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# Tax Reform: Challenges and Possibilities

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Many critics of the current tax system have proposed fundamental overhaul as a solution. Some propose a flat tax, while others suggest abolishing the income tax system entirely and adopting a national sales tax.

While supporters of the status quo have raised a host of objections, each proposal represents a sensible alternative to our current tax system. The following discussion focuses on the need for the reform of our current tax code. It examines the two major tax reform proposals – the flat tax and the national sales tax – analyzing the potential costs and benefits of each proposal.

Originally unconstitutional, income taxes were permanently imposed on Americans with the ratification of the 16th Amendment in 1913.

Initially, rates were extremely low. In fact, the tax rate on the first $20,000 of income was a mere one percent, while the highest rate was still a fairly reasonable seven percent on all income above $500,000. In 1994 dollars that would equate to a one-percent income tax on all income up to $250,000, while the seven- percent rate would apply only to income earned above six million dollars. Clearly, our current system of extreme progressivity would come later. In fact, as late as 1939 only five percent of the population was required to file income tax returns.[1]

Today, the federal income tax is extremely progressive. Dangerously burdensome on both the taxpayer and the economy – and maddening in its complexity – it has become a detriment to America's economy.

In the words of Congress' chief tax analyzers, the Joint Economic Committee, "…since its 1913 enactment, the income tax system has fallen prey to a multitude of unintended purposes including income redistribution, social engineering, and government micro-management of saving, investing, and spending decisions."[2]

In fact, the percentage of an average family's income consumed by taxes is significantly higher than believed appropriate by most Americans.

A recent survey conducted by *Reader's Digest* found that a majority of Americans believe the maximum tax burden that should be placed on a family of four is 25 percent of its total income. The survey found this to be the case regardless of the respondent's race, age, income level, or sex. Clearly, most Americans don't believe a family should be forced to give more than a quarter of its earnings to government.[3]

Yet the average family of four in America pays nearly 40 percent of its earnings in taxes. That's more than it spends on food, clothing, and housing combined.[4]

Meanwhile, that burden continues to rise. In 1998 alone, total tax federal, state, and local collections are estimated to total $2.667 trillion. That represents a 5.7 percent increase over 1997 collections. Put another way, that represents an average of $26,434 in taxes collected from every family in America, or an average of $9,881 per resident.[5] Between 1981 and 1998 the federal tax collection per person increased by more than 40 percent.[6]

Many will argue that any increase in revenues over the last several decades can be attributed to the growth in the nation's economy and population. However, as the Heartland Institute points out,

> Federal, state, and local tax revenues all rose much faster than inflation or population growth since 1960. Individual tax burdens grew dramatically, relative to personal income, until the 1980s, when sustained economic growth and lower rates of inflation allowed personal income growth to keep pace with the rising cost of government.[7]

Further, the top marginal tax rate (the percentage paid in taxes on the last dollar one earns) has gone from seven percent in 1913 to as high as ninety percent and currently is 39.6 percent. This represents a significant increase in progressivity and income redistribution.

Not only has the amount of taxes collected increased, the complexity of the tax code has grown as well. Currently there are over 2,000 IRS Code pages, 12,000 pages of regulations, and 200,000 court pages. Experts have estimated that businesses and individuals spend over 5.4 billion hours on federal tax compliance a year. In addition, it is estimated that more than $200 billion a year is spent on compliance.[8] Far from a mere inconvenience, the complexity of the tax code is an economic burden on families and businesses alike.

The complexity of the current tax code has led to inherent inequalities within the law. Year after year of pigeonholed tax credits, deductions, and loopholes has led to marginal tax rates that Diana Furchtgott-Roth and Kevin Hassett of the American Enterprise Institute describe as resembling the New York City skyline.

For example, under the provisions included in 1997's well-intentioned tax package, a family of four with an income of $20,000 faces a 21% marginal tax rate. That same family of four earning $30,000 a year and taking advantage of the new tax credits included in 1997's bill faces a marginal tax rate of zero. This occurs thanks to the phase out of one tax credit and the phase in of another.[9]

Simplification through tax reform – a major attribute of both the flat tax and national sales tax – would relieve the American public of the burdensome compliance costs associated with the current system. This, in turn, would free up millions of hours of manpower and billions of dollars that could be funneled into the economy.

Furthermore, eliminating the excessive progressivity of the current tax code would spur the economy as the disincentive to work declined. The American value of fairness and equality would also be reinstated into the tax code – reducing resentment towards the code and therefore increasing compliance.

The economic benefits of flattening and lowering tax rates (a national sales tax is essentially a "flat" tax on all goods) are significant and well documented.

It is important to first discredit the myth that lowering the top marginal tax rate would lead to a decline in revenues. The Joint Economic Committee has found that,

> Since the early 1950s, federal receipts have hovered closely around 19 percent of gross domestic product (GDP). Remarkably, this trend has persisted regardless of whether the top tax rate has been as high as 91 percent or as low as 28 percent . . . Similarly, revenue from the personal income tax has averaged just over 8 percent of GDP.[10]

So, lowering and flattening the tax rates would not reduce receipts and would increase fairness in the tax code.

Reducing the progressivity of tax rates has historically led to some of the greatest economic growth in the century. In 1964, the Kennedy tax cut flattened the top marginal tax rate from a staggering 91 percent to 70 percent. This led to a growth rate of 5.1 percent. During his Presidency, Ronald Reagan reduced the top marginal tax rate from 70 percent to 28 percent – leading to a growth rate of four percent between 1983 and 1989.[11]

It seems clear that by reducing the disincentive to work, the economy grew – leading to increased revenues.

In fact, the National Center for Policy Analysis notes that, ". . . higher tax rates divert resources from the private sector, encourage the waste of resources through tax avoidance and channel resources into the less productive underground (or informal) economy."[12]

Research has rebuked the theory that by flattening and lowering the top marginal tax rate the rich would no longer pay their fair share in taxes. The National Center for Policy Analysis has found that:

- Between 1921 and 1926, the highest tax rate fell from 73 percent to 25 percent. Although the tax rates of people earning more than $100,000 (1929 dollars) fell by almost two-thirds, their share of the total federal income tax revenue rose from 28 percent to 51 percent.

- In 1963 when the top tax rate was 91 percent, the top 5 percent of taxpayers paid 35.6 percent of all income taxes. In 1965, when the top rate had been lowered to 70 percent, the top five percent of taxpayers paid 38.5 percent of all income taxes.

- In the 1980s when the top tax rate was reduced from 70 percent to 28 percent for the wealthiest taxpayers, the share of taxes paid by the top one percent of income earners grew from 18 percent in 1981 to more than 27 percent in 1988.[13]

The benefits of lowering and flattening tax rates are clear: a stimulated economy, increased equality and fairness in the tax code, and simplification.

Both the flat tax and the national sales tax would greatly benefit the country and the taxpayer.

The Tax Foundation has calculated the tax liability for the average American family to be $3,967. Under the 17% flat tax proposed by Congress Dick Armey (R-TX), that same family's tax liability would fall to $2,990. Under the 15% national sales tax proposed by Congressman Billy Tauzin (R-LA), that same family would have a tax liability of only $3,222.[14]

The benefit of moving to a consumption based tax system such as the flat tax or sales tax go far beyond their direct benefits on taxpayers via lower tax burdens. Dale W. Jorgenson, Chairman, Department of Economics and Frederic Eaton Abba Professor of Economics at Harvard University, have identified what they believe to be the seven major benefits to moving to a consumption based tax. They are included in the table below.

### The Growth Boosting Power of an Consumption Tax[15]

- An immediate and powerful impact on the level of economic activity;
- A sharply higher tax rate on consumer goods and services;
- Individuals would sharply curtail consumption of both goods and leisure, which would produce a dramatic jump in savings and a substantial rise in labor supply;
- A radical shift away from consumption toward investment; real investment would leap upward by staggering 80%;
- Holding net foreign investment consistent, exports would jump to 29% while imports would rise only slightly; the initial export boom would gradually subside, while remaining around 15% higher under the current tax system;
- Since producers would no longer pay taxes on profits or other forms of income from capital and, since workers would no longer pay taxes on wages, prices received by producers would fall by an average of 20%; and industry outputs would rise by an average of 20% with substantial relative gains for investment-goods producers;
- In the long run, producers' prices would fall by almost 25% relative to prices under an income tax. The shift in the composition of economic activity toward investment and away from consumption would dramatically redistribute economic activity. Production would increase in all industries, but the rise in production of investment goods would be much more dramatic.

Jorgenson notes that a consumption tax may be implemented through either a flat tax, a value-added tax, or a retail sales tax, although he does not express a preference for any particular method.[16]

Obviously, the current reluctance to move to a flat tax or national sales tax has great economic costs both to the country and the average taxpayer. The question remains, however, which proposal is best for America?

Currently, there exists a great debate within the economic and policy community regarding which of the two major tax reform plans is best suited for America. In the following sections we will examine the flat tax and the national sales tax closely – analyzing the strengths and weaknesses of both.

The intent is not to draw a conclusion regarding which may or may not be the better plan. Rather, the intent is to focus attention on the competing plans – allowing the reader to make his own decision on the more preferable option.

In the end, the desired result of our analysis is an educated electorate that understands the possibilities for improving our tax system.

## The Flat Tax

The first thing to remember about the flat tax is that, like its competitor the sales tax, it is a consumption tax – not an income tax. Many believe the flat tax is simply the current income tax with one flat rate, but that is not the case.

But what is a consumption tax? Most people associate a consumption tax with a sales tax in that the tax is levied at the point of purchase or "consumption." But there are many different ways to levy a consumption tax.

To understand a consumption tax it is important to understand how income – or wages – are defined in an economic sense. To an economist, income is defined as consumption plus savings. An income tax taxes *both* consumption and savings. A true consumption tax, on the other hand, would tax income *minus* savings.

Our current tax system ". . .includes in its tax base wages, interest, dividends, and capital gains, all of which are consistent with an income tax. At the same time, however, the current tax system excludes some savings, such as pension and Individual Retirement Account contributions, which is consistent with a tax using a consumption base." [17]

Therefore, our current system is a combination of an income tax and consumption tax. A flat tax would move to a pure consumption tax with no taxation of interest, dividends, or capital gains earned by individuals.

This is important to understand due to the current double taxation of savings. Under the current tax system, a corporation pays a 35% top marginal tax rate on its income. However, when it disburses the once taxed income to its shareholders it is taxed again – normally at a top rate of 39.6 percent.

In fact, families often experience several different levels of taxation under our current code. As Michael Boskin, former Chairman of the Council of Economic Advisors, notes,

> The family first pays taxes on their own income (perhaps their wages). That is tax one. They save some of that after-tax income in the form of corporate equities. But the corporation pays corporate taxes (on behalf of the family as a shareholder). That is a second tax. Then the family pays taxes again when it receives dividends or capital gains (in this case one has to net out inflation, deferral, the possibly slightly lower tax rate, incomplete loss offset, and so on to determine the true effective tax rate). That is a third tax on saving. If the family is fortunate enough to accumulate, even at a few thousand dollars a year

compounded over a lifetime, enough to leave a taxable estate,
the saving is taxed a fourth time.[18]

So, through the implementation of a consumption tax, the current system of multiple taxation would be avoided. The benefits of a flat tax will be discussed in length later, for now it is important to remember that a flat tax (like a sales tax) is a consumption tax.

But how does a flat tax work exactly? How would it be implemented? At what rate would consumption be taxed? Would deductions be allowed?

To answer these, and other, questions regarding a flat tax we will examine the most popular of the current flat tax proposals, the Armey-Shelby flat tax. Named after its two main cosponsors, House Majority Leader Dick Armey (R-TX) and Senator Richard Shelby (R-AL), it is the flat tax plan most often discussed.

| **Current Tax System** | **Armey-Shelby Flat Tax** |
|---|---|
| Imposes high tax rates that discourage work and entrepreneurial activity. | Allows individuals to earn as much as they can without being punished by the tax system. |
| Punishes saving and investing with high tax rates and double taxation. | Ends high tax rates and double taxation of savings and investment. |
| Unfairly levies different taxes on people with similar incomes. Special deductions and exemptions often are available to only select few. | Treats everyone the same, with all taxpayers paying the same low tax rate. Eliminates special deductions and loopholes. |
| Drives investment into unproductive tax shelters. | Ends all tax shelters, allowing more productive investments. |
| Encourages spending more than saving by taxing savings and investment at least twice, sometimes three times. | Ends punitive taxation of savings and investment, leaving individuals free to decide whether to spend, save or invest. |
| Is overly complex with high administrative and compliance cost. | Ends complexity by eliminating the multitude of deductions, exemptions, and credits. |
| Redistributes income. | Promotes the creation of income and economic opportunity for all Americans.[19] |

The Armey-Shelby flat tax is based on the flat tax originally devised by Robert E. Hall and Alvin Rabushka, two senior fellows at the Hoover Institute at Stanford University. In 1981, Hall and Rabushka proposed replacing the federal individual income tax and the federal corporate income tax with a flat rate consumption tax. Although the Armey-Shelby Flat Tax is not an exact facsimile of the Hall-Rabushka plan, it closely follows its model.

The Armey-Shelby Flat Tax is comprised of two components: a wage tax and a cash flow tax on businesses. Under their plan, an individual's wages would be taxed at a 20 percent rate with the rate dropping to 17 percent in the third year of implementation.[20]

All wages, salaries, and pensions would be taxed. Furthermore, government employees and employees of nonprofit organizations would be required to add to their wage tax base the imputed value of their fringe benefits.[21]

However, the individual flat tax would not be applied to Social Security payments – repealing the taxation of Social Security benefits to high-income households. Contributions to Social Security would still be taxed in that they would not be deductible and would be made out of after tax income.

According to the plan, firms would pay the business tax on their Social Security contributions while individuals would be responsible for the wage tax on their Social Security contributions.[22]

Under the Armey-Shelby Flat Tax individuals would receive no deductions but would be allowed the following exemptions:

- $22,000 for a married couple filing jointly
- $14,400 for a single head of household
- $11,000 for a single person; and
- $5,000 for each dependent

The Armey-Shelby Flat Tax would index all exemptions for inflation.[23]

As previously mentioned, noticeably absent from the Armey-Shelby Flat Tax is the personal taxation of all savings, dividends, and capital gains – thus eliminating the double (and sometime greater) taxation of savings.

Businesses would also pay a 20 percent tax rate for the first two years (falling to 17 percent in the third year) on the difference (if positive) between gross revenue and the sum of purchases from other firms, wage payments, and pension contributions. Covered by the business tax would be all corporations, partnerships, and sole proprietorships.[24]

Businesses would no longer be able to deduct state, local, and payroll taxes. Pension contributions would be deductible but there would be no deductions for fringe benefits.[25]

Form 1 **ARMEY-SHELBY FLAT TAX FORM** 1999

| | | |
|---|---|---|
| Your first name and initial | Last name | Your Social Security number |
| Present home address | | Spouse's Social Security number |
| City, Town or Post Office Box, State and ZIP Code | | Your occupation |
| | | Spouse's occupation |

| | | |
|---|---|---|
| 1. Wages, Salary, and Pensions ................................................ | 1 | |
| 2. Personal Allowance................................................................ | | |
| a. $23,200 for married filing jointly............................................ | 2(a) | |
| b. $11,600 for single.................................................................. | 2(b) | |
| c. $14,850 for single head of household..................................... | 2(c) | |
| 3. Number of dependents, not including spouse.............................. | 3 | |
| 4. Personal allowances for dependents (line 3 multipled by $5,300).. | 4 | |
| 5. Total personal allowances (line 2 plus line 4)............................. | 5 | |
| 6. Taxable wages (line 1 less line 5, if positive, otherwise zero)....... | 6 | |
| 7. Tax (17 percent of line 6)...................................................... | 7 | |
| 8. Tax already paid................................................................... | 8 | |
| 9. Tax due (line 7 less line 8, if positive)..................................... | 9 | |
| 10. Refund due (line 8 less line 7, if positive)................................ | 10 | |

## Benefits of a Flat Tax

One of the most often touted benefits of the Armey-Shelby Flat Tax is the favorable impact it will have on the economy. The Joint Economic Committee has found that "(f)lat-rate income taxes are significantly more favorable to economic growth than progressive taxes. Personal income in flat-rate income tax states grew about 25 percent faster than did personal income in states with a progressive rate structure."[26]

One of the reasons for the increase in economic output would be the increased incentive to work created by reduced top marginal tax rates. Put simply, if you are able to keep more of the money you earn, you will have a greater incentive to work more and earn more money.

As Hall and Rabushka themselves note,

> Economists have devoted a great deal of effort to measuring the potential stimulus to work from tax reform. Their consensus is that all groups of workers would respond to the flat tax by raising their work effort. A few workers would reduce their hours either because the flat rate would exceed their current marginal rate or because the reform would add so much to their incomes that they would feel that earning was less urgent. But the great majority would face much improved incentives.[27]

Hall and Rabushka have determined that moving to flat tax system similar to the Armey-Shelby Flat Tax would result in an increase in total annual output of goods and services in the U.S. economy of approximately 3 percent. That equates to a $200 billion increase in economic output yearly – nearly $750 per American.[28]

Alleviating the double taxation discussed earlier would also benefit the economy greatly. The double taxation of savings and investment disproportionately reduces the incentive to create new businesses – thus harming capital formation.

Initiating a flat tax would increase the incentive of capital formation, the result being an increase in the ratio of capital stock to GDP. In turn, Hall and Rabushka conservatively estimate ". . . a 2 to 4 percent growth in GDP on account of added capital formation within seven years."[29]

As for the overall effect on the economy, Hall and Rabushka predict – again conservatively – that a flat tax would produce a 3 percent increase in output from increased total work in the U.S. economy and a 3 percent increase from added capital formation and improved entrepreneurial incentives. This 6 percent real growth over seven years would mean ". . . each American will have an income about $1,900 higher, in 1995 dollars, as a consequence of tax reform."[30]

Michael Boskin is less conservative in his estimation of the flat tax's effect on the economy and predicts a 10 percent growth in the economy following the transition to a flat tax.[31]

Hall and Rabushka are not the only economists singing the praises of a flat tax. The bipartisan Joint Economic Committee (JEC) has studied the flat tax and determined it would have substantial benefits for both individuals and businesses.

| Benefits of a Flat Tax According to the Congressional Joint Economic Committee[32] | |
|---|---|
| **Benefit to Individuals** | **Benefit to Businesses** |
| Frees savings and investments from double taxation. After income has been taxed once at a low, flat rate and saved or invested, the returns are not taxed again. | Ends punitive double taxation of business income and fosters increased savings and investment needed for development and expansion. |
| Ends taxation of capital gains. An individual's income investment in a home or small business would be free from the punitive double taxation of capital gains when sold. | Ends individual capital gains and dividends taxation, and would spur increased corporate investment. |
| Ends estate and gift taxes that represent double taxation and unfairly transfer income from families to the government. | Allows 100 percent first-year expensing of new business investment (plant, equipment, and land), eliminating one of the biggest accounting nightmares – numerous depreciation schedules that can stretch up to 40 years for investments or purchases. |
| Slashes the time, effort, and cost of complying with the tax code. Taxes could be filed on a form the size of a post-card. | Spurs new investment and increased productivity by quickly freeing up capital needed in fast growing businesses through immediate expensing. |
| Reduces interest rates on home mortgages, credit cards, and auto loans. Since interest income is no longer taxable under the flat tax, interest rates would drop to reflect the tax-free status of interest. | Eliminates the cost of keeping track of all interest and dividends paid out (1099 forms); because this income would only be taxed at the business level. Corporate income would not be taxed again when interest and dividends are paid to individuals. |
| Stops punishment of individuals and families who work longer or harder to improve their standard of living. With only one tax rate, government would no longer take an increasingly larger bite of someone's income. One tax rate means a spouse's income could no longer push a family into a higher bracket. | Eliminates the growth disincentives caused by high marginal tax rates now faced by expanding businesses. |
| Increases individual freedom of choice and civil liberties. One low tax rate would allow people to keep more of their money as they earn it and would end government's current micro-management of people's behavior through the tax code. A simple flat tax would dramatically reduce the IRS's infringements on privacy. | Eliminate the corporate Alternative Minimum Tax (AMT), which forces many businesses to calculate their taxes twice under two different methods. Reduces complexity in the taxation of multinational corporations. The flat tax only applies to domestic operations of all businesses, whether they are domestic, foreign, or mixed ownership. Only the revenue from sales of a product within the United States, plus the value of products at export would be reported. |

From simplicity to fairness, a healthier economy to the elimination of double taxation, the flat tax appears to have many attributes. Certainly, if implemented true to its form, the flat tax would simplify the current tax code and treat taxpayers more equally, (which may or may not be desirable, depending on your political philosophy).

While the data dealing with a flat tax's effect on the economy are more complicated, history and many of today's top economic thinkers suggest its effect would be beneficial and wide. If nothing else, it would surely represent a decisive change from today's bloated, complicated, and unfairly progressive tax code.

The Armey-Shelby Flat Tax does have its detractors, however. Many economists and political scientists are skeptical of the flat tax and have raised several arguments against the passage of a flat tax. This section examines many of these arguments and attempt to determine the validity of each.

**Effect on Charities.** Many opponents claim that a flat tax – which would eliminate the charitable deduction – would cause a precipitous decline in charitable givings and therefore adversely effect charities.

However, the effect the charitable deduction has on charitable contributions is almost always overstated. Nearly half of the charitable donations made every year are done so by people who take the standard deduction and therefore receive no economic benefit from their charitable contributions.[33]

In fact, charitable contributions are more closely linked to the growth of personal income. History has shown that

> over the past several decades, increases in giving have closely tracked increases in personal income. *This trend continued during the 1980s when, even as the tax value of the deduction declined and fewer taxpayers were able to take the charitable deduction, charitable giving increased.* Because incomes will increase significantly under the flat tax, giving will rise in the long run as well, even without the charitable deduction.[34]

**Effect on Health Care.** Some scholars have noted that the Armey-Shelby Flat Tax would not allow businesses to deduct the health care benefits they provide their employees – claiming this would reduce a firm's incentive to provide health care. Furthermore, they note that the personal deduction of health care costs exceeding 7.5 percent of adjusted income would be eliminated – also reducing health care benefits for many Americans.[35]

Health benefits were first widely provided during World War II as a way of luring labor while wages were frozen. In fact, health benefits are part of income and should therefore be taxed.

Under the Armey-Shelby Flat Tax, an employer could choose to pay workers increased cash wages – which are deductible – rather than provide health care benefits. The end result would give employees more choice and control over their health benefits since they would be free to purchase their own plan with their increased salary.

With respect to the personal deduction for health care costs, Hall and Rabushka note that "(t)he nearly half of all taxpayers who take the standard deduction, the bottom half of the income distribution, rarely take advantage of this deduction."[36]

In fact, Hall and Rabushka point out that IRS records show that ". . . only 5.5 million of the 113.8 million returns filed in 1992 selected medical and dental expense deductions . . . (t)he richest 5 percent of those 5.5 million returns took more than 10 percent of total medical deductions, which means the richer you are, the greater the tax subsidy you receive – which is surely absurd."[37]

**Effect on Mortgages and Housing Market.** One of the most popular arguments against the Armey-Shelby Flat Tax is that by eliminating the home mortgage deduction, it would prevent millions from owning a home -- devastating the housing market and real estate business.

Hall and Rabushka have a fairly simple, and fairly controversial, rebuttal to this argument. Along with other prominent economists, Hall and Rabushka argue that the elimination of deduction and interest taxation will cause interest rates to fall.

Lower interest rates will, in turn, produce lower mortgage payments that they believe will more than offset the elimination of the mortgage deduction. They suggest a transition plan could allow present homeowners to deduct 90 percent of their interest until they re-negotiated their loans under the new, lower rate.[38]

While few, if any, economists doubt interest rates will fall, many don't believe they will decrease enough to offset the loss of the home mortgage deduction. Thus there may be a small adverse impact on the housing market.

**Effect of the Flat Tax on the "Rich".** Another favorite chorus of flat tax opponents is that the Armey-Shelby Flat Tax is little more than a tax cut for the wealthy, financed on the backs of middle-class Americans.

While it is true that the relatively small number of wealthy Americans who took few deductions would see a decrease in their taxes, those wealthy Americans who took advantage of the current system to avoid taxes through tax shelters, large deductions, purchasing municipal bonds, and other gimmicks would pay significantly higher taxes.[39]

There are two other points to keep in mind as well. First, according to the Tax Foundation, historical trends show that "lowering high marginal tax rates on upper income earners may increase, not decrease, total tax revenues. In effect, as marginal tax rates fall, high-income earners are encouraged to earn more and shelter less, which increases the amount of taxes paid."[40]

So, while the top 1 percent of wage earners currently pay over 30 percent of total federal income taxes and the top 5 percent pay nearly half of total federal income taxes, a reduction in the top marginal rates could actually increase the percentage of total taxes paid by the "rich."[41]

Second, Hall and Rabushka point out that ". . .the flat tax includes a generous personal allowance. This means that millions of working families will no longer pay any income taxes. Those in the middle class will face a lower rate of tax."[42]

Finally, one of the main principals of a fair tax code is equality. A universal, flat, rate treats all Americans equally. As the Congressional Joint Economic Committee recently asked, "What could be more fair than having two people with the same income pay the same tax?"[43]

**Those Who Live off of Interest and Capital Gains Will Pay No Taxes.** Many believe that, since the Armey-Shelby Flat Tax does not tax savings, individuals whose income is derived solely from interest income or capital gains will pay no tax. This is patently false. Hall and Rabushka refute this assertion directly in their book, *The Flat Tax*.

> The flat tax puts the equivalent of a withholding tax on interest and capital gains. The business tax applies to business income before it is paid out as interest or if it is retained in the business and generates capital gains for stockholders. The interest, dividends, and capital gains received by individuals in all income categories have already been taxed under the business tax. The rich, along with all other recipients of business income, have already been taxed under the business tax – they cannot escape it. What they receive as dividends, interest, or capital gains is after-tax income, in exactly the same way that recipients of wages receive take-home pay.[44]

One of the principal reasons for not taxing savings at the individual level was to avoid the double taxation that currently exists in our tax code. Under the Armey-Shelby Flat Tax, an individual who lives off dividends, interest, or capital gains will pay taxes once – just like all other taxpayers.

Relatively simple in concept and inherently more fair than today's convoluted tax system, the flat tax has many assets. While transition problems could make reform less palatable, they can be overcome.[45] Upon examination, the flat tax clearly warrants consideration as a type of tax reform that must take place in America's near future.

## The Sales Tax

As previously mentioned the sales tax is a method of collection based solely on consumption, or in economic terms, income minus savings. Compared to our progressive and extremely complex system of taxation, a sales tax is relatively simple. A sales tax would tax all citizens by the same method. Under a sales tax both individual and corporate income taxes, as well as gift, estate and federal excise taxes would be replaced by levies imposed on the consumer at the time of the final sale of an item. This approach is thought of as a true "consumption" tax, because it eliminates the ability of the government to tax income at more than one source.

Under the current system, the withholding process takes pay from individuals even before they see it. Some people, even after years of work, fail to recognize what a staggering amount of their income is lost to taxes. Instead, people see only what they netted, not what they grossed through their own labor.

Similarly, corporate taxes are hidden, because they are eventually passed on to the consumer in the form of higher prices – with shareholders and workers effected as well. However, with a sales tax, consumers will feel the impact directly of paying their taxes to the government. Moreover, people will not have to meet the convoluted and oppressive set of requirements set forth under current law.

The tax code, as it exists, is often used as an instrument of social engineering. This perversion ignores the basic principle of American democracy – equality. A sales tax, on the other hand, seeks to collect taxes for the purpose of providing services to the people of the country, not distributing wealth. Ostensibly, what this means is that people will be given more freedom to use their money as they see fit and in turn, increase the amount of accountability on representatives to allocate tax revenue wisely.

Significant discussion has already been given to the inefficiencies and malfeasance of the current system. Again, the central point in this paper goes beyond the juxtaposition of two alternative systems of taxation. Rather, it hopes to highlight the many deficiencies of the current tax system and the many varied possibilities of reform. Just as in the discussion of the flat tax, this section will outline the advantages and disadvantages of the national sales tax.

Determining the appropriate rate and base for a national sales tax is a source of debate. Because of the amount of negative publicity the Internal Revenue Service has received over the last few years, several sales tax proposals have been developed. Most of these plans call for the repeal of the 16th Amendment, leading to the elimination of the IRS.

Many factors exist, however, which will invariably effect the rate of taxation under a national sales tax and these warrant discussion.

For instance, many scholarly institutions – including the Brookings Institution – argue that variables such as tax evasion, the fluctuation of state and local taxes, reduction of the tax base by political or other forces, government spending, and transition issues, including economic growth, all play a key role in shaping the tax rate under a sales tax.[46]

Indeed, evasion alone may have a significant impact on how high the rate need be to replace the current system. Extant literature shows that rates for a national sales tax anywhere between fifteen and thirty percent are plausible.

Arguing on behalf of their sales tax proposal, Representatives Bill Tauzin (R-LA) and Representative Dan Schaefer (R-CO), have outlined nine principles that apply to most – if not all – of the sales tax proposals currently being discussed:

- **No income is taxed until it is consumed.** Capital gains and interest income are not taxed as long as that income is reinvested. The income is taxed only when it is consumed. The same is true for income derived from labor.

- **Deductions are no longer a relevant concept under a sales tax.** Taxpayers, not the government, get the first crack at peoples' paychecks. There are no deductions from the paycheck, so there is no need for a tax deduction for state and local taxes or for charitable contributions. All money paid for taxes to other levels of government, or given to charities, is tax free (or equivalent to a 100% deduction under the income tax).

- **All services as well as goods sold at retail are taxed.** A sales tax would also apply to utility bills, legal fees, video rentals – any and every final good or service that is consumed.

- **No tax should be hidden in prices – all the burdens should be visible in the tax rate.** This way everyone knows what the cost of government is and can make rational decisions about its value relative to other costs we incur. All retailers would be compensated for their paperwork; otherwise compliance burdens would be hidden in their prices.

- **No business consumption (input) is taxed.** Nothing used to directly or indirectly produce a good for retail consumption is taxed.

- **The broader the base, the lower the rate—and the rate must be kept as low as possible.** If food, housing and clothing were exempted from a sales tax, the rate would automatically double and the rich would needlessly benefit.

- **Businesses do not pay taxes, they collect them.** Under any tax system – including the income tax – only consumers pay taxes. Businesses simply pass the cost of taxes on to the consumer and shareholders. For instance, businesses add the tax and its collection costs into the price of their goods and services, while reducing wages and the returns on capital to investors or owners. In each case the cost is borne by individuals through higher purchase prices, lower wages, or lower returns on investments.

- **The government only collects the tax on the value of a good once**. To avoid multiple taxation, a 100 percent rebate would be given on all used property sales.

- **Just about any criticism that applies to the NST also applies to the current income tax system and the flat tax.** The problem of determining whether a good was purchased for business or personal use is the same no matter what type of tax system. In all cases, prices go down and take-home pay goes up—more than offsetting the addition of the sales tax.[47]

As these principles demonstrate, the national sales tax's broad base is designed to generate enough revenue to maintain government programs, while providing more opportunity to individuals and businesses than is currently allowed.

The NST is very similar in nature to state sales taxes that most Americans already pay. Like the flat tax, a national retail sales tax would treat all economic activity equally, but taxpayers would receive a universal credit—an exemption from paying taxes on purchases up to the poverty level.[48]

The inclusion of a provision that allocates universal credit, such as a rebate, to low-income Americans deals directly with criticisms levied by tax reform opponents who feel that under either a national sales tax or flat tax the poor would suffer.

Economist David Burton explains that, "A family would not be asked to support the government until it was able to support itself. The rebate would be paid monthly in advance to every family. Conversely, a family that worked and saved to improve its standard of living, independence, and security would not be punished by steeply graduated tax rates."[49]

By treating all citizens the same, and eliminating the practice of social engineering through the tax code, a sales tax would provide considerable economic and social benefits over our current system of taxation.

However, in order to determine the viability of a sales tax, all facets must be examined. First, benefits of the NST will be discussed, followed by its drawbacks, and finally, the many transition issues that have been raised will be examined.

## Benefits of a Sales Tax

**Fairness.** Probably the largest promise that a national sales tax carries with it is its fairness. Americans commonly hold that all citizens in this country are equal to one another, especially in the eyes of the law. Income taxes violate this basic yet vital principle by giving special preferences based on level of income, special deductions and exemptions, and countless other loopholes. As Dan Mitchell of the Heritage Foundation puts it, "The sales tax would restore fairness in the system by ensuring that all taxpayers, all income, and all products are treated the same."[50]

For example, people wouldn't be subjected to double taxation on their income and their savings. Under a sales tax, people would have the choice to put their money into savings, free from taxes, letting the money accrue interest for as long as needed and would not have to pay a cent to the government until they used the money for consumption. This would create a huge incentive to save; and with increased savings the entire economy stands to prosper tremendously.

**Savings Increase.** Professor Laurence J. Kotlikoff contends that with the NST in place the savings rate would immediately triple. "After beginning slowly, U.S. capital stock would gradually increase at least 29 percent and potentially as much as 49 percent. Over time, the increase in capital stock would raise per capita productivity by seven percentage points, and increase real wages by 6 percent." The reason according to Kotlikoff is that, "a consumption tax, such as a sales tax, provides more incentive to save and invest than does income tax. Saving provides the funds that business uses to engage in investment, which leads to more capital stock, greater output and productivity and higher real wages."[51]

The effect of this growth can produce very tangible rewards for all Americans – regardless of their social and economic status. Conversely, by double taxing Americans, our current tax code lowers wages, eliminates jobs, and depresses the standard of living. When combined with local, state and other federal taxes, our current system of taxation takes as much as 40 percent of taxpayers' income.

"America has one of the worst savings rates in the industrialized world," argues Douglas W. Kmiec, a professor of law at Pepperdine University Law School in Los Angeles. "The savings rate encouraged by a sales tax would drive lending rates down to tax-free bond levels, and that means as much as $100 billion per year in lower federal borrowing cost and more money available for mortgages and business expansion.

Eliminating the income tax would make U.S. goods for export cheaper, thereby making American products more competitive abroad."[52]

**Civil Liberties.** By eliminating or lessening the role of the IRS, another benefit of a national sales tax would be increased civil liberties for all taxpayers. The current tax code gives an incredible amount of power to the IRS to investigate virtually all aspects of peoples' lives, to seize property, to freeze assets, and to garnish a person's wages.

Further, peoples' basic Constitutional rights are not respected under the current code. If the government believes that someone owes them money, it is then contingent upon the taxpayer to make his own case to prove his innocence. This reversal of the burden of proof is an anathema to our rights as guaranteed in the Constitution. Adoption of a sales tax would quickly remedy this malady.

**Effect on Lobbying.** In addition to reducing the intrusiveness of the IRS, there is an added political benefit in the reduction of special interest lobbying. Mitchell notes, "the tax code is the result of [86] years of special deals, loopholes and preferences. Each one of these loopholes benefits a special interest that has used campaign contributions and lobbying to enlist the help of politicians who voted to create the tax shelter . . . the national sales tax would remove from the tax system the corrupting process of exchanging loopholes for political support."[53]

Mitchell's contention of how a national sales tax would impact political processes is very important. There is a strong connection between the tax breaks and political contributions. Plans such as a sales tax or a flat tax, which endeavor to end such special benefits and tax everybody at one rate may become a critical part of campaign finance reform.[54]

By decreasing the political influence on the tax structure, a sales tax would considerably lessen the impact of special influences and help return fairness and democracy to the tax code.

**Compliance Costs Decrease.** As noted above, the compliance costs associated with the current tax code reach $200 billion a year – placing a severe cost on families, businesses and the American economy.[55]

Small businesses – the chief force in creating new jobs in this country – are disproportionately hurt by these compliance costs. Kotlikoff states, "small corporations spend $724 million to comply with the income tax for every $100 they pay in tax. Replacing the payroll tax, the income tax, and the estate and gift tax with a single, simple national sales tax on the retail sale of all goods and services would dramatically improve the economic environment."[56]

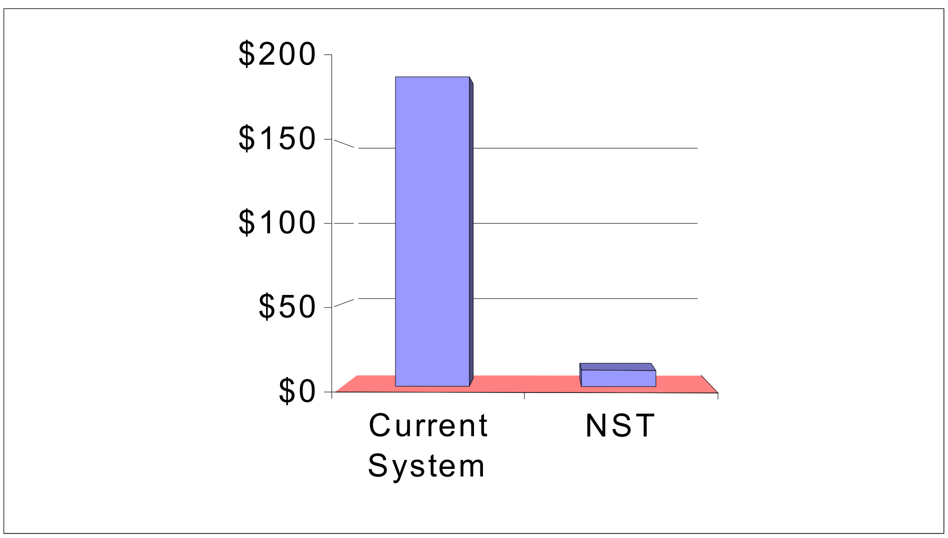
What a sales tax promises to deliver is the most simple and least intrusive method of taxation available. The clearest testament to this is that there would no longer be any tax returns. Advocates for a sales tax argue that they want to make April 15th just like any other day of the year.

Imagine never having to worry about turning all tax material in on time, complying with indecipherable regulations, or needing the advice of a tax expert. A national sales tax would make tax returns obsolete. Representative Tauzin explains, "The only people who would be bothered with collecting taxes would be the retailers of America, who now collect them for the state, and who would be paid a commission."[57]

The states have already demonstrated their ability to collect taxes stemming from retail sales. While adding a national sales tax would increase the compliance burden placed on states, it would be more than offset by the reduction in private sector time and money that would have otherwise been spent complying with the current system. The graph below illustrates the disparity regarding compliance costs under a national sales tax as opposed to graduated income taxes.

## Compliance Costs Under the Current System and a Sales Tax

(Figures in billions) Source: *Tax Foundation*




In addition to the benefits to individual liberty and the overall economy, the savings that would result from a sales tax are substantial. Nevertheless, what Tauzin and Schaefer have proposed has never been implemented and therefore, it is worthwhile to also consider to the potential downfalls of the national sales tax.

## Arguments Against a Sales Tax

**Ratification.** A national sales tax could be adopted without repealing the 16th Amendment. However, one of the main attractions of a sales tax is that it could eliminate the need for a national income tax and, possibly, the IRS.

In fact, most supporters of a sales tax argue that it is essential to repeal the 16th Amendment upon adoption of a sales tax. Without such a measure, the Congress would be free to impose both a sales tax *and* an income tax – worsening the current state of the American taxpayer. Thus, while it is not technically necessary to repeal the 16th Amendment to impose a sales tax, to fail to do so would be potentially disastrous.

Clearly, repealing the 16th Amendment would be an enormous task. Both houses of Congress would require a two-thirds vote on the measure and then at least 38 state legislatures would have to pass favorable judgment on it to be ratified. Mitchell contends, "Even amendments that garner 80 percent or more in polls, such as the Balanced Budget Amendment, have a hard time getting two-thirds majorities in Congress."[58]

Payroll taxes – Social Security and Medicare – could also be affected by the implementation of a sales tax. Currently, there is no progressivity in either payroll tax, but Mitchell warns that progressivity may be introduced to Social Security and Medicare payroll taxes if they are not repealed. If a sales tax was unable to meet the revenue demands of those programs, there is a risk that "politicians would gradually alter the payroll tax so that it degenerates into something that more closely resembles the current progressive income tax."[59]

**Sticker-shock.** Apart from Social Security there are other political and economic concerns over a sales tax. One of the main issues affecting a sales tax and its potential for support is the "sticker-shock" effect that could potentially frighten people away from large purchases.

For example, if you were going to buy an average family-sized sedan for $20,000, the taxes on that vehicle would be about $3,000. A house on the market for $150,000 would have an added tax burden of $22,500. That amount of money exceeds the capital needed for a down payment and may force consumers to lower their living standards. Amortizing such costs over the life of a home or car cold reduce visibility and add complexity to the tax.

In the short term, better savings rates as a result of a sales tax would probably not help consumers accrue enough money to completely meet their added retail costs. However, in the long term, decreased interest rates and higher returns on investment may prove to offset sticker-shock and eventually make financing large purchases more feasible.

**Exemptions.** Of course, the savings rate and the viability of a sales tax are dependent upon a stable economy. If exemptions were added, upward pressure would be applied to the tax rate. This, in turn, could produce political incentive for special interests to once again lobby for loopholes.

Very simply, the more loopholes that exist, the higher a sales tax rate must climb to fund the government at its current size. Some of the proposals claim that no exemptions will be offered on any goods or services; making special reference to clothing, medicine, food, and shelter. Most, however, would offer a rebate up to the level of poverty. The contention here is that a rebate, wholly different from an exemption, would allow those below the poverty level to pay for the basic necessities of life.

The rebate, similar to the flat tax's family allowance, has the added advantage of coming before the payment for goods or services, unlike an exemption, which would be administered at the time of sale. Still, any effort to pass a sales tax needs an aggressive plan to counter proponents of special preferences and penalties.

Undoubtedly, lawmakers will turn up the rhetoric to campaign for preferences for people suffering medically or from some other social condition. As Dan Mitchell puts it, "opponents will try to kill the sales tax by exploiting these sensitive issues and special interest groups, representing certain industries or consumers, will work hard to carve out exemptions."[60]

We have already seen debate at the state level suggesting that if exemptions are allowed to a sales tax, the government will grow ever larger determining what should be exempted. For example, in New York state lawmakers agonized over the nutritional value of marshmallows. As it turned out, tiny marshmallows—the hot chocolate variety – were deemed to have nutritional value, whereas larger marshmallows were characterized as candy and therefore, failed to qualify for exemption. Do we want our lawmakers, at any level, wasting their time on such frivolous debate? Are we prepared to get into the minutia over what constitutes basic need on a myriad of different issues such as housing, clothing, medical care, and others?

Despite the best intentions of the supporters of a sales tax, if exemptions do make their way into the plan, Americans will find themselves answering to an IRS that is potentially as large and as abusive as the one today. When a sales tax is being considered by Congress, its authors would be wise to insist upon rebates, not exemptions.

**IRS Will Continue to Exist.** As discussed previously, the complete elimination of the IRS – while desirable – is not likely. To one extent or another, the agency will likely remain to collect revenue and distribute rebates. With the size of the IRS in question, it is crucial that sales tax proponents do everything possible to protect the states and retailers who will largely shoulder the burden of tax collection.

As Representative Armey contends, "Businesses collect a relatively small share of the income tax, since three quarters of the income in the economy is labor income, paid by individuals. But under a national sales tax, there is no direct tax on individuals, so businesses will be responsible for collecting several times what they collect today." Armey continues to explain, "What this means is that IRS scrutiny and abuse of American businesses could be expected to rise proportionately."[61]

**Value Added Taxes.** For the states, Congress would have to take special steps to ensure the proper functioning of a sales tax. Under most sales tax proposals, local, state, and federal taxes would have to coexist within one system of collection. Currently, however, five states do not collect sales taxes. Obviously, the federal government would be forcibly requiring these states to establish a system to collect sales taxes.

Moreover, advocates for the national retail sales tax would have to resist pressure to turn the sales tax into a value added tax (VAT). As Dan Mitchell explains, "a VAT taxes the 'value added' to a product or service at each stage of the production process."[62] VATs are widely used throughout Europe and in Japan, because they give lawmakers the ability to impose levies on goods and services from many points.

By taxing a product at each stage in its production, the government is able to tax a single item multiple times. Furthermore, because the tax is imposed during a products' manufacturing stage, it is essentially hidden from the consumer. Hidden taxes allow governments to tax products at levels higher than would normally be tolerated by the populace.

Additionally, under VATs, governments have the right to determine the value of certain services or goods—making it possible, as with exemptions, to allow deleterious loopholes and preferences enter the system. "Free market supporters traditionally have been skeptical of a VAT, viewing it as a hidden tax that would become a money machine for politicians," argues Mitchell.[63]

Value Added Taxes are clearly are at odds with the expressed goals of most sales tax proponents given that VATs raise peoples' tax burden and create the opportunity for malfeasance to lard the system with special preferences. For this reason, politicians should be clear about their stance on exemptions and value-added systems before they enter the fray over a national sales tax.

**Foreign Trade.** The final criticism of a sales tax is that it may actually serve to hurt foreign trade. Representative Armey states, " an immutable law of economics holds that trade surpluses and deficits are linked to the amount a nation lends or borrows. When savings are low, the trade deficit must be high, but if we substituted a tax on imports for some other tax, it will not affect the way Americans save . . . the trade deficit will stay the same."[64]

However, this effect depends upon the savings rate and domestic production. If the savings rate does increase as projected under a sales tax – allowing for more domestic investment—there would be less need to rely upon foreign capital. As this reliance continually decreases, and Americans invest more and more at home, the trade deficit will fall.

The idea of eliminating one method of revenue collection and completely replacing it with an alternative system, such as a sales tax, is a radical departure from our tax policy of the last 85 years. However, the need for change is acute and it is clear that the flat tax and the national sales tax are the two best ideas to provide relief to American taxpayers.

Beyond the merits and drawbacks of each proposal there are transition issues that must be faced in order to determine if the flat tax and a national sales tax are capable of making the proverbial jump from theory to practice.

## Transition Issues

In addition to the political challenges of passing tax reform, significant transition issues must be addressed before any type of proposal is adopted. Further, it stands to reason that the more fundamental the change to the system, the greater the need for a transition blueprint.

There is a dearth of literature that specifically focuses on what form the transition from one system of taxation to a new one should take. J. D. Foster, Chief Economist and Executive Director of the Tax Foundation, argues, "While the principles underlying tax reform are well established, the principles underlying the transition are not. The 'transition issue' is often left as the after-thought to be handled later by technicians."[65]

Foster contends that there are two "moral and economic principles" involved in developing transition issues:

- Transition rules should prevent, insofar as possible, instances of retroactive taxation or retroactive tax relief.

- Tax reform transition rules should be as simple as possible.

The first principle is aimed at preventing unfair tax liability to individuals as new tax rules are applied to arrangements made under the former system.

Conversely, it also seeks to protect against large windfalls, such as "when certain activities or investments, subject to tax under current law would face a lower rate of tax or would be tax free under tax reform."[66]

The second principle deals with the impetus for change – simplicity. Americans are weary of the endless set of instructions and compliance guidelines that they must adhere to. The transition to the new system must be as simple and as taxpayer-friendly as the reform promises to be, if popular acceptance it to ensue.

The principles that Foster establishes for a successful transition are critical for both the short-term and long-term viability of any type of fundamental reform such as the flat tax or NST. Still, there are literally hundreds, possibly thousands, of other sub-issues that warrant attention. Foster posits that in order to logically order such issues they may be grouped according to whether:

- A correct and simple solution is to "grandfather" the existing tax treatment for those economic arrangements and activities undertaken before the tax reform.

- The existing tax code has created tax assets such as Foreign Tax Credits for which there is no natural analog in the new tax system and so grandfathering would be ineffective.

- The taxpayer has a claim on future income from currently owned assets and the income would be taxed more lightly or not at all under the new tax system.

The performance of transition strategies will help determine the economic vitality of this country well beyond the implementation of reform. However, as this analysis suggests, more research is warranted on how transition issues and sub-issues are identified, defined, categorized, and given consummate treatment. As Foster notes, "The ability and willingness of tax reformers to address these [transition] issues directly will affect the pace at which tax reform moves from dream to reality."[67]

## Conclusion

The purpose of this paper has been to highlight the critical need for major tax reform. Both the flat tax and a national sales tax have been considered for their merits and potential shortcomings. Additionally, the various transition issues surrounding tax reform were raised. As described, the intent was not to lead readers to a desired conclusion. Rather, our intent was to generate further discussion and debate on tax reform – leading to comprehensive change.

Americans demand, and deserve, tax reform. It should be sooner, rather than later. The longer Congress waits to provide that reform, the longer the economy will perform below its potential and the longer Americans will be overtaxed. Journalist Frank Sullivan once remarked, "To produce an income tax return that has any depth to it, any feeling, one must have Lived and Suffered."[68] At the center of tax reform proposals there is a potential to show Americans that generating and collecting revenue need not be so arduous. To date, the flat tax and the National Sales Tax are the only reform proposals that seek to maximize positive living and minimize the amount of suffering Americans must endure at the hands of their own government.

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