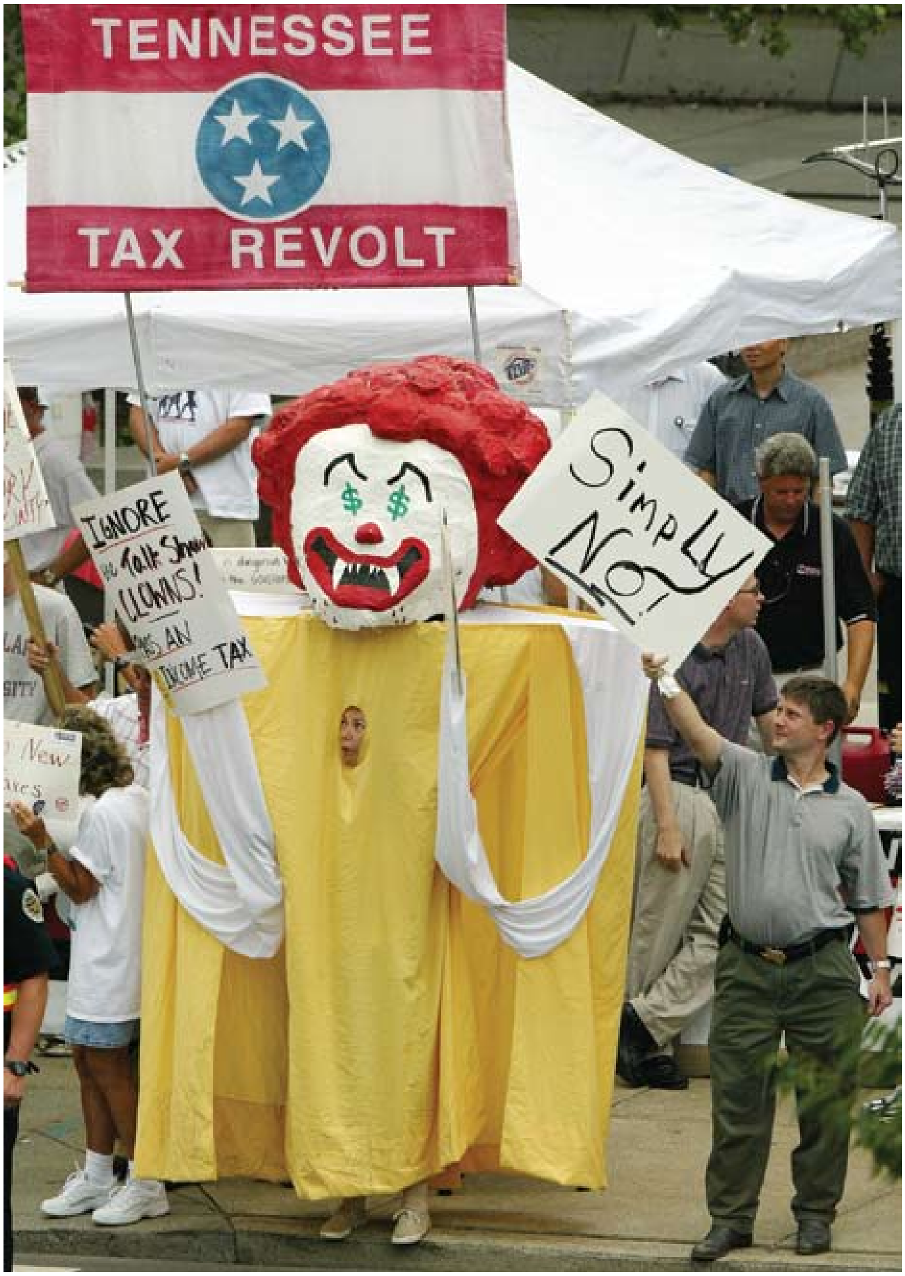
5. Abraham Lincoln authorized the collection of the first federal income tax during the Civil War. The formal federal income tax that Americans are familiar with today was created in 1913 as a result of the Sixteenth Amendment. Ask students to research the history of this amendment to the Constitution and the federal income tax. How did the federal income tax begin? How has it changed over time into what we have today?

Which organizations are exempt from taxes and why?

Our tax law recognizes that there are many forms of religious, charitable, social, political, work-related, and other groups that generally are not intended to be money-making operations and that deserve to be treated differently from businesses. As a result, the tax law recognizes a broad variety of categories of tax-exempt organizations, providing different gradations of tax benefits and reporting burdens according to the type of activity involved. For example, charitable organizations are not only tax-exempt, they can provide donors with a charitable donation deduction. On the other hand, trade associations, advocacy organizations, and other non-charitable nonprofits do not provide donors with a charitable deduction. Religious organizations receive perhaps the most deference, as they are excused from the usual requirements of applying to the IRS to be recognized as tax-exempt, and they are also exempt from annual information reporting requirements.

Americans are probably most familiar with the federal income tax, which was first enacted by President Lincoln during the Civil War to pay for the war effort. The modern income tax originated in 1913, following adoption of the Sixteenth Amendment to the Constitution. Early income taxes were collected in annual lump sums. How are federal income taxes collected today?

In the midst of World War II, the federal income tax changed from a lumpy tax—payable all at once on April 15—to a pay-as-you-go tax, payable through payroll withholding. For businesses and self employed individuals, payments were spread over the year, in most cases in quarterly installments as an "estimated tax"—still somewhat lumpy, but much less so than before. This helped make the federal income tax much more politically acceptable. Other pay-as-you-go taxes include payroll taxes and sales taxes, which have seen less political controversy than other forms of taxation.



Income tax supporter Jane Hussain, of Nashville, dressed in a clown costume, urges legislators to pass an income tax. On the right is anti-income tax protester Mike Southerland. Protesters on both sides of the issue line the street in front of the state Capitol in Nashville, Tenn., June 19, 2002. (AP Photo/John Russell)

How has economic development in the United States affected our tax system?

Industrialization transformed the American economy from a farm-based system to a more developed economy based on manufacturing, distribution, and large-scale organizations. People began taking regular jobs and receiving regular paychecks from their employers, and businesses' books became subject to external audit and verification for the benefit of lenders and shareholders. If our economy were still dominated by farmers and merchants, it would be much more difficult to implement an income tax. Employees, who are subject to employer-based reporting and withholding, and businesses that have strong non-tax reasons to maintain accurate financial reports, form the core of the income tax system. Reports on modern tax compliance point to the informal economy and cash-based businesses as problem areas of particular concern, in part because of the absence of external checks on accuracy. In a less developed economy, these difficult areas of collection and enforcement would be more dominant, making the income tax less manageable.

Our federal income tax is "progressive," imposing higher tax rates on those with higher incomes and lower tax rates on those with lower incomes. Do you think our current progressive tax system reflects American values?

Emergence of wide variations in wealth and incomes gave rise to heightened concerns about allocating tax burdens based on ability to pay—which is one of the most important reasons to have an income tax. Even if there were only a single tax rate, an income tax will collect more from a higher income family. Our progressive rate structure takes this notion further, and imposes a higher rate of tax on higher income levels. This recognizes that a high rate of tax is a much greater hardship at lower income levels than at higher income levels. On the other hand, progressive taxation might be—at least at its extremes—at odds with broadly held social values honoring hard work, accumulation of wealth, and respect for private property. The federal income tax saw rates that topped out between 70 percent and 94 percent at various stages during and after World War II. These rates came to be seen as confiscatory and as hostile to work and success. This political backlash caused changes that moderated rate structures—although not abandoning the idea that rates should go up with incomes. The first tax legislation enacted under President Ronald Reagan capped the federal individual rate at 50 percent; the top individual rate under the Tax Reform Act of 1986 was 28 percent; and rates since then have not reached as high as 40 percent.

In what other ways do American tax laws reflect American values?

The tax system does more than just collect taxes—it is heavily used as a mechanism to reward and punish behavior. The government attempts to keep track of such tax provisions by reporting on so-called "tax expenditures." The tax expenditure concept is based on the notion that some provisions of the tax law resemble outlay programs, and are not strongly related to the economic measurement of a neutral tax base, such as the standard annual net income. Some of the largest tax expenditures support home ownership; charitable giving; employer-based health insurance; and retirement savings. There are a variety of tax expenditures implementing significant national policies on energy production and conservation; low-income housing; urban renewal; education; and income security for low-income families, especially the working poor.

Governments also enforce punishments through the tax system. So-called "sin taxes" are placed on alcohol and tobacco products, some say, in an effort to curtail their consumption. Current efforts to restrict exorbitant executive paychecks rely mostly on penalty taxes and deduction restrictions. We can also expect significant proposals to use the tax system to make burning of carbon-based fuels more expensive, in hopes of moderating greenhouse gas emissions.

William J. Wilkins is a partner at the law office of WilmerHale in Washington, D.C. Prior to accepting this position, he served on the United States Senate Committee on Finance. He is currently chair of the American Bar Association's Section of Taxation. **Tiffany Willey** is a program manager for the ABA's Division for Public Education in Chicago, Illinois. She is the managing editor of *Insights on Law and Society*.