WE ARE TAXING THE WRONG THING

Eliminating Income Taxes and the Deficit

"The hardest thing to understand in the world is the income tax."
–Albert Einstein

HOW DO YOU feel about paying taxes? Do you remember your reaction to receiving your first paycheck and seeing how much had been deducted? I have hired several young people for their first jobs, and each of them has had the same reaction when receiving their first paycheck. First, they experience a feeling of accomplishment, followed by shock and dismay when they see the bite that taxes take out of their pay. They gasp, "There must be some mistake! Are you sure this is right?"

I then walk them through their payroll deductions. It is always a sobering experience. I remember one young woman who had just graduated from college looking at me with tears in her eyes and saying, "I thought I had it tough in college. Now I only have two weeks off each year, and so much of my pay is gone I can't afford what I thought I could." Later she said, "I finally appreciate my parents. I see how hard it's been for them."

Income Taxes are a financial burden for everyone, but we hunker down and pay them because we know we must. After all, we pay for cars, places to live, food, and clothing, so we accept that we also must pay for roads, schools, and national security.

Over time, many of us forget how much we pay in income taxes. We think of our salaries as being the net amount of our paychecks. In this chapter you will be reminded of how much you do pay in taxes—not to depress you, but to show you how much more you could have if we were to adopt a new means of paying for government spending.

"You don't pay taxes—they take taxes."
–Chris Rock

TAXATION IN A NEW LIGHT—
BALANCING THE MONEY SUPPLY

In 1913, the government gave the Federal Reserve the responsibility for printing and destroying money. In other words, the Fed manages our money supply.[1] One implication of the Fed's power is that *instead of taxing income, it is entirely possible for the Fed to print the money necessary to pay the government's bills*.

There is, of course, a glaring problem with this idea: if the Fed prints money to pay the government's bills, the money supply will mushroom and the dollar will plummet in value—*that is, unless we find a way to systematically evaporate the new money.* If we could somehow eliminate those dollars once the government has used them, the money supply would remain constant, and inflation would not occur.

There is a way to do this. It entails understanding taxation from a different perspective: realizing that taxation is merely a means of removing dollars from the money supply to make up for the dollars the government spends. Money is removed from the money supply when it is taxed, and it re-enters the money supply whenever the government makes a payment, whether it is a check to Lockheed for the acquisition of a missile, or a social security payment to a citizen in Iowa.

The system I am proposing for balancing the budget treats money as if it were moving through the water cycle. Just as water flows across the landscape, government spending flows throughout the economy. The key is that water also evaporates; otherwise it would overfill the rivers, lakes, and oceans, resulting in flooding (inflation). Just as water evaporates to make way for more rainfall, money must evaporate to make way for new money.

> For every newly created dollar the government spends, another dollar must be removed from the money supply.

The problem with our current tax system is that *we only evaporate money from one source:* income. The water cycle works so well because evaporation occurs a little at a time throughout the entire system, not just from isolated sources. In the same way, taxes should come from the *entire* economy instead of just from Lake Income.

Imagine what would happen if the water for our nation's rainfall evaporated from a single lake. It would be catastrophic to the lake, and there would be a nation-wide drought. That is essentially how the government operates today; we pay high taxes that drain our personal resources, and we have a deficit. What we need is a means of distributing taxes evenly throughout our economy.

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[1] http://www.federalreserveeducation.org/about-the-fed/history/

[2] The figure for personal income is rounded, based on December 31, 2014, and from

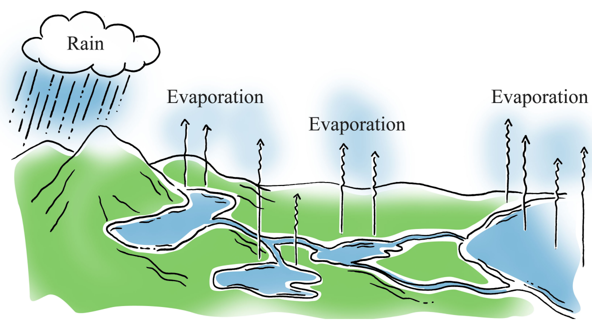
INTRODUCING THE FINANCIAL SETTLEMENTS TAX

Instead of taxing our income, my solution is to evaporate *tiny* amounts of money from the abundance of transactions called "financial settlements," whose volume dwarfs income. I call this the Financial Settlements Tax (FST).

Essentially, a financial settlement is the process by which money changes hands. Anytime you deposit a check, sell a stock on Wall Street, or swipe your debit card at the grocery store, you have completed a financial settlement. Statistically speaking, the number of financial settlements that occur on a day-to-day basis far exceeds the amount we earn in income. Thus, taxing financial settlements would spread out the burden of government spending.

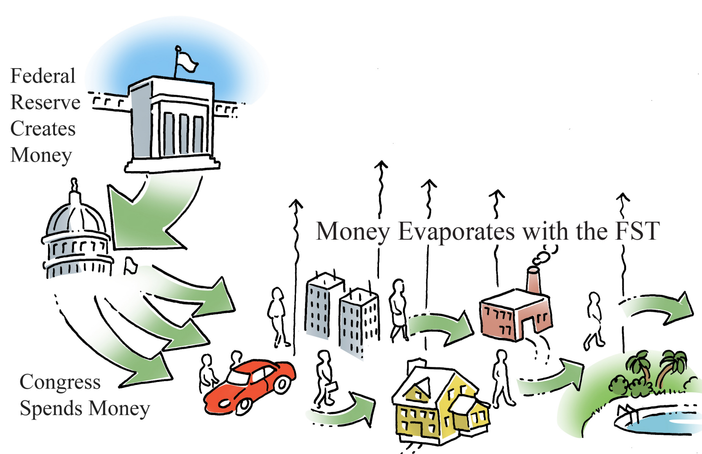
In the diagram of the Water Cycle below, evaporation balances rainfall.

EVAPORATION BALANCES THE WATER CYCLE



In the diagram of the Monetary Cycle below, the Federal Reserve creates the money that Congress spends. The same amount of money that the Fed creates is evaporated, or removed from the money supply, through the FST. The diagram illustrates how the FST would evaporate money broadly from the entire economy, rather than depleting a single source (income). That way, no one ends up losing.

THE FST BALANCES THE MONETARY CYCLE



How the Math Works

By primarily taxing income, we have selected far too narrow a category of economic transactions to tap. Personal income totals almost $15 trillion annually,[2] while the federal budget is $3.9 trillion per year.[3] Trying to extract $3.9 trillion from $15 trillion results in heavy taxes and a deficit.

Taxing income is one of those archaic constructs in our monetary system that leads to scarcity in the material economy, as consumer spending is critical to production. If we were to tap a much broader segment of our economy, such as financial settlements, we could greatly reduce the burden on any single taxpayer, and the monetary economy would foster abundance in the material economy. In fact, the math is so favorable that no taxpayer ends up being the loser.

Here is the short and sweet mathematical basis for taxing financial settlements. Settlements made through banks[4] and non-banks[5] (such as credit unions), plus securities cleared,[6] totaled $4,456 trillion dollars in the year 2013.[7] *That is nearly 300 times the amount of our collective income.* Clearly, we are taxing the wrong thing!

Dividing the government's 2015 budget of $3.9 trillion by $4,456 trillion yields 0.0875%—the percentage that must be evaporated from each financial settlement in order to balance the budget. We will round that number up to 0.1%, a mere tenth of one percent, for the purposes of this book.

The Financial Settlements Tax is an astounding tool. At the low rate of 0.1%, the FST would eliminate the need for personal and corporate federal income taxes, Social Security taxes, Medicare taxes, unemployment taxes, estate and gift taxes—even excise and customs taxes—all of which cause much pain and yet fall hundreds of billions of dollars short of balancing the budget.

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[2] The figure for personal income is rounded, based on December 31, 2014, and from http://bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=58

[3] The figure for the federal budget is rounded, for the year 2015, from the White House budget summary, page 163, from http://www.whitehouse.gov/omb/budget.

[4] The Bank for International Settlements (bis.org) is an excellent source for data on settlements. Table 11 in the Committee on Payment and Settlement Systems' report, "Statistics on Payment Clearing and Settlement Systems in the CPSS Countries," published December 2014 (affectionately known as the Red Book), shows that settlements through the Clearing House Interbank Payment System (CHIPS), Fedwire, checks, ACH, and on-us payments totaled $1,429 trillion in 2013.

[5] Table 8 in the Red Book shows that the use of payment instruments, ACH, cards and checks by non-banks totaled $92 trillion in 2013.

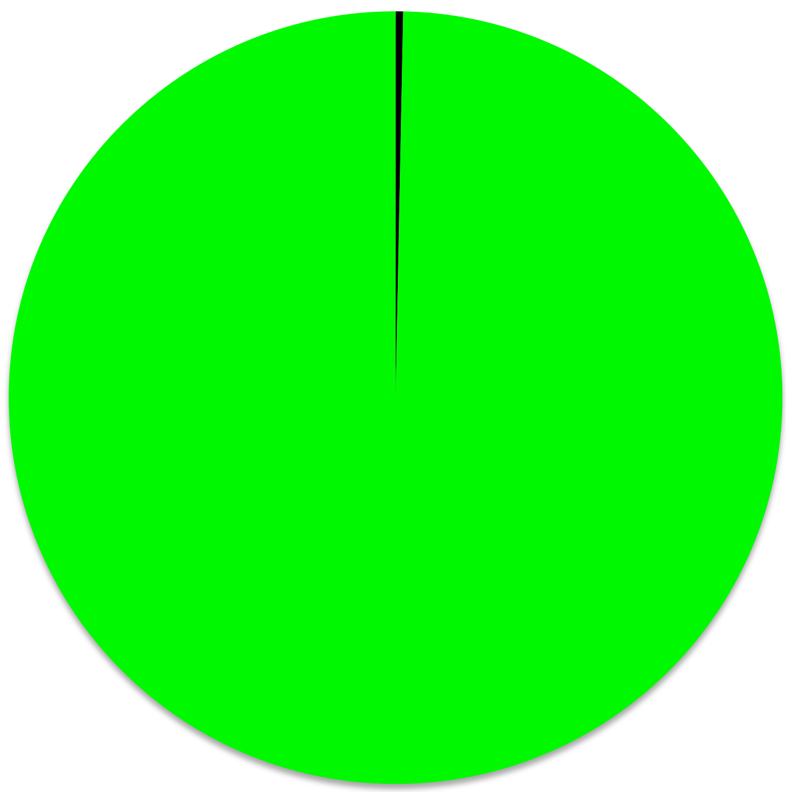
[6] Table 21 in the Red Book shows that the value of contracts and transactions cleared at the National Securities Clearing Corporation, the Fixed Income Clearing Corporation, the Government Securities Division, and the Mortgage-Backed Securities Division totaled $2,517 trillion in 2013. Table 26 in the Red Book shows transactions cleared at the Depository Trust Company and the Federal Reserve totaled $418 trillion in 2013.

[7] The figures of $1,429 trillion from Table 11, $92 trillion from Table 8, $2,517 trillion from Table 21 and $418 trillion from Table 26, total $4,456 trillion for the year 2013.

Instead of paying up to $400 in taxes on $1,000 of income, you would pay only $1. And instead of a half trillion-dollar deficit, the budget would be balanced.

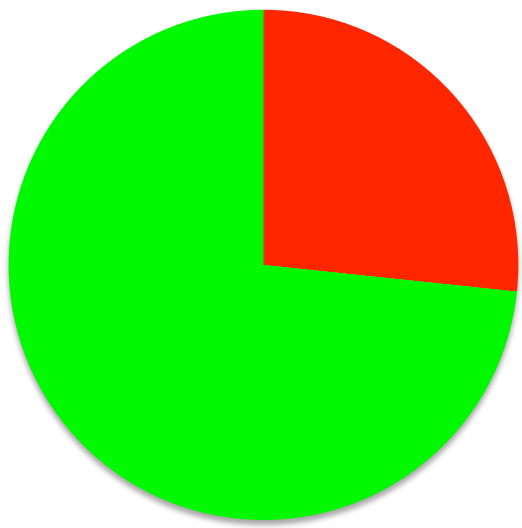
The graph below compares the amount of income in our nation (the thin black line) to the amount of financial settlements (the green area). It is clear we are taxing the wrong thing when graphically seeing that financial settlements outweigh income nearly 300:1.

INCOME VERSUS FINANCIAL SETTLEMENTS

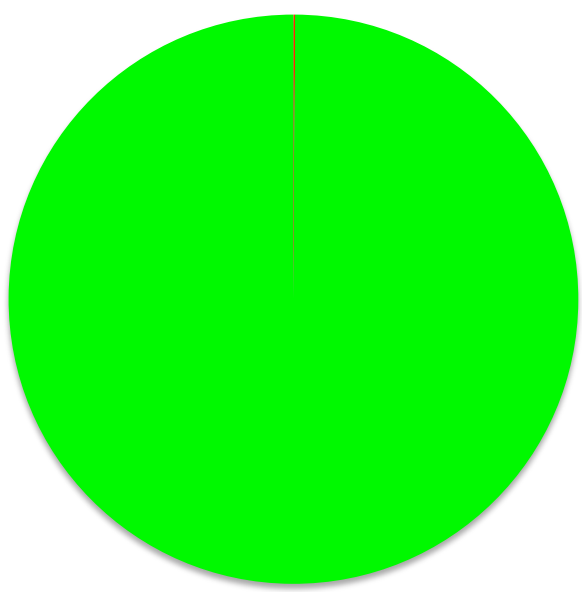


Contrast our federal budget (red) with our national income (green) in the first diagram. Then compare our federal budget (red) to the total amount of financial settlements (green) in the second diagram. Once again, it is apparent that we have been taxing the wrong thing.

THE FEDERAL BUDGET COMPARED TO INCOME



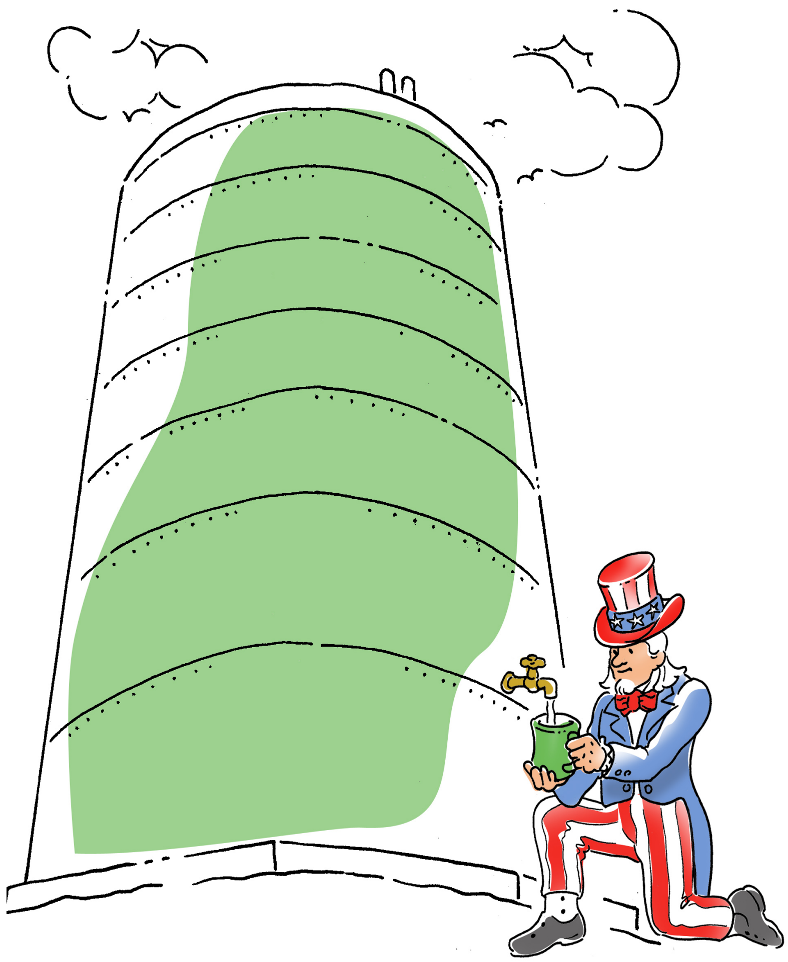
THE FEDERAL BUDGET COMPARED TO FINANCIAL SETTLEMENTS



The next two illustrations compare income taxes to the Financial Settlements Tax from yet another perspective.

WHY INCOME TAXES ARE SO EXPENSIVE
Paying $3.9 trillion from a $15 trillion bucket

WHY THE FST IS SO INEXPENSIVE
Paying $3.9 trillion from a $4,456 trillion tank



The reason the Financial Settlements Tax works, and the reason it is painless, is that it taps every settlement. Only a tiny fraction of settlements are taxed today—those settlements that we deem to be "income." With the FST, we are primarily taxing the burgeoning monetary economy. Essentially, we are exacting a tiny squeak from an enormous balloon (the financial sector) that dwarfs the material economy you and I live in.

Fortunately, the caretakers of that balloon are people like you and me, so they will benefit from the Financial Settlements Tax just as we will. In fact, the balloon itself is so large that the FST will barely have any effect on it.

The FST is a prime example of how we can engineer the monetary economy to *benefit* the material economy, rather than having the monetary economy create *barriers* for the material economy, as it does now. The result is a smaller bite out of your paycheck.

What the FST Would Mean to You

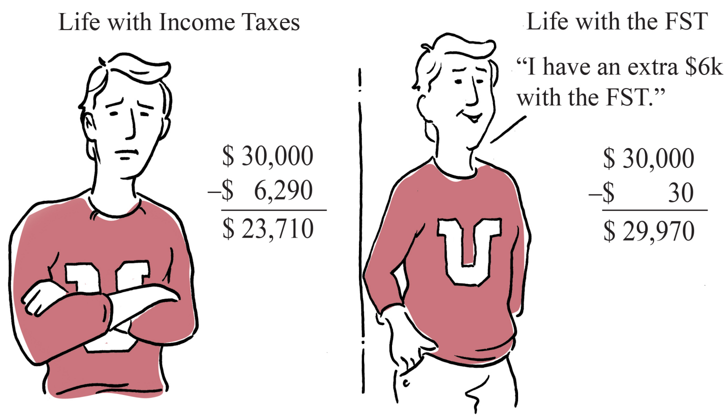
What would the Financial Settlements Tax mean for you personally? As we continue to explore the solutions in this book, we will examine the benefits of each solution for individual citizens. For this purpose, we will track the effect of each solution on several hypothetical characters:

- Tom, in his early twenties, feels fortunate to earn $30k per year. He has some credit card debt, is considering college, and aspires to be an entrepreneur.

- Amanda, a professional in her early thirties, earns $50k per year, has student loans and credit card debt, and is hoping to buy a home.

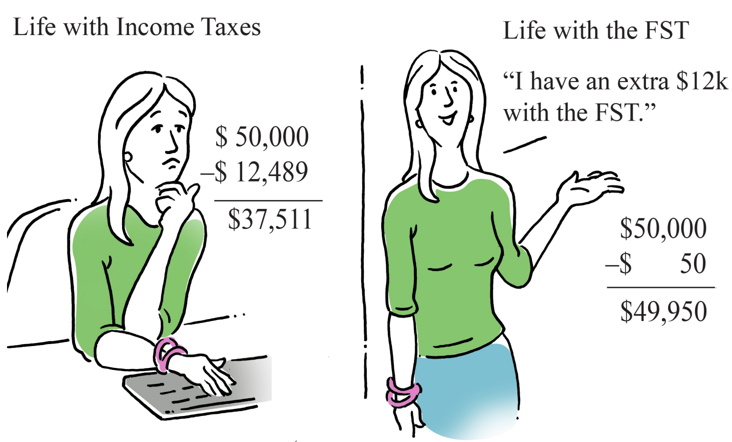
- Jennifer and Joe, married professionals in their early forties with a combined income of $100k, have two children and own a home. They pay student loans, a mortgage, and credit card debt.

TOM

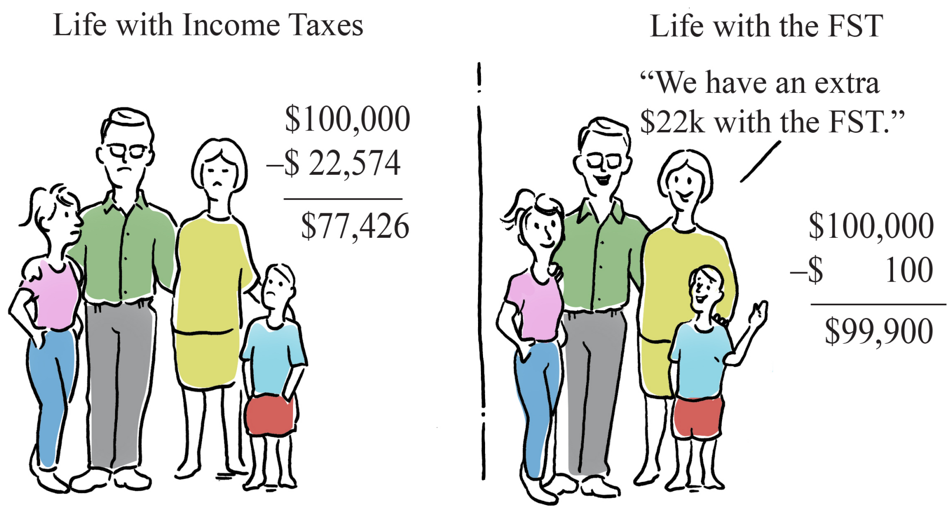


Let us consider the effect the Financial Settlements Tax would have on each of these characters. Tom would pay just $30 per year with the FST, compared to over $6k in income taxes and Social Security taxes, boosting his net income by 26%. For Tom, the extra $6k per year in net pay would be a game changer, allowing him to take classes at his local community college to learn how to start his own business.

AMANDA



Amanda's tax bill of $12k would be reduced to just $50 with the FST, boosting her net pay by 33%. Amanda could save $10k each year for a down payment on a home and still have an extra $2k annually in disposable income.



The $22k that Jennifer and Joe pay in taxes is a significant burden, especially with two children. Reducing the payment to just $100 with the FST would substantially increase their net income. With the extra money Jennifer and Joe could spend $5k annually on family vacations, invest $15k per year in a college fund for their children, and still have $2k left over.

The calculations for our characters' income taxes and Social Security taxes were derived from IRS tax tables and were calculated based upon certain assumptions.[8] Although the actual figures for each person will vary, it is easy to see how powerful a solution the FST would be for increasing your net income.

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[8] Tom and Amanda's taxes were calculated as follows: income – $5,950 standard deduction – $3,800 personal exemption = value applied to tax table, plus income x .9235 x .133 per Form SE for Social Security tax. Jennifer and Joe's taxes were calculated as follows: gross income of $100,000 – $11,900 standard deduction – ($3,800 x 4 exemptions) = a tax of $10,291 based on the Form 1040 tax table, plus $100,000 x .9235 x .133 based on the Form SE for Social Security tax. No deduction was taken for mortgage interest, as it was assumed to be equal or less than the standard deduction.

What the FST Would Mean to Our Nation

Because the Financial Settlements Tax would put more money in everyone's pocket, consumer spending would increase and our nation's Gross Domestic Production (GDP) would rise. Since businesses would no longer pay corporate or FICA taxes, they would have more money to expand and hire new employees. And because our government would be operating in the black, our national debt would no longer skyrocket. Together, these factors would propel our economy to new heights. But the benefits of the FST go well beyond this.

Under the Financial Settlements Tax, companies would no longer use foreign subsidiaries to hide from U.S. taxes, as foreign tax rates are higher than the FST. Likewise, the problem of "inversions," or companies moving their headquarters offshore, would be solved with the FST. Instead, we would see a return of the dollars that multinational companies currently stash offshore, which would increase the volume of financial settlements in our nation. Eliminating income taxes would also bring a flood of money from foreign corporations and individuals into our country, resulting in increased investment in our economy and even more financial settlements. In short, the U.S. would become an international tax haven.

Finally, the Financial Settlements Tax would save Social Security. According to current Social Security Administration estimates, trust funds supplementing the payment of Social Security benefits will be exhausted in a dozen years. At that time, benefits to retirees will need to be cut and/or FICA tax rates increased.[9] In other words, the Social Security program is already insolvent, with expenditures exceeding receipts; it is currently in its final stages of unraveling. The FST would eliminate this ticking time bomb, bringing solvency to our Social Security program.

If you are retired, the Financial Settlements Tax would allow you to continue receiving benefits without fear of losing them in the future. If you are young, the FST would protect you from higher FICA taxes and ensure that Social Security will still be around when you reach retirement age.

In summary, the overall effect of the Financial Settlements Tax is that our economy would boom, and you and I would be better off financially. The FST is a simple solution for what once seemed to be an intractable problem. We no longer need to suffer the pain of high taxes and deficit spending. Instead, we have a non-partisan solution in which we all win, with everyone contributing a tiny portion of each financial settlement that we make. It is a solution similar to the way we each painlessly contribute to the evaporation that is necessary for rainfall when we drink a glass of water.

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[9] http://www.ssa.gov/policy/docs/ssb/v70n3/v70n3p111.html

Could the FST Replace State and Local Taxes?

Just as it is surprisingly inexpensive to replace federal taxes with a Financial Settlements Tax, it is also feasible to replace state and local taxes with the FST. State and local income taxes, property taxes, and sales taxes totaled $1.3 trillion in 2013.[10] If the tax rate on financial settlements was set at 0.12%, we could not only eliminate federal income taxes, but we could also eliminate state and local taxes. In other words, simply by debiting $1.20 every time a $1,000 deposit is made in a bank or credit union, or a security is sold on Wall Street, we would no longer have to pay state and local income taxes, property taxes, or sales taxes.

It is likely that such a proposal would be popular with a number of states, especially if state rights were not impacted. The easiest way to accomplish this would be for the Federal Reserve to make a flat disbursement to each state based solely upon the state's population. Whether or not a state elected to charge its citizens additional taxes would be left up to the state.

Using the Financial Settlements Tax to eliminate state and local taxes is not one of my campaign commitments, however. Such a proposal would need to come from the states, and only once the FST had been successfully implemented at the federal level.

Implementing the FST

The Financial Settlements Tax would be relatively easy to implement, insofar as government programs go. It would not require the creation of new government agencies, nor would it require 73,954 pages of complex tax code, as our current system does.[11]

The Financial Settlements Tax would involve a single adjustment to the clearing process for financial institutions: if you deposited a check for $1,000 into your bank account, for example, the bank would only credit you $999.[12] Because the bank deleted $1 from your deposit, you would no longer have to file IRS forms, nor would you have federal payroll taxes withheld from your paycheck.

The $1 that is not credited to your account would not go to the bank, nor would it be sent to the government; it would simply "evaporate." Thus the money not credited to your account would be removed from the money supply, simply because it is no longer on *anyone's* balance sheet. Because this money evaporates continually, the Fed would be free to print new money, paying for government spending without causing inflation. The

[10] https://www.census.gov/govs/qtax/historical_data.html

[11] The page count is obsolete almost the moment you write it. For an up-to-date count see: http://www.cch.com/TaxLawPileUp.pdf

[12] The FST would occur only when you make deposits, and not when you make withdrawals.

Financial Settlements Tax is a way to destroy money, making room for the new money being created by the Fed to pay for government spending.

> The process of not crediting a portion of a deposit to any account deletes that money from the money supply.

The $1 would be debited because you engaged in a financial settlement when you deposited your $1,000 check. Remember: depositing a check, receiving a wire, or receiving money from the sale of stock are all examples of financial settlements. In short, any money received by anyone is a financial settlement. Most people, when they hear the plan for a Financial Settlements Tax, assume it is the banks that will be up in arms over the FST, but that is not so. The money is not coming from the banks; it is coming directly from customers.

ENFORCING THE FST

The Financial Settlements Tax would be easier to enforce and more difficult to game than income taxes. In large measure, the feasibility of enforcement is tied to the party responsible for compliance, which is why we require employers to withhold taxes rather than relying on employees to make payments on their own.

With the FST, the government would look to highly regulated institutions to evaporate transactions, and evaporation would be an automatic part of the clearing of financial settlements, whether the institution is a bank, a non-bank such as a credit union, or a securities clearinghouse. Notably, the payer from whose funds the FST is deducted would not have any say in the process.

The feasibility of enforcement is also tied to the pain of compliance. Whereas federal income taxes deduct 20–40% of personal income, the cost of the Financial Settlements Tax would be miniscule, so the incentive to avoid the FST would be far lower than the incentive to avoid income taxes.

Person-to-person cash transactions would avoid evaporation, of course, just as they are a means of avoiding income taxes today. Such transactions are impossible to track, and their volume is tiny compared to the size of the economy, so for this reason I have excluded them from the Financial Settlements Tax.

I have had some very interesting reactions when talking to people about the Financial Settlements Tax. One analyst at the Fed expressed her concern that people would stop depositing checks with the FST.

“What would they do with their checks if they don’t deposit them?” I asked.

“I don’t know, but they’ll game the system,” she insisted. “They’ll make their employers pay them in cash.”

"Do you really think they'll do that to save 0.1% when they don't ask for cash to avoid payroll taxes of 30% or more?" I asked. "And look at the fees that the banks charge. Three dollars for an ATM withdrawal; the FST is lower than that!"

She paused and shook her head, "I just don't think people will put up with it."

"And the taxes that we pay are easier to put up with?" I asked.

As I thought through that conversation, I realized how easy it is to settle for things the way they are, and how hard it is to change. We are so easily trapped into lives of quiet desperation. We cannot let our nation die of quiet desperation.

The Pain of a Century of Income taxes

During President Lincoln's administration, the government's need for revenue increased sharply because of the Civil War. By temporarily imposing a small tax on the income of the wealthy, the government was able to cover its expenses.[13] After the Civil War, the idea of permanently taxing income was vigorously debated for decades. In 1913, income taxes became a permanent fixture of the government's revenue plan; again, a small percentage of the income of the wealthiest citizens was taxed.

That soon changed, however, and tax rates fluctuated wildly for the next century.[14] The tax rate for the wealthiest skyrocketed from 7% in 1913 all the way to 77% in just five years. You can imagine the outcry that caused. High rates for the wealthy remained in place for years, until they briefly fell to 24% in 1929. They bounced back almost immediately with the Great Depression, reaching 63% in 1932, and then climbed ever higher for a full decade until they hit 94% in 1942.

Rates remained at this level for 22 years, barely fluctuating, until they were reduced to 77% in 1964. This was followed by yet another reduction a year later, to 70%, where they remained for 17 years. President Reagan dropped the rate for the wealthy to 50% in 1982, followed by further reductions until they hit a low of 28% in 1988. In 1991 President Bush edged rates up to 31%, followed by a hike to 39.6% by President Clinton in 1993. Finally, ten years later, rates edged back down to 35%.

It is surprising to many that for most of the past century, tax rates for the wealthy have been much higher than they are today. In fact, unless we adopt a radically different means of paying for government spending, history indicates that tax rates are likely to increase. This is sobering news for anyone who believes that the sting of government taxes is a recent development and could be reduced if we just returned to "the good old days."

If you think we are imposing hefty taxes today, and are concerned that we have a deficit, tomorrow will be worse. The pain we feel from this is polarizing our nation. It

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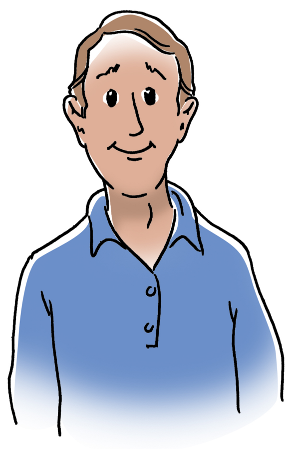
[13] www.taxhistory.org, www.archives.gov, www.civilwar.org

[14] www.taxpolicycenter.org, www.cch.com, www.taxfoundation.org, and http://qz.com/74271/income-tax-rates-since-1913/

causes us to point fingers and let conflicting accusations fly: “the rich aren’t paying their fair share”; “the poor aren’t paying their fair share”; “the government spends too much”; and “the government needs to spend more to get us out of this mess.”

The problem with this way of thinking is that we are pre-supposing pain as a given. The truth is that we are suffering from an artificial barrier to greater prosperity that can be removed once we understand the root of the problem. In fact, the solution is neither paying higher income taxes nor cutting government spending.

Once we understand how our economy has changed since the civil war, we see that the solution comes in an entirely different form—the Financial Settlements Tax. We have simply been taxing the wrong thing. We no longer need to shoulder the burden of income taxes.



“The marvel of all history is the patience with which men and women submit to burdens unnecessarily laid upon them by their governments.”
–George Washington