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MAKING SENSE OF COMPETING TAX REFORM PLANS

(Updating *Backgrounder* No. 1055, "Which Tax Reform Plan is Best for America?," September 26, 1995.)

INTRODUCTION

American taxpayers, disgusted with today's flawed tax system, increasingly support efforts to scrap it for something entirely new. With the exception of the White House, there is almost universal agreement that America's tax system is anti-growth and anti-family. And to add insult to injury, tax laws are mind-numbingly complex, simultaneously punishing average taxpayers while creating special preferences for those with the right lawyers, accountants, and lobbyists.

But what should replace the current system? Should America have a flat tax? If so, which flat tax? Or is the answer a sales tax or value-added tax? Should a new tax system punish success by imposing higher tax rates as income rises? With so many different tax reform plans being proposed, taxpayers understandably need some objective way of measuring which plan will generate the most benefits. The following table, based on nine criteria, gives an overall grade to each of the major tax reform plans.¹

TAXPAYERS AND THE ECONOMY Grading Tax Reform Proposals

Armey/Shelby flat tax	A	National sales tax	B
Forbes flat tax	A	Buchanan flat tax	B-
Specter flat tax	A-	Gramm flat tax	B
Value-added tax	B+	Gephardt tax reform plan	C
Nunn-Domenici USA tax	C+	Kemp Commission	<i>Not a specific plan, but the commission report outlines the features of a pro-growth tax system and probably would be ranked in the top tier.</i>

¹ Note: This study describes in detail the Forbes, Gramm, and Buchanan flat tax plans as well as the Kemp Commission report. The earlier plans graded here are described in Daniel J. Mitchell, "Which Tax Reform Plan is Best for America," Heritage Foundation *Backgrounder* No. 1055, September 26, 1995.

The Nine Criteria:

- ✓ **One Low Rate** — because work, saving, and investment should be rewarded, not punished;
- ✓ **Simplicity** — because the pain of paying taxes should not be compounded by complexity;
- ✓ **Savings and Investment** — because the tax code should not penalize these activities needed to increase growth;
- ✓ **Social Engineering** — because people, not politicians, should be in charge of how their money is spent;
- ✓ **Intrusiveness/Civil Liberties** — because a tax code granting the government too much power is not part of the American ideal;
- ✓ **Fairness** — because the law should apply equally to all;
- ✓ **Risk** — because a new tax plan should not contain pitfalls;
- ✓ **Evasion** — because everyone should pay his fair share;
- ✓ **International Competitiveness** — because American workers deserve the highest wages and living standards.

On these and other criteria, “pure” flat tax plans score the highest. Direct consumption taxes also fare well, with their only significant liability being the risk that politicians would use them as an additional source of revenue rather than as a replacement for the current system. Modified flat tax plans score higher than the current system, but they do maintain significant amounts of double taxation and are not graded as high as pure flat taxes. Tax reform proposals which resemble the current system, needless to say, fare poorly.

Since no tax system is perfect, any grading scale is somewhat subjective. If a reform, or a particular feature of a plan, moves as close to the ideal as possible, it earns a grade of “A.” Proposals or parts of proposals that reflect a significant improvement over current law receive “B” grades. A grade of “C” means the tax plan or the particular feature of the plan was no better or worse than the tax code is today, while “D” and “F” grades reflect substantially worsening and worst case, respectively.

THE NEW TAX PLANS

Several major proposals have been introduced since “Which Tax Reform Plan is Best for America?” was published by The Heritage Foundation in September 1995. This analysis updates that publication with detailed analysis of the plan put forward by the National Commission on Economic Growth and Tax Reform (the Kemp Commission) as well as plans prepared by Senator Phil Gramm (R-TX) and presidential candidates Steve Forbes and Pat Buchanan.

The following are the key features of the tax reform proposals released in recent months:

The Kemp Commission —The report issued by the National Commission on Economic Growth and Tax Reform cannot be graded on the same scale as the other plans because it is not a legislative proposal.² The report, for instance, does not specify a rate and is largely silent on the issue of itemized deductions. Instead, the commission’s report outlines the key principles of a sound tax system and makes several recommendations as to how any acceptable reform package could be structured. Many of the general recommendations—such as tax all income at one rate, but one time, and require a supermajor-

² *Unleashing America’s Potential: A pro-growth, pro-family tax system for the 21st century*, report of the National Commission on Economic Growth and Tax Reform, January 1996. Reprinted in *Tax Notes*, Vol. 70, No. 4 (January 22, 1996).

ity to increase the rate—are very desirable and will be judged, to the extent possible, against the nine criteria.

The Forbes flat tax — Very similar to the Arme y/Shelby proposal, the Forbes flat tax would replace the current personal and corporate income tax systems with a simple 17 percent tax on all income. All labor income, with the exception of a generous personal allowance (\$36,000 for a family of four), would be taxed at the individual level. Taxes on business and capital income (interest, dividends, profits, capital gains, and rents) would be withheld and paid at the business level. Unlike the current system, no income would be subjected to more than one layer of tax. Both businesses and individuals would be able to use postcard-size tax returns.

Gramm flat tax — Senator Phil Gramm favors a 16 percent tax rate, but his flat tax is substantially different from many of the existing proposals. He keeps deductions for home mortgage interest and charitable deductions, but the biggest difference is the continued double taxation of many forms of income. Capital gains taxes would not be abolished, while income used for savings would continue to be taxed twice and the bias against business investment would be reduced, but it would not be eliminated. By making these modifications, and also by choosing to tax corporate profits at the individual rather than business level, the Gramm plan would not achieve the same level of simplicity as a “pure” flat tax.

The Buchanan flat tax — Similar in many ways to the Gramm proposal, the Buchanan plan contains a low 15 percent rate, but many types of income are double-taxed. Corporate profits would continue to be taxed at both the individual and business level. Savings would be taxed twice. There would be a flat 17 percent rate on corporations, but provisions biasing the current system against investment, such as the alternative minimum tax and depreciation, would remain. On the individual side, the plan also continues deductions for such items as home mortgage interest and charitable contributions, thus adding considerable complexity when compared to traditional flat tax plans.

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 plans reflect nine important principles of sound tax policy.

LOW RATES

A low, single rate treats all citizens equally under the law and ensures 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.

Kemp Commission report *A*

The report does not specify a rate, but makes clear that the rate should be as low as possible.

Forbes flat tax *A*

With a rate of 17 percent, the Forbes plan earns high marks.

Gramm flat tax *B+*

The low 16 percent rate ranks highly, but the double taxation of certain income (discussed in the savings and investment section) is a problem.

Buchanan flat tax **B+**

Like Gramm's plan, Buchanan's deserves credit for one low rate. It also suffers, however, from the same flaw.

SIMPLICITY

The current income tax requires hundreds of forms and consumes more than 5 billion hours of taxpayer time each year. Business compliance costs are particularly large.

Kemp Commission report **N/A**

Any plan calling for one rate and taxing income only one time will automatically generate substantially greater simplicity. A specific grade, however, is difficult without knowing the specific structure of the flat tax and whether deductions would remain.

Forbes flat tax **A**

Like Armev/Shelby, the entire tax code is compressed down to postcard size. All taxpayers need to calculate is their total income and family size.

Gramm flat tax **B**

The plan would have some level of simplification, but capital gains, depreciation, itemized deductions, and other provisions limit the scope of benefits. Taxing dividends and interest on the individual form will also necessitate continued use of more than one billion 1099 forms.

Buchanan flat tax **B-**

The business side of the tax code, which generates the most compliance costs, remains largely untouched. The Buchanan plan also continues the estate tax, thus missing an opportunity to remove a source of considerable complexity.

SAVINGS AND INVESTMENT

Having one low rate is a necessary feature of a pro-growth tax system, but it is not the only piece of the puzzle. Equally important is that the tax code be designed so that income is taxed only one time. The current system hinders the growth of incomes and living standards by the multiple taxing of savings and investment.

Kemp Commission report **A**

The panel makes clear that no income should be taxed more than one time. Combined with the low rate, this would generate significantly higher levels of capital formation.

Forbes flat tax **A**

Like other pure flat tax proposals, the Forbes plan does not discriminate against income used for savings and investment.

Gramm flat tax **B**

Some double taxation is eliminated, but the treatment of capital gains, savings, and depreciation will leave continued bias against capital formation.

Buchanan flat tax **B-**

Like Gramm, Buchanan errs by not fully addressing the bias against savings and investment. In addition to double-taxing capital gains, savings, and depreciation, Buchanan retains the estate tax and the alternative minimum tax.

SOCIAL ENGINEERING

The tax code today rewards some types of activity, everything from putting a child in day care to buying a home. Other behaviors, however, such as savings and investment, are penalized harshly. Once a tax system strays from the concept of treating all income equally, regardless of how it is earned or how it is spent, the door is open for special interests to add special preferences to the tax code on behalf of wealthy clients.

Kemp Commission report **A-**

The report clearly states that the tax system should apply neutrally. It does not, however, completely rule out deductions that would shift behavior.

Forbes flat tax **A**

Other than a family allowance, there is no preference, loophole, or exclusion in the Forbes plan.

Gramm flat tax **B**

In addition to the bias against savings and investment, the Texas Senator's plan retains deductions for home mortgage interest and charitable contributions.

Buchanan flat tax **B**

Shortcomings are similar to the Gramm proposal.

INTRUSIVENESS/CIVIL LIBERTIES

In part because of the Internal Revenue Code's mind-numbing complexity, but also because of legislative directives, the IRS engages in tax collection activities that many believe are abusive. Moreover, complexity invites government intrusion to verify many tax returns. A simple tax code, with easily understood rules that apply to everyone, would solve much of this problem. Thus, the highest grades are given to proposals that minimize the scope of and opportunity for intrusion.

Kemp Commission report **A**

Even without details, it is hard to see how a tax system based on the commission's report could fail to eliminate the vast majority of problems. Indeed, its very first recommendation is to repeal the entire Internal Revenue Code.

Forbes flat tax **A**

The only possible source of conflict between an individual taxpayer and the IRS under a flat tax are total income earned and the size of one's family. Whatever other problems remain, such as deductions for the self-employed, would be a fraction of those that exist now. Businesses will benefit even more dramatically because of the simplicity.

Gramm flat tax **B**

Continued double taxation of some forms of capital income preserves opportunities for tax avoidance behavior that would necessitate the attention of the tax authorities and the maintenance of a layer of enforcement bureaucracy.

Buchanan flat tax**B**

Like the Gramm plan, the Buchanan flat tax is an improvement, but many potential conflicts in the tax code will remain.

FAIRNESS

Fairness in the tax system should mean equal treatment. Any special provision, whether to punish or reward, violates the principle that the law should apply equally.

Kemp Commission report**A**

The recommendations and tone of the commission's report clearly indicate strong support for treating all taxpayers and all income equally. Declares the report: "[I]f one taxpayer earns ten times as much as his neighbor, he should pay ten times as much in taxes."³

Forbes flat tax**A**

All taxpayers pay the same rate, and all income is taxed one time.

Gramm flat tax**B**

The single rate is a dramatic improvement over today's code, but the double taxation of savings and investment and itemized deductions undermine the goal of equality.

Buchanan flat tax**B**

Better than current law, but suffers from the same problems as the Gramm flat tax.

DOWNSIDE RISK

While many tax reform proposals are conceptually attractive and would help the economy if enacted, they should not be examined in a vacuum. The political process causes any plan to evolve over time, generally in an undesirable direction. Thus, the probability of a plan that will retain its beneficial design features should be considered.

Kemp Commission report**N/A**

As long as no itemized deductions are allowed, a tax plan based on the commission's report should be stable and long-lasting. Without clear guidance on the use of deductions, however, it is difficult to assign a grade. The supermajority requirement to raise taxes, if enacted, would help considerably.

Forbes flat tax**B**

The single rate and purity of the Forbes plan, combined with support for a supermajority, provide a significant margin of safety. As with any proposal, it is difficult to bind the hands of future politicians completely.

Gramm flat tax**C+**

One rate is a big improvement, but with double taxation and deductions retained, political pressure to include further distortions would soon develop. The influence of lobbyists might be curtailed, but not by much.

3 *Unleashing America's Potential*, p. 12.

Buchanan flat tax C+

Once again, the plan mirrors both the good and the bad features of the Gramm proposal. Government would have the ability to discriminate on the basis of how income is earned and how it is spent.

EVASION

To maintain public support, a tax system must ensure that everyone plays by the same rules. If the public views the law as corrupt or unenforcable, there will be pressure to return to the old system. This means that the new tax must not create opportunities or incentives for taxpayers either legally or illegally to shift behavior just to avoid taxes.

Kemp Commission report A-

Assuming a tax system faithfully follows the report's recommendations, it is hard to see how a new tax system could offer many chances to evade taxes. It is not clear, however, whether capital income would be collected at the source.

Forbes flat tax A

Because of the single low rate, this plan would offer minimal incentives to evade. Taxing all income at the source eliminates more than one billion 1099 forms and simplifies enforcement considerably.

Gramm flat tax B

While better than current law, some forms of income are double taxed and others maintain a preference. This will encourage taxpayers to arrange their affairs in ways to minimize or avoid taxes.

Buchanan flat tax B

Like the Gramm plan, one low rate will reduce incentives to avoid, but differential treatment based on sources and uses of income will create opportunities for evasive behavior.

INTERNATIONAL COMPETITIVENESS

In a world where capital can react quickly to changes in a nation's business climate, a tax system which minimizes the tax burden will attract increased investment. This will translate into more jobs and higher incomes. Unfortunately, America has been moving in the wrong direction.

Kemp Commission report A

One of the panel's recommendations is to eliminate the foreign tax provisions of the current code which do so much to drive jobs offshore and hinder the competitiveness of U.S. firms. Combined with the other features—tax at a low rate and tax only one time—this would benefit America immensely.

Forbes flat tax A

Eliminating the double tax on income earned overseas and fixing all the problems imposed on income earned in the U.S. will increase competitiveness and boost job creation substantially.

Gramm flat tax B

One low rate will help, but the multiple taxation of capital will prevent complete realization of possible benefits.

Buchanan flat tax C

Has the same pluses as the Gramm plan, but the threat of higher taxes on trade will have a sharply negative effect on U.S. competitiveness.

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 that have been offered to correct these flaws, reforms based on the pure flat tax are the best. Direct consumption taxes, assuming no loopholes and complete repeal of the income tax (16th Amendment and all), are very attractive, with modified flat taxes generally next in desirability. The closer a plan resembles the current system, needless to say, the more limited its benefits.

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