

The Thomas A. Roe Institute for Economic Policy Studies

September 26, 1995

WHICH TAX REFORM PLAN IS BEST FOR AMERICA?

INTRODUCTION

Tax reform is gaining momentum. Lawmakers from both parties are proposing sweeping changes in the income tax system, such as the Armey-Shelby flat tax (the most widely known of the proposed reforms), a national sales tax, the Nunn-Domenici USA tax, the Gephardt 10 percent tax, and a value-added tax. Almost every Republican presidential candidate endorses some form of radical tax reform, and House Speaker Newt Gingrich (R-GA) and Senate Majority Leader Robert Dole (R-KS) asked former Congressman and housing secretary Jack Kemp to chair a commission to recommend how best to reform the tax code.

Each of the tax reform proposals assumes that the existing income tax system is fundamentally broken and cannot be fixed without a complete overhaul. But they achieve this in significantly different ways. The question is, which approach would be best for taxpayers and the economy?

TAXPAYERS AND THE ECONOMY Grading Tax Reform Proposals

Table with 2 columns: Tax Reform Proposal and Grade. Rows include Armey/Shelby flat tax (A), Specter flat tax (A-), Value-added tax* (B+), National sales tax* (B), Nunn-Domenici USA tax (C+), and Gephardt 10 percent tax (C).

*Grade contingent on permanent repeal of the current federal income tax

1 Other bills have been introduced which are variants of the major reform proposals. Senator Arlen Specter (R-PA), for instance, has introduced a flat tax which maintains certain deductions.

When evaluated based on nine different criteria, including the degree to which they lower tax rates, simplify the system, address the bias against savings and investment, and treat taxpayers fairly, the plans based on the flat tax model developed by Stanford University Professor Robert Hall and Hoover Institution Senior Fellow Alvin Rabushka score highest.² Direct consumption taxes also fare well, but proposals that more closely resemble the current system are graded the lowest.

Since no tax system is perfect, this grading scale is somewhat subjective: A for reform as close to the ideal as possible,³ B for significant improvement over the current system, C for no significant effect one way or the other, D for a plan (or a feature of a plan) demonstrably worse than today's tax code, and F for significantly worse than today's tax code.

In order to understand these grades, it is necessary to identify what is wrong with the current system and then to determine how each reform plan addresses each of these flaws.

WHAT IS WRONG WITH THE CURRENT SYSTEM

Today's tax code has few defenders. Former Internal Revenue Service Commissioner Shirley Peterson states that there is nothing logical about the way the code is constructed now.⁴ As House Minority Leader Richard Gephardt points out:

It has become a test of legal brainpower, an accountant's decathlon, a treasure hunt for hidden deductions and buried tax breaks. Our tax code has become a dense fog of incentives, inducements, and penalties that distort the most basic economic decisions, constrain the free market, and make it hard for Americans to run their own lives. The Internal Revenue Service has become a symbol of what is wrong with American government.⁵

And Senate Majority Leader Bob Dole has summed up many of the problems with the current system, noting:

During much of the past century, tax policy has been a primary tool with which government has wielded power, fed the bureaucracy, and redistributed wealth.... Any fair system would not penalize, but instead reward people for working harder, investing wisely, and saving more. It would eliminate the lobbyist-drafted loopholes that benefit the few, but force the rest of us to pay.⁶

The current income tax system is both anti-growth and discriminatory. Its problems, while seemingly endless, fall into several broad categories:

-
- 2 Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Cal.: Hoover Institution Press, 1995).
 - 3 For example, a flat tax with a 10 percent rate is superior to a flat tax of 17 percent. Such a proposal, however, implicitly assumes a decline in the size of government that is not likely to occur in the near future. The Arney/Shelby flat tax earns high grades within the context of what is practical, at least in the short term.
 - 4 Andrew Ferguson, "Postcard from Heaven," *The Washingtonian*, April 1995.
 - 5 Remarks by House Democratic Leader Richard Gephardt, Center for National Policy, July 6, 1995.
 - 6 Senator Bob Dole, remarks prepared for delivery before the Economic Club of Chicago, Illinois, September 5, 1995.

- ✗ **High tax rates** —Under present law, a successful entrepreneur will pay more than 40 cents of each additional dollar earned to the federal government. This burden can rise to over 50 cents when state income taxes are included and to more than 80 cents when estate taxes are added. These excessive rates penalize productive economic behavior and reduce incentives to work, create wealth, and take risks.
- ✗ **Complexity** —The large number of forms, regulations, and rulings forces many Americans to pay professionals to fill out their tax forms. According to the Tax Foundation, annual compliance costs total nearly \$200 billion (in addition to the taxes paid to Washington and the loss in economic growth caused by excessive rates).⁷
- ✗ **Multiple taxation** —Some forms of income, particularly from savings and investment, are subject to as many as four levels of tax. For example, a dollar of capital income could be subject to corporate income, personal income, capital gains, and estate taxes. This combined burden becomes confiscatory and undermines incentives to save and invest.
- ✗ **Social engineering** —Politicians have turned the tax code into a bewildering system of special preferences, penalties, and deductions. Some income is taxed more than once, while other income is not taxed at all. Such complexity is inevitable in a tax system that rewards those with expensive lawyers and accountants and allows lawmakers to micromanage the economy while collecting large campaign contributions from donors seeking to change or preserve sections of the tax code.

THE COMPETING TAX PLANS

While there is widespread agreement on what is wrong with the tax system, there is considerable debate over which plan best solves these problems. The following are the key features of the major tax reform proposals currently under consideration:

Armey/Shelby flat tax — Based on the Hall/Rabushka flat tax, H.R. 2060 and S. 1050, sponsored by House Majority Leader Richard K. Armey (R-TX) and Senator Richard Shelby (R-AL), would replace the current personal and corporate income tax system with a simple 17 percent tax on all income. With the exception of a generous family allowance, all labor income is taxed at the individual level. Taxes on business income (such as interest, dividends, capital gains, and rents) are withheld and paid at the business level. Both businesses and individuals would fill out postcard-sized returns.

⁷ Arthur Hall, "Compliance Costs of Alternative Tax Systems," *Special Brief*, The Tax Foundation, Washington, D.C., June 1995.



Tax Forms on a Postcard: The Arme-y-Shelby Flat Tax

Form 1		Individual Wage Tax		1998
Your first name and initial (if joint return, also give spouse's name and initial)		Last name		Your social security number
Home address (number and street including apartment number or rural route)			Spouse's social security number	
City, town, or post office, state and ZIP code			Your occupation	
			Spouse's occupation	
1	Wages, Salary and Pensions	1		
2	Personal Allowance			
	(a) \$22,700 for married filing jointly	2(a)		
	(b) \$11,350 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 multiplied 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% 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		

Form 2		Business Tax		1998
Business name		Employer Id. Number		
Street address		County		
City, town, or post office, state and ZIP code		Principal product		
1	Gross revenue from sales	1		
2	Allowable costs			
	(a) Purchases of goods, services, and materials	2(a)		
	(b) Wages, salaries, and pensions	2(b)		
	(c) Purchases of capital equipment, structures, and land	2(c)		
3	Total allowable costs (sum of lines 2(a), 2(b), and 2(c))	3		
4	Taxable income (line 1 less line 3)	4		
5	Tax (17% of line 4)	5		
6	Carry-forward from 1997	6		
7	Interest on carry-forward (6 percent of line 6)	7		
8	Carry-forward into 1998 (line 6 plus line 7)	8		
9	Tax due (line 5 less line 8, if positive)	9		
10	Carry forward to 1999 (line 8 less line 5, if positive)	10		

Source: Office of Representative Dick Arme-y.

National retail sales tax —This proposal would replace the personal and corporate income taxes with a sales tax. Many details remain unknown, such as what tax rate would be applied and what goods and services, if any, would be exempted. As of publication, there is no legislation to create a national sales tax, although Representatives Dan Schaefer (R-CO) and Billy Tauzin (R-LA) may introduce a bill shortly.

Value-added tax —This tax, known as the VAT, is similar to a national sales tax, except that it is levied on the additional value created at each stage of production. For example, instead of a 25 percent retail sales tax on purchases at a furniture store, the VAT would tax the logs as they go to the sawmill, the lumber as it goes to the furniture manufacturer, the furniture as it goes to the store, and the same furniture as it is sold to the consumer. The net effect, however, is the same: a 25 percent tax on the value of the retail sale. There currently is no legislation to replace income taxes with a VAT, although House Ways and Means Committee Chairman Bill Archer (R-TX) intends to introduce some type of direct consumption tax.

Nunn/Domenici USA tax —Sponsored by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM), the Unlimited Savings Account tax (S. 722) creates the equivalent of an unlimited Individual Retirement Account (IRA) and replaces the current rate structure with a three-rate structure that includes a top rate of 40 percent. Some deductions are lost or curtailed, and at least one new deduction is created. The corporate income tax is replaced by a VAT.

Gephardt 10 percent tax —This plan, introduced by House Minority Leader Richard Gephardt (D-MO), broadens the tax base by eliminating such preferences as deductions for charitable contributions and state and local taxes and taxing the value of fringe benefits. The proposal also replaces the five current tax brackets with five new brackets ranging between 10 percent and 34 percent.

Specter flat tax —Using the same model as the Arney/Shelby flat tax, Senator Arlen Specter (R-PA), in S. 488, proposes a slightly higher rate and lower personal allowance in order to maintain limited deductions for charitable contributions and the full deduction for home mortgage interest.

Other tax reform proposals are expected in coming months. Senator Connie Mack (R-FL) may introduce a version of the flat tax which presumably will have many of the same economic benefits as the Arney/Shelby legislation. Senator Bill Bradley (D-NJ) is rumored to be preparing a tax reform bill, though no details are available and his decision to retire may alter those plans. Finally, as the tax reform debate heats up, the Administration might introduce its own plan. The President has said that he finds the flat tax appealing, and Chief of Staff Leon Panetta introduced flat tax legislation as a Member of Congress in 1983. The White House also has expressed interest in the value-added tax,⁸ although it is unlikely that the Administration would support a VAT as a replacement for the income tax.

8 Clay Chandler, "Clinton May Jump Into Tax Reform Fray," *The Washington Post*, August 2, 1995.

GRADING THE TAX PLANS

While each reform has an overall grade, it is particularly useful to see how the different proposals address specific flaws in the current system. The grades in the following section indicate the extent to which different tax plans reflect nine important principles of sound tax policy.

Low Rates

Low tax rates ensure that taxpayers have little incentive to hide, shelter, and underreport income. Because willingness to work, save, invest, and take risks is tied to the expected rewards of such behavior, the lower the tax rate(s), the higher the level of economic growth.

Armev/Shelby flat tax

A

The flat tax popularized by the House Majority Leader begins with a 20 percent rate that phases down to 17 percent in the third year.

National retail sales tax

A

Assuming a low rate and with income not taxed directly, the penalty on the creation of wealth would be minor.⁹

Value-added tax

A

As with the national sales tax, a VAT with a low rate would have minimal impact on working, savings, and investment.

Nunn/Domenici USA tax

D

The top tax rate in the USA tax is 40 percent, even higher than in current law. To make matters worse, it applies to taxable incomes as low as \$24,000 for a family of four.

Gephardt 10 percent tax

C

Like the current system, the Minority Leader's plan has five separate rates. These rates are slightly lower than in current law, but the expansion of taxable income and the income levels at which the different rates apply offset this minor improvement.

Specter flat tax

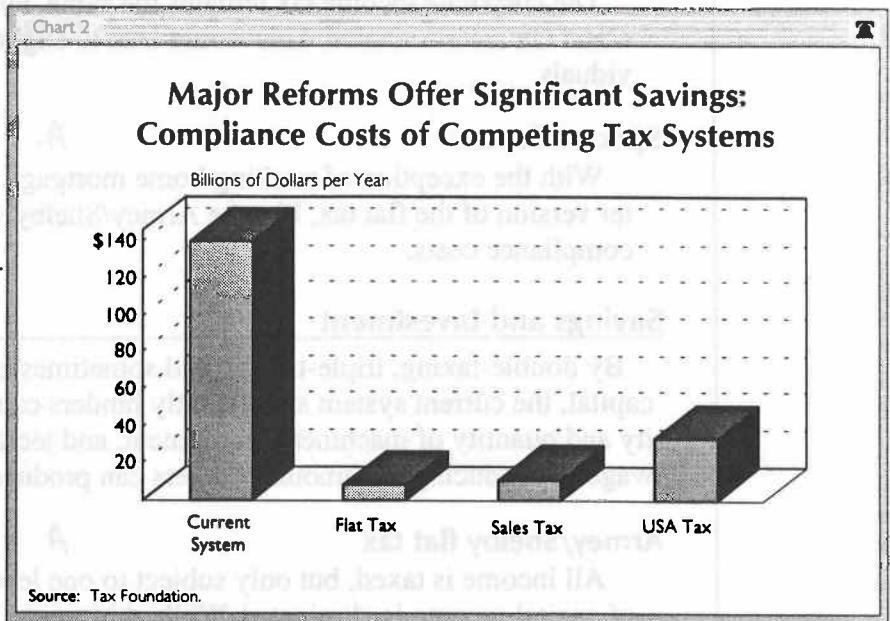
A-

The Specter plan's low 20 percent flat rate would stimulate increased work, savings, and investment when compared with current law, although it could be even lower if the remaining deductions were scrapped.

⁹ All taxes, including the sales tax and VAT, are paid out of income. The difference between these taxes and a flat tax is that the flat tax collects revenues when the income is earned, while direct consumption taxes collect the revenue when income is spent. Either way, a key to economic growth is keeping the rate as low as possible.

Simplicity

The current income tax has more than 400 different forms, requires more than one billion 1099 forms (tracking interest and dividend income), and necessitates more than five billion hours of effort each year.¹⁰ While individuals rightly complain about the costs of simply compiling information, calculating their taxes, and understanding forms, compliance costs for business are twice as high.



Armed/Shelby flat tax **A**

The current system's plethora of documents, paperwork, and complex record-keeping would be greatly simplified by two postcard-sized forms, one for individuals and one for business.

National retail sales tax **B**

Compliance costs for individuals would disappear, though retail businesses would bear an increased burden because they would be responsible for collecting the tax and complying with reporting requirements.

Value-added tax **B+**

Individual compliance costs would vanish, as would the daunting complexities of the corporate income tax, but businesses would have to maintain detailed records to calculate their share of tax liability as goods and services travel through the production process.

Nunn/Domenici USA tax **B-**

Since the burden of the corporate income tax is even worse than a VAT, compliance costs for business would fall under a USA tax. Individual compliance costs could rise relative to the current system, however, because of requirements for tracking deposits and withdrawals into the unlimited IRA.

¹⁰ James Payne, *Costly Returns: The Burdens of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies Press, 1993).

Gephardt 10 percent tax C+

The corporate income tax remains the same, but many deductions for the personal income tax are eliminated. This would lead to slightly lower compliance costs for individuals.

Specter flat tax A-

With the exception of tracking home mortgage and charitable contributions, the Specter version of the flat tax, like the Armev/Shelby version, also significantly reduces compliance costs.

Savings and Investment

By double-taxing, triple-taxing, and sometimes even quadruple-taxing income from capital, the current system significantly hinders capital formation. This reduces the quality and quantity of machinery, equipment, and technology in the economy and lowers wages by reducing the amount workers can produce.

Armev/Shelby flat tax A

All income is taxed, but only subject to one level of tax. The current multiple taxation of capital income is eliminated. While this would boost savings and investment compared to current law, the effect would be to make the tax code neutral, neither encouraging nor discouraging savings, investment, or consumption.

National retail sales tax A

By not taxing income directly, the retail sales tax removes the bias in the existing system against savings and investment.

Value-added tax A

Like the sales tax, the VAT addresses the capital formation problem by ending income taxation altogether.

Nunn/Domenici USA tax B

While the USA tax eliminates the bias against savings and investment caused by multiple taxation by providing an unlimited IRA, it dampens incentives to save and invest by imposing sharply graduated rates.

Gephardt 10 percent tax D-

The Minority Leader's plan not only retains the existing anti-savings, anti-investment features of the current system, but also makes the tax code even more hostile to savings and investment by including provisions such as an increase in the tax rate on capital gains.

Specter flat tax A-

As with all flat taxes based on the Hall/Rabushka model, there is no bias against capital formation. The continuation of certain deductions, particularly the mortgage interest deduction, does result in a mild distortion of market forces.¹¹

11 G. Pascal Zachary, "Mortgage Deduction Comes Under Fire: Tax Breaks Inflate Rates and Home Prices,

Social Engineering

The tax code today rewards some types of activity, everything from putting a child in daycare to buying a home. Other behaviors, however, such as savings and investment, are penalized harshly. Particularly disturbing is the ability of special interests to add special preferences to the tax code on behalf of wealthy clients.

Armey/Shelby flat tax

A

The only preference in the pure flat tax is a family allowance. Government would not attempt to steer economic decisions or try to penalize or reward different types of behavior.

National retail sales tax

A

Presuming it would apply equally to all goods and services, the retail sales tax would get government out of the business of micromanaging private decisions. There is a danger, of course, that politicians would impose higher rates on unpopular goods and services (tobacco, caviar, imports) while granting lower or zero rates to others (food, shelter, health care).

Value-added tax

A

Like the sales tax, a pure VAT ends government favoritism and efforts to subsidize certain industries or activities. The same caveat—the potential for discriminatory rates—applies.

Nunn/Domenici USA tax

B

Some deductions are eliminated, but this is offset by the creation of new ones such as a deduction for educational expenses. The USA proposal, however, does end the current code's explicit penalties on savings and investment.

Gephardt 10 percent tax

B-

With the exception of the home mortgage interest deduction, special preferences in the tax code are eliminated. The Minority Leader's plan even taxes fringe benefits. Existing penalties on savings and investment, however, are made even worse by increasing the capital gains tax.

Specter flat tax

A-

Except for continuing limited individual deductions for mortgage interest and charitable contributions, the Specter version of the flat tax takes government officials out of the business of picking winners and losers.

Intrusiveness/Civil Liberties

In part because of the code's numbing complexity, but also because of legislative directives, the IRS engages in tax collection activities that many believe are abusive. A simple tax code, with easily understood rules that apply to everyone, would solve much of this problem. Because all tax systems ultimately are based on coercion, and thus are accompa-

nied by police powers for the taxing authority, the highest grades are given to proposals that minimize the scope and opportunity for intrusion.

Armey/Shelby flat tax

A

By dramatically reducing the complexities of the current system, this plan would leave taxpayers with less reason to fear the IRS. For individual taxpayers, the only possible areas of controversy are the size of one's family and the amount of labor income earned (taxes on capital income are withheld and paid at the business level). Whatever problems remain—including how the self-employed handle deductions, particularly if they work out of their homes—would be a fraction of those that exist now.

National retail sales tax

A

Small businesses will not appreciate collecting taxes for the federal government, but the level of intrusion resulting from a properly designed sales tax is small compared with the current system. This is particularly true in states that already impose sales taxes.

Value-added tax

A

In its pure form, the VAT should minimize most tax collection abuses. Businesses would need to maintain records, but the impositions on privacy would be small compared with the current system.¹²

Nunn/Domenici USA tax

C

Much of the current tax system is left in place. Moreover, the government will require detailed financial records from individuals who lower their tax burden by saving.

Gephardt 10 percent tax

C

Some deductions disappear, presumably reducing the potential for disputes with the IRS, but the multiple taxation of savings and investment becomes more pervasive, a step that will create more conflicts between citizens and tax authorities. The net effect is probably zero.

Specter flat tax

A-

Simple and straightforward, the Specter flat tax should eliminate most abuses. Retention of certain limited deductions, however, requires record-keeping and creates opportunities for IRS intrusion into taxpayers' personal affairs.

Fairness

Fairness in the tax system should mean equal treatment. Any special treatment, either preference or penalty, violates this principle. All taxpayers—and all income—should be treated equally.

12 This does not imply that the flat tax, sales tax, or VAT have no negative impact on privacy or are free of government intrusion. These grades simply mean that the level of government snooping is smaller than the current system's and about as low as can be achieved given that government is forcibly extracting hundreds of billions of dollars out of the economy.

Armey/Shelby flat tax

A

All taxpayers pay the same rate, and all income is taxed once. The only exemption is the zero bracket amount (personal allowance) based on family size.

National retail sales tax

A

All taxpayers presumably will pay the same rate, and all goods and services presumably will be taxed. As with the flat tax, there probably will be some mechanism to eliminate any tax liability for those with low incomes.

Value-added tax

A

Like the retail sales tax, the VAT theoretically should apply equally to all taxpayers and not discriminate by charging different rates. Also, there likely will be a process by which to offset the tax burden for the poor.

Nunn/Domenici USA tax

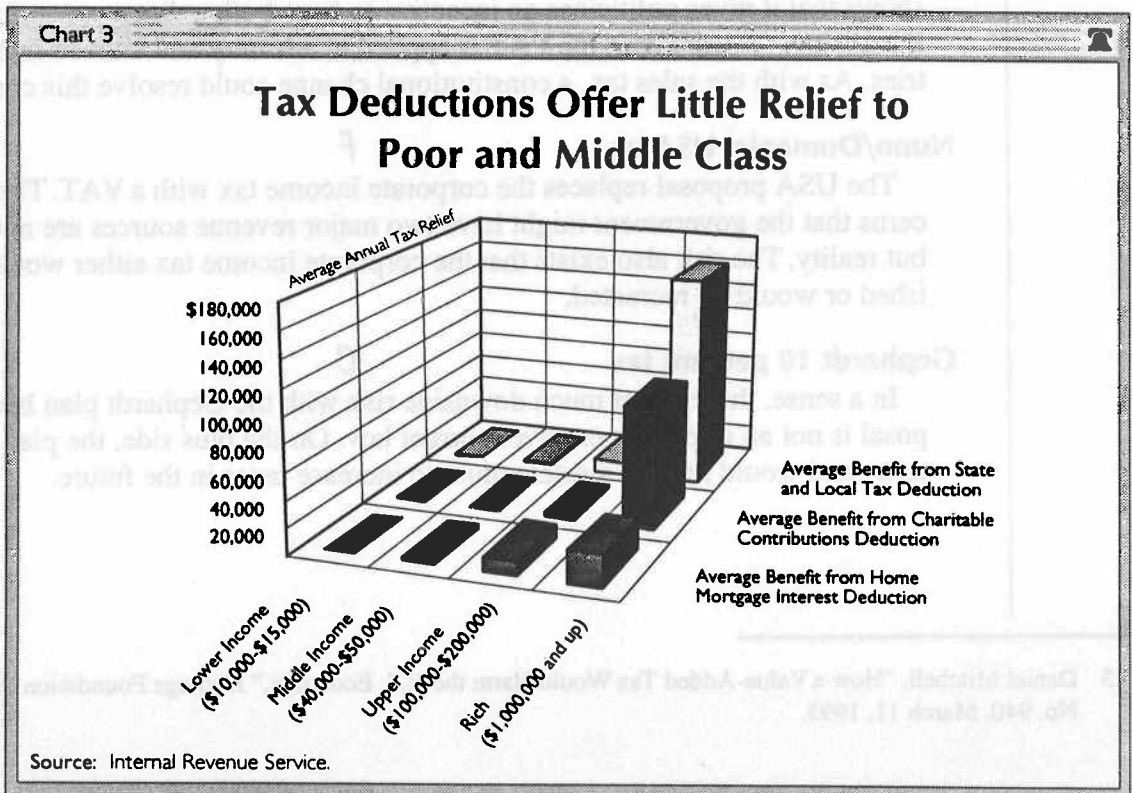
C-

Maintaining steeply graduated rates means that the law will not apply equally to all taxpayers. Government would continue to interfere with economic decisions by granting preferential treatment to certain activities. Also, the estate tax would remain, applying double taxation to the affected income.

Gephardt 10 percent tax

D-

Like the USA tax, the Gephardt proposal includes steeply progressive rates that explicitly impose special penalties on certain citizens. Compounding this error is its exacerbation of the current code's multiple taxation of capital income. The only provision that precludes a failing grade is the elimination of some deductions.



Specter flat tax

A-

This proposal has all the fairness of the Arme y plan, with the exception of modest deductions for mortgage interest and charitable contributions.

Downside Risk

While many tax reform proposals are conceptually attractive and would boost the economy if enacted, they should not be examined in a vacuum. The long-term ability of each tax to retain these theoretical benefits must be considered.

Arme y/Shelby flat tax

B

Just as lawmakers began raising rates after the 1986 tax reform act, future Congresses could undo a flat tax. One advantage of a pure flat tax, however, is that any changes would be obvious to voters.

The worst that could happen is that policy might drift back to where it is now, but a constitutional amendment requiring a supermajority to raise tax rates would address this concern.

National retail sales tax

F

The great risk with a retail sales tax is that politicians might adopt a direct consumption tax, but never get around to abolishing the income tax. Also, if state experience is any indication, a sales tax might be manipulated so that some products are exempted while others are subjected to punitive rates. A constitutional amendment explicitly barring an income tax would solve this problem.

Value-added tax

F

All the risks inherent in a retail sales tax exist with a VAT. The European experience shows that it gives politicians an incentive to have both a direct consumption tax and an income tax.¹³ Moreover, the VAT is applied at arbitrary and uneven rates in most countries. As with the sales tax, a constitutional change could resolve this concern.

Nunn/Domenici USA tax

F

The USA proposal replaces the corporate income tax with a VAT. Therefore, concerns that the government might have two major revenue sources are not just theory, but reality. The risk also exists that the corporate income tax either would never be abolished or would be recreated.

Gephardt 10 percent tax

C

In a sense, there is not much downside risk with the Gephardt plan because the proposal is not an improvement over current law. On the plus side, the plan creates no new taxes and would require a referendum to increase taxes in the future.

13 Daniel Mitchell, "How a Value-Added Tax Would Harm the U.S. Economy," Heritage Foundation *Backgrounder* No. 940, March 11, 1993.

Specter flat tax

B-

Like the Armev/Shelby proposal, the Specter flat tax is haunted by the evidence since the 1986 tax reform act. Because the Specter version explicitly accepts the notion that policymakers should impose tax preferences because it preserves certain deductions, the risks are somewhat higher that the tax code could be skewed even further.

Evasion

Support for any tax system and its long-term viability depends on how the law works. If there are opportunities for individuals to evade taxes—and if enough of them take advantage of those opportunities—the public will view the law as corrupt. Moreover, the loss of revenue will encourage politicians to raise rates on those who do comply with the law, thereby encouraging still more evasion. The downward spiral of higher rates followed by more evasion could be endless.

Armev/Shelby flat tax

A

Because of its low rate, this tax provides minimal incentives for evasion. Moreover, by taxing business income at the source, it eliminates the need for more than one billion 1099 forms and simplifies enforcement considerably.

National retail sales tax

D

The evidence suggests that retail sales taxes higher than about 10 percent are subject to widespread evasion.¹⁴ Indeed, almost every country with a VAT originally had a sales tax but changed once rates crept above that level because of problems with complexity and compliance.¹⁵

Value-added tax

B+

A VAT does allow the government to enforce much greater compliance than is possible under a sales tax because the tax is collected at each stage of the production process and there is no need to track whether a product is being sold at retail or wholesale.

Nunn/Domenici USA tax

B

The high tax rates in the USA tax will increase incentives to use the underground economy. Moreover, because there will be no tax on income put into savings (and no taxes levied on funds withdrawn from savings), there could be incentives to find ways to manipulate this system.

Gephardt 10 percent tax

C

Evasion is not likely to change significantly under the Minority Leader's plan. Eliminating certain deductions could reduce evasion opportunities, but increasing the multiple taxation of capital income will increase incentives to hide or underreport income.

¹⁴ *Taxation in OECD Countries*, Paris, OECD, 1993, pp. 73-78.

¹⁵ *Ibid.*

Specter flat tax

A-

Retaining limited deductions and taxing at a slightly higher rate could cause a modest reduction in compliance compared to a pure flat tax since there would be an opportunity to exaggerate deductions.

International Competitiveness

In a world where capital funds react quickly to changes in a nation's business climate, a tax system that rewards entrepreneurship will attract increased investment and job creation. A system that penalizes growth with high tax rates and imposes multiple levels of taxation on capital income, by contrast, will suffer from capital flight. In addition to their effects on growth, international provisions in the current code are a major source of complexity. Unfortunately, as Chart 4 illustrates, America has undermined its ability to compete by raising tax rates while most of our competitors have been cutting tax rates.

Armev/Shelby flat tax

A

By eliminating the multiple taxation of capital income, all flat taxes based on the Hall/Rabushka model will trigger a surge of new investment and jobs in the United States. By ending the complex practice of taxing American companies and individuals on their foreign income (already taxed in the country where it is earned), the flat tax model will lower compliance costs dramatically and encourage more U.S. firms to enter the global market.

National retail sales tax

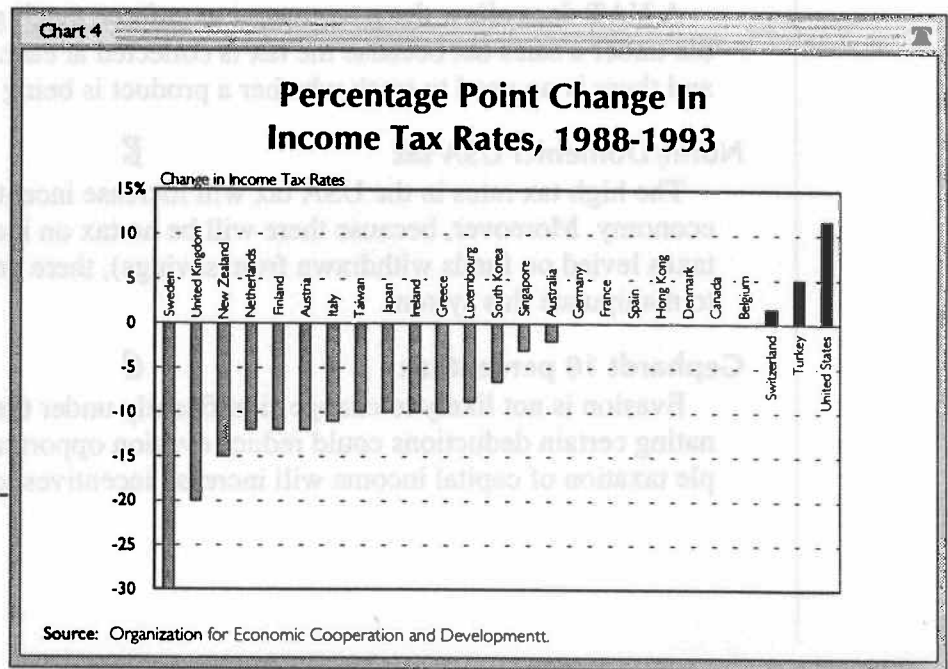
A

Replacing the current, deeply flawed income tax with a direct consumption tax will boost international competitiveness, increase investment, and stimulate job creation.

However, the benefits result from ending the income tax, not from imposing the sales tax.

Some proponents argue that a sales tax would help the economy and the balance of trade, because it would be levied on goods and services coming into the country while exports would be exempt.

This would not create a competitive advantage for America.¹⁶ Products sold in America, whether foreign-made or domestic, would be subject to the U.S.



sales tax. Likewise, products sold in other countries, whether domestic or American-made, would be subject to applicable sales taxes or VATs in those countries.

Value-added tax

A

As with the retail sales tax, a VAT will attract foreign investment and encourage job creation. As noted above, these benefits do not flow automatically from a direct consumption tax. VATs and other sales-based taxes simply create level playing fields. Their benefits stem from elimination of the income tax.

Nunn/Domenici USA tax

B

Like the Armev/Shelby flat tax, the USA tax largely ends the complex practice of taxing businesses on income earned overseas. It also eliminates most multiple taxes on capital income, a reform that would encourage foreign investment. Unfortunately, some of these incentives would be offset by high marginal tax rates.

Gephardt 10 percent tax

C

Because the current tax system penalizes growth with high tax rates and imposes multiple levels of taxation on capital income, it is extremely destructive to international competitiveness. The Minority Leader's proposal might exacerbate this problem somewhat by expanding the multiple taxation of capital income.¹⁷

Specter flat tax

A-

With a low rate and no tax burden on foreign income because it already is taxed by the nation where it is earned, the Specter flat tax would boost growth and attract capital from overseas.

CONCLUSION

The current income tax system demands comprehensive reform. High rates punish success, excessive complexity drains productive resources, and punitive taxation of capital income retards savings and investment. Of the many proposals have been offered to correct these flaws, reforms based on the Hall/Rabushka flat tax are the best. The flat tax replaces the current five-tiered punitive rate structure with a simple, fair 17 percent rate. The current system's plethora of documents, paperwork, and complex record-keeping is replaced by two postcard-sized forms, one for individuals and one for business.

Direct consumption taxes like the retail sales tax and VAT theoretically achieve similar results, though such proposals also risk creating major new sources of tax revenue for the federal government. If these proposals were made contingent on enacting a constitutional amendment barring income taxes, this concern would disappear. Finally, plans that attempt to preserve features of the current system, such as the USA tax and the Gephardt 10 percent tax, fall short of the goal. By maintaining a discriminatory system of graduated rates, these plans fail the critical tests of growth, simplicity, and fairness.

¹⁶ Bruce Bartlett, "Why a VAT Won't Help U.S. Trade," *The Wall Street Journal*, August 30, 1993.

¹⁷ Stephen J. Entin, "Gephardt Tax Plan: Complex and Biased Against Saving and Growth," IRET Congressional Advisory No. 47, IRET, Washington, D.C., July 7, 1995.

COMPREHENSIVE GRADES						
	Arney/ Shelby	Specter	VAT	Sales	USA tax	Gephardt
Rates	A	A-	A	A	D	C
Simplicity	A	A-	B+	B	B	C+
Savings & Investment	A	A-	A	A	B	D-
Social Engineering	A	A-	A	A	B	B
Civil Liberties	A	A-	A	A	C	C
Fairness	A	A-	A	A	C-	D-
Risk	B	B	F	F	F	C
Evasion	A	A-	B+	D	B	C
International Competitiveness	A	A-	A	A	B	C

Daniel J. Mitchell
 McKenna Senior Fellow in Political Economy