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HOW THE ARMEY-SHELBY FLAT TAX WOULD AFFECT THE MIDDLE CLASS

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The presidential campaign has focused national attention on the flat tax. Some candidates in the Republican primary favor the flat tax, and even President Clinton, who currently does not support a single-rate tax system, advocates a fairer, simpler system.[1]

This growing support for the flat tax and fundamental tax reform has enlivened critics who claim that a flat tax system will raise taxes on the middle class. To explore this argument, The Heritage Foundation analyzed the flat tax proposal put forward by Representative Richard Armey (R-TX) and Senator Richard Shelby (R-AL), which includes a 17 percent tax, the same rate as proposed by Republican presidential candidate Steve Forbes.[2] The analysis used the Internal Revenue Service Public Use File for 1991, the most detailed and complete publicly available database of individual income tax returns.[3]

This analysis of the Armey-Shelby plan shows no increase in the taxes paid by the vast majority of middle-class Americans when compared with their current tax burden. In fact, on average, a 17 percent flat tax would lower taxes on all income groups (see Table 1[4]). Among the key findings:

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1 *Economic Report of the President, Together with the Annual Report of the Council of Economic Advisers* (Washington, D.C.: U.S. Government Printing Office, 1996), pp. 84-89.

2 While the tax reform proposal offered by Mr. Forbes uses the same tax rate as the fully implemented Armey-Shelby plan, the proposals are not identical. The Forbes plan, for instance, has a larger personal allowance.

3 For a detailed description of our analysis, see the Technical Note at the end of this paper.

4 Tables 1 and 2 do not show the effect of any special rules to ease the transition from the current tax system to the Armey-Shelby flat tax. Thus, these tables probably overstate the amount of additional taxes some businesses would pay under a flat tax. For example, current tax policy requires businesses to depreciate their equipment purchases over a fixed period of time, often 15 years. Thus, many businesses have a large amount of unused depreciation that they have been carrying on their books as an asset. However, the Armey-Shelby flat tax does away with tax depreciation for capital equipment and replaces this policy with one that permits businesses to expense their purchases of land, structures, and equipment in the year that these items are purchased. To move from the current system to the Armey-Shelby flat tax means either writing off billions of dollars in accumulated depreciation or enacting a "transition rule" that would allow businesses to use accumulated depreciation for a few years as a deduction from gross sales. The Heritage Foundation is engaged in developing and analyzing such rules and will provide commentary on transition issues at a future date.

Table 1

Armey-Shelby Flat Tax at 17% Reduces Taxes on All Average Households in All Income Groups

	Current Average Household Tax Payments	Average Household Taxes at 17% Flat Tax	Percentage Change in Taxes Paid from Current to 17% Flat Tax	Percentage of Households With Lower Taxes
Under $15,000	$1,934	$979	-49.37%	87%
$15,000 to $30,000	3,119	2,007	-35.67%	84%
$30,000 to $50,000	5,974	5,048	-15.50%	79%
$50,000 to $75,000	11,126	9,831	-11.64%	67%
$75,000 to $100,000	17,860	16,212	-9.23%	66%
$100,000 to $200,000	33,282	30,851	-7.30%	65%
$200,000 and Above	175,382	78,267	-55.37%	74%

Note: Amount equals taxes levied on labor and small business income combined. 1991 data converted to 1994 dollars.
Sources: I.R.S. Public Use File for 1991; Heritage Tax Model.

Question: Does a 17 percent flat tax raise taxes on the middle class?
Answer: No. The majority of taxpayers in every income bracket enjoys a tax cut under an Armey-Shelby flat tax with a 17 percent rate.[5]

Question: If a married couple gross $60,000 in wages, how much will they save in taxes under a 17 percent flat tax?
Answer: If they also have two children, they will save $2,488 in taxes. That is a 35 percent lower tax bill.[6]

Question: Does everyone pay the same flat tax rate, even the very rich?
Answer: Yes and no. Everyone faces the same 17 percent rate. However, the flat tax taxes only the difference of total income minus the generous family deduction ($33,300 for a family of four). Because the 17 percent tax is levied on the difference, families with incomes of $50,000 to $75,000 pay only 10 percent of their income, while families with incomes between $200,000 and $500,000 pay 16 percent of their income in taxes.

Question: If everyone gets a tax cut with a 17 percent flat tax, won't that mean lower tax revenues and higher deficits?
Answer: While nearly all individuals pay less tax, many medium- and large-size businesses will pay more. Also, many prominent economists believe that a flat tax will produce a bigger economy, which should result in more federal tax revenues.[7]

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5 Economists and sociologists for decades have been trying to reach agreement about what constitutes the middle class. We certainly will not attempt to enter that debate in this paper. However, broadly defining the middle class as single- and multi-person households with incomes between $30,000 and $100,000 probably includes what most analysts view as middle-class.

6 For estimates of how much average tax bills are reduced by a 17 percent flat tax in each state, see William W. Beach and Daniel J. Mitchell, "The Flat Tax Cuts Individual Income Taxes in Every State," Heritage Foundation *F.Y.I.* No. 86, February 7, 1996.

Question: Since the Armey-Shelby flat tax proposal eliminates the Earned Income Tax Credit, what happens to low-income taxpayers?

Answer: The Earned Income Tax Credit (EITC) allows low-income taxpayers to claim a credit that generally eliminates their income tax liability and restores some of the income taxed away by the Social Security tax (clearly the largest tax most low-income families pay). The Armey-Shelby bill replaces the EITC with a family deduction that more than doubles current family deductions. While details are unclear, the proposal intends to continue other aspects of the EITC under the government's welfare programs. About 24 million families who pay federal income taxes now will pay no income taxes under the fully implemented Armey-Shelby flat tax.

What Is a Flat Tax?[8]

A flat tax would repeal the current income tax code and replace it with a system based on the following principles:

1. **Tax all income with no deductions except a generous allowance based on family size.** Today's complex system could be replaced by two simple, postcard-size forms, one for business and one for individuals.
2. **Tax all income at one rate, applying the law equally to all taxpayers.** Everyone faces the same 17 percent rate, and the government would not punish or subsidize taxpayers on the basis of how they earn or spend income.
3. **Tax all income just once, ending the bias against savings and investment.** Capital income would be taxed on the business form to ensure compliance, and labor income would be taxed on the individual form.

The Armey-Shelby flat tax proposal follows each of these principles. For individuals, only the income from wages, salaries, and pensions is taxed. Individual taxpayers add up income from these sources and then deduct generous personal and dependent exemptions. What is left after these deductions is taxed at 17 percent (after a two-year phase-in period). For businesses, taxes are paid on income from the sale of goods or services. The business first adds up all of its income and then subtracts what it paid out in wages and salaries, what it purchased in order to make its products or provide its services, and the cost of all buildings, land, and other "capital structures" purchased during the tax year. The income that is left after these subtractions is taxed at 17 percent.

Distribution of Tax Payments

Table 1 shows the dollar and percentage reduction in average household tax payments under a 17 percent flat tax.[9] These estimates combine so-called labor income (wages and salaries) with all of the small business income currently reported on IRS Form 1040, Schedules C, E, and F.[10]

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7 Economists are beginning to publish analyses of how a flat tax would effect economic activity. One of the most important essays to appear so far is by Alan J. Auerbach of the University of California, Berkeley, and the National Bureau of Economic Research. See Auerbach, "Tax Reform, Capital Allocation, Efficiency and Growth," paper presented at Brookings Conference on Fundamental Tax Reform, February 15-16, 1996.

8 The Heritage Foundation has published a number of other papers on tax reform and on the flat tax specifically. See Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995, and Daniel J. Mitchell, "Which Tax Reform Plan Is Best for America?," Heritage Foundation *Backgrounder* No. 1055, September 26, 1995.

9 The Heritage Foundation used the largest publicly available tax database to construct these estimates. The Internal Revenue Service Public Use File for 1991 is a statistically significant sample of all of the individual income tax returns

The most striking feature of this flat tax distribution table is how much taxes are reduced for very low and very high incomes. At the low end, millions of households see their tax payments disappear as a result of the generous family deduction. Specifically:

✓ About 24 million families who pay federal income taxes now will pay no federal income taxes under the fully implemented Armey-Shelby flat tax.

✓ Nearly everyone else below $30,000 will see their taxes fall.[11]

Taxpayers at the high end of the income scale also see a substantial reduction in income taxes. These tax cuts result from two factors: the lower tax rate (a drop from an average effective rate of 33 percent to about 17 percent) and an end to the practice of double or triple taxation of so-called passive income (dividends, interest, and capital gains). Dividends and interest actually are payments made by companies to stockholders and depositors out of company income that already has been taxed. Furthermore, individuals buy company stock and make time deposits in savings accounts with after-tax income. Thus, all of the cash transactions associated with, say, a dividend are based on income that already has been taxed. To collect additional tax on dividends, interest, and capital gains constitutes double taxation, thus violating the principle of taxing all income only once and at its source. This double taxation would be ended under the Armey-Shelby flat tax.

Taxing income only once at its source results in a tax cut at the upper end of the income scale, just as it results in a tax cut for lower- and middle-income households with income from interest, capital gains, and dividends. While nearly 34 percent of all dividends claimed as income goes to households with total incomes below $50,000 (largely households with retired taxpayers), the average dividend income reported by upper-income households is much greater: $37,695 for incomes of $200,000 and above as opposed to $2,050 for incomes of $50,000 or below.[12] Thus, the exclusion of this income from taxes paid by individuals has a greater effect on taxes paid by wealthy people than on taxes paid by people of more limited means.

Because businesses under Armey-Shelby would pay taxes on the income from which they make dividend and interest payments, it is correct to say that the taxes on these payments are withheld at the business level in much the same way that income taxes on wages and salaries currently are withheld at the business level. Table 2 shows the effects of this withholding on the tax liabilities of households.[13] The dividend and interest payments received by households in Table 2 have been taxed at the business level, and these taxes are added to the 17 percent Armey-Shelby taxes of Table 1. A quick comparison of Tables 1 and 2 shows who shoulders the burden of dividend and interest taxes. As income rises, the implicit burden of taxes on these forms of income also increases.

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filed in 1991. Estimates of current average tax payments were calculated by applying the 1996 tax rates and bracket amounts to net taxable income. The estimates of flat tax liabilities were calculated using the provisions of the tax reform proposal advanced by the Majority Leader of the U.S. House of Representatives, Representative Richard Armey (R-TX), and Senator Richard Shelby (R-AL). See H.R. 2060 and S. 1050.

10 See Technical Note.

11 For example, the family deduction for a single taxpayer is $11,350; for a married family of four, it is $33,300; and for a head of household with two children, it is $25,450. Only incomes greater than these amounts are taxable under the Armey-Shelby flat tax.

12 See Internal Revenue Service, *Individual Income Tax Returns 1991*, Publication 1304 (Rev. 3/94), p. 28, Table 1.4, cols. 9 and 10.

13 It is possible also to view taxes on capital gains as "withheld" taxes: The net present value of corporations is connected intimately to their ability to remain profitable while paying all of their taxes. However, households rather than businesses control the timing of capital gains realizations, which makes the analyst's job of estimating the business tax liabilities for capital gains exceptionally difficult. Thus, taxes on capital gains are not shown in Table 2. If they could be shown, the total tax liabilities of high-income households under a fully phased 17 percent flat tax would be even greater.

Table 2

How the Armey-Shelby Flat Tax Affects Households If Withheld Corporate Taxes on Dividend and Interest Payments Are Included with Labor and Small Business Taxes

	Current Average Household Tax Payments	Average Household Taxes at 17% Flat Tax	Percentage Change in Taxes Paid from Current to 17% Flat Tax
Under $15,000	$1,934	$1,448	-25.10%
$15,000 to $30,000	3,119	2,788	-10.63%
$30,000 to $50,000	5,974	5,909	-1.09%
$50,000 to $75,000	11,126	10,866	-2.33%
$75,000 to $100,000	17,860	17,729	-0.73%
$100,000 to $200,000	33,282	33,826	1.63%
$200,000 and Above	175,382	133,277	-24.01%

Note: 1991 data converted to 1994 dollars.
Sources: I.R.S. Public Use File for 1991; Heritage Tax Model.

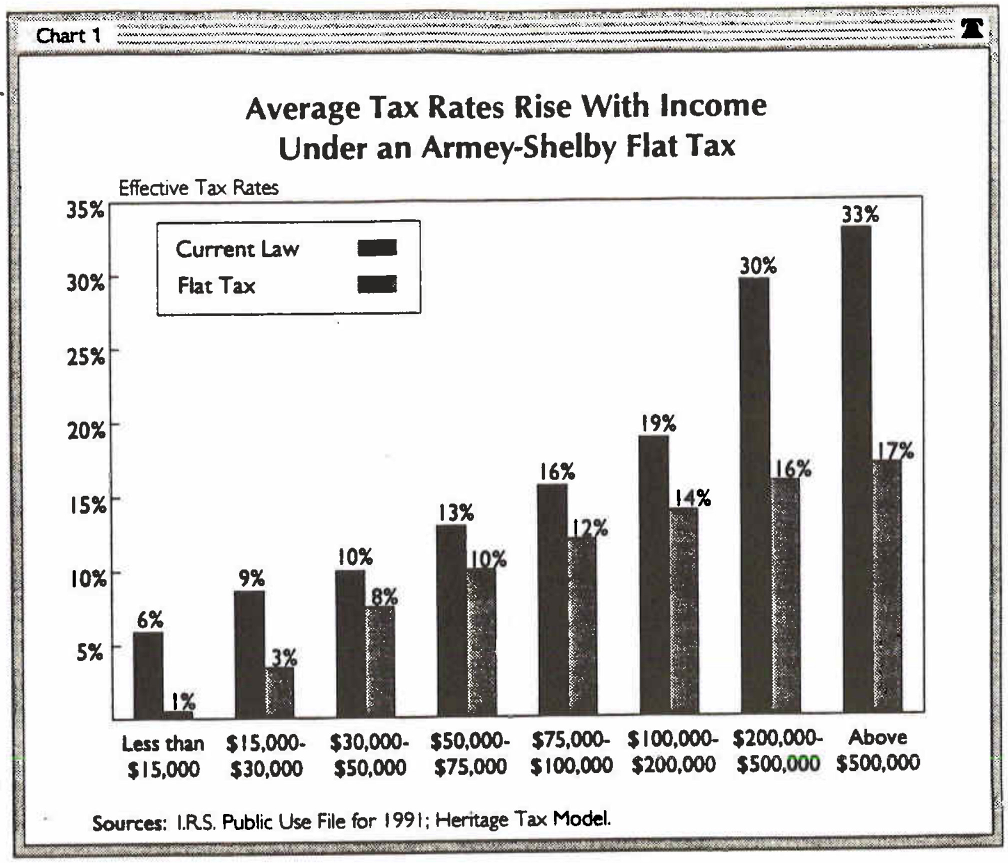
It is worth noting in this regard that corporate income taxes increase under an Armey-Shelby flat tax. This increase largely offsets decreases in individual tax payments during the tax's two-year implementation period; Heritage's tax models currently estimate that taxes from individuals will fall by $51 billion, while taxes from corporations will rise by $52 billion.

Progressive Nature of the Flat Tax

While it is certainly true that the flat tax as proposed by Representative Armey and Senator Shelby taxes income at one rate, the taxpayer and dependent exemption causes the actual rates paid by taxpayers to increase as incomes rise. For example, a single taxpayer without children and making $25,000 would be exempt from income tax on the first $11,350 and would pay a 17 percent tax on the remaining $13,650. The tax would be $2,321, or 9.3 percent of $25,000. If part of the $25,000 was dividend income, of course, tax already would have been taken out at the corporate level. A single taxpayer making $250,000 would pay a 17 percent tax on $238,650 under the Armey-Shelby bill. The tax would be $40,571, or 16.2 percent of total income. It is the presence of the exemption that makes the flat tax "progressive."[14]

14 Some advocates of the flat tax say that a taxpayer with 10 times the income pays 10 times more tax. Actually, the flat tax requires wealthier taxpayers to pay somewhat more than that, since the taxpayer and dependent deductions remain the same regardless of income level. In the above example, the richer taxpayer, who has 10 times more income, pays 17.2 times more tax than the poorer taxpayer.

Technical Note



The data shown in Tables 1 and 2 and Chart 1 are based on income tax records contained in the IRS Public Use File for 1991, a statistically accurate sample of all individual income tax returns for that year. The file contains 115,000 taxpaying households and 178 tax variables per household. When a variable is multiplied by its weight, the value of the variable equals its national total. Thus, the value of wage and salary income for a family earning $35,000 equals the national total for families in that income class when it is multiplied by its national weight. These are the same data the IRS's own Statistics of Income Division uses when preparing its annual analysis of taxpayers. They are the most accurate and complete tax data available for public use.

The tax payments shown in Tables 1 and 2 include all of the kinds of taxable income that individuals now report on their annual 1040 tax form. Individuals currently report labor income (for example, wages and salaries) as well as business income from self-employment, trusts, partnerships, farming operations, and other business activities. However, the more prominent flat tax proposals make an important change in the way small business income is reported. Proposals similar to the Armey-Shelby bill separate labor income from business income and allow businesses to deduct from their gross income the costs of operations, the value of land and capital structures purchased during the year, and the wages and salaries paid to their employees.

This separation of labor income from business income makes comparing the current tax system with a flat tax system difficult. In order to compare current taxes fairly with those collected under a flat tax, we added together the flat taxes individuals would pay on their labor income and on their small business income. This combination is reported in the flat tax columns of Tables 1 and 2. Thus, both sets of numbers include taxes paid on labor and business income.

Finally, with respect to the effect higher business taxes might have on low- and middle-income families, many tax analysts believe that higher business taxes mean higher prices for consumers. Low - and middle-income households have more difficulty paying higher prices than do wealthier households. Thus, these analysts argue that increases in business taxes that produce higher consumer prices really amount to regressive "tax" increases on those families least able to pay for them.

While there maybe some truth to this view, the measurement of the relationship between tax changes and price changes is very difficult. First, the flat tax is expected to reduce many of the costs business faces, most particularly the cost of capital. Thus, firms may decide not to pass along tax increases to consumers. Second, more than half of all businesses will see a tax decrease under the Armey-Shelby bill, which could result in lower consumer prices. Third, history shows that firms in competitive markets are less likely to charge consumers for tax increases than firms in regulated, uncompetitive markets. The Heritage Foundation will address this issue in a future paper.