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FLAT TAX OR SALES TAX? A WIN-WIN CHOICE FOR AMERICA

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INTRODUCTION

The current tax code of the United States is irreversibly broken and should be repealed. The tax laws undermine the country's prosperity by imposing needlessly harsh penalties on work, savings, and investment. Although many taxpayers face confiscatory tax rates and often are forced to pay more than one layer of tax on their income, the politically well-connected can take advantage of special deductions, credits, preferences, shelters, and loopholes to minimize their own tax liability. The result of this double standard is a tax system that not only penalizes productive behavior, but also violates the fundamental constitutional principle of equal treatment under the law.

The good news is that Congress is considering two major plans to fix the tax code: the flat tax and the national retail sales tax. Replacing the current system with either of these two taxes immediately would restore the principle of fairness to the tax system because both would treat all taxpayers equally. Both the flat tax and a national sales tax would replace today's discriminatory tax structure with a single low rate. In addition, either plan would eliminate the current tax code's bias against savings and investment and promote the kind of capital formation that America needs to boost workers' incomes and raise long-term economic growth. In addition, because far fewer personnel and far less paperwork would be needed to collect "contributions" under either plan, the ultimate result would be a dramatic downsizing of the Internal Revenue Service (IRS) bureaucracy and billions of dollars in compliance costs saved each year.

How is it that these different types of taxes could produce such similar results? The answer lies in the fact that the flat tax and sales tax are almost identical in purpose and principle. Both rest on the fundamentally sound principle that all income should be taxed at one low rate and only one time, and that the tax should be collected in the least intrusive

way possible. The only obvious difference between the two is the collection point of those taxes. A flat tax is collected up front, imposing a single layer of tax on income when it is earned, and a sales tax imposes one layer of tax when the income is spent. In both cases, income is taxed, but only once and presumably at a very low rate.

Throughout the United States, the debate about tax reform has changed over the past decade. No longer do politicians and the electorate ask whether the tax system should be changed; instead, they ask how and when. Members of Congress should take advantage of this win-win opportunity to eliminate the current incomprehensible system and champion the features and benefits of the flat tax and a national retail sales tax.

HOW WOULD THE FLAT TAX WORK?

For many Americans, the flat tax means simply that everyone would be taxed at “just one rate.” Even though the 17 percent tax rate is a key feature of the flat tax,¹ it would be only one element of the comprehensive reform.² The flat tax eliminates inequalities in the current tax code by treating all taxpayers—and income—equally. With the exception of exemptions based on family size, all income would be taxed, but only one time. For fairness and simplicity, there would be no deductions, credits, preferences, or loopholes. To achieve even further simplicity, taxes on most business and capital income (such as dividends and interest payments) would be withheld and paid at the business level.

The leading legislative proposal to create a flat tax is sponsored by House Majority Leader Richard Armey and Senator Richard Shelby (R-AL). Under the flat tax, the current Internal Revenue Code’s 480 forms would be replaced by two simple postcard-size forms. Individual taxpayers would receive a generous allowance based on family size (more than \$33,000 for a family of four) but would be responsible for paying a tax of 17 percent on any wage, salary, and pension income above that amount. The tax on all other income, including interest, dividends, rents, royalties, and business profits, would be withheld and paid at the business level (much as an employer withholds and pays individual income tax for workers). Because the government would not be allowed to tax any income more than once, both the capital gains tax and the death (or estate) tax would be eliminated. The flat tax also would get rid of all itemized deductions like the write-off for home mortgage interest, charitable contributions, and state and local income and property taxes. On the business side,³ the flat tax wipes out all features of the current code that undermine U.S. competitiveness, including the alternative minimum tax, rules on pensions and deferred compensation, depreciation (which would be replaced with first-year expensing), international tax provisions, and uniform capitalization rules. (See Chart 1.)

Instituting the flat tax would not affect payroll taxes for Social Security and Medicare. Even though these programs, funded by payroll taxes, certainly require fundamental reform, the debate surrounding these entitlements is not likely to be tied to discussions about reforming the income tax system.

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- 1 Actually, there is nothing special about the 17 percent rate. It is widely associated with the flat tax, however, because both House Majority Leader Richard Armey (R-TX) and former presidential candidate Steve Forbes selected the 17 percent rate for their nearly identical flat tax proposals.
 - 2 For a thorough discussion of the flat tax, see Daniel J. Mitchell, “Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax,” Heritage Foundation *Backgrounders* No. 1035, May 25, 1995.
 - 3 For an analysis of the flat tax and its impact on business, see Daniel J. Mitchell, “A Guide to the Flat Tax: What Everyone in Business Should Know,” Heritage Foundation *Backgrounders* No. 1103, February 10, 1997.



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

Form 1		Individual Wage Tax		1999
<small>Your first name and initial (if joint return, also give spouse's name and initial)</small>		<small>Last name</small>		<small>Your social security number</small>
<small>Home address (number and street including apartment number or rural route)</small>			<small>Spouse's social security number</small>	
<small>City, town, or post office, state and ZIP code</small>		<small>Your occupation</small>		
		<small>Spouse's occupation</small>		
1	Wages and 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 <i>(line 3 multiplied by \$5,300)</i>		4	
5	Total personal allowances <i>(line 2 plus line 4)</i>		5	
6	Taxable wages <i>(line 1 less line 5, if positive; otherwise zero)</i>		6	
7	Tax <i>(17% of line 6)</i>		7	
8	Tax already paid		8	
9	Tax due <i>(line 7 less line 8, if positive)</i>		9	
10	Refund due <i>(line 8 less line 7, if positive)</i>		10	

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

Source: Office of Representative Dick Arme-y.

HOW WOULD A NATIONAL SALES TAX WORK?

The national retail sales tax proposal would repeal the personal and corporate income tax code and replace it with a tax on all final sales of goods and services to consumers.⁴ Although such a tax resembles the state sales taxes most Americans pay already, a national retail sales tax is much broader in scope and would require a tax rate roughly equal to the rate imposed by the flat tax. All economic output, including such activity as services that traditionally escape state sales taxes, would be subject to the tax. Like the flat tax, a national retail sales tax would treat all economic activity equally, but taxpayers would receive a universal credit—a measure that would have the effect of protecting all taxpayers from having to pay tax on purchases up to the poverty level.

The leading legislative proposal to create a national retail sales tax is sponsored by Representatives Dan Schaefer (R-CO) and Billy Tauzin (R-LA); the lead Senate proponent has been Senator Richard Lugar (R-IN). The sales tax bill introduced in the House would eliminate the individual and corporate income taxes, along with all related provisions such as the death tax and capital gains tax. To replace these levies, the government would impose a 17.65 percent tax on the value of all final sales to consumers.⁵ To protect lower-income citizens from taxation, the legislation also would require the government to send all households periodic rebate checks, the net effect of which would be to offset the tax burden on purchases up to the poverty level. A family of four, for example, would receive a rebate from the government equal to the tax on about \$18,500 of purchases. The rebate, which would be added in equal increments to workers' paychecks throughout the year, would total nearly \$3,000. (Although it is not as generous, the rebate mechanism in the sales tax proposal would serve the same role as the family allowance in the flat tax; on the other hand, however, the smaller personal allowance would facilitate a lower tax rate.) To avoid creating a tax preference for government output, the national sales tax would impose an excise tax on the payrolls of federal, state, and local governments. Retailers would be compensated for their efforts to collect and then pay the taxes by receiving a rebate of 0.5 percent on any tax they collect or \$200, whichever is greater. Finally, the sales tax legislation also provides a fee of 1 percent to any state that agrees to administer the tax.

Americans for Fair Taxation has proposed an alternative sales tax that would eliminate not only all personal and corporate income taxes but all payroll taxes as well. Proponents of this approach—which has not been introduced in Congress yet—argue that Social Security and Medicare payroll taxes must be repealed if all direct federal taxes on income are to be extinguished.⁶

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- 4 For a thorough discussion of the national retail sales tax, see David R. Burton and Dan R. Matromarco, "Emancipating America from the Income Tax: How a National Sales Tax Would Work." *Cato Institute Policy Analysis* No. 272. April 15, 1997.
 - 5 Measured on an "apples-to-apples" basis, a 17.65 percent sales tax rate is equal to a flat tax rate of 15 percent. This seemingly odd result occurs because income taxes invariably are measured on a tax-inclusive basis while sales taxes traditionally are measured on a tax-exclusive basis. For example, under a 17 percent flat tax, a taxpayer with \$100 of taxable income will send the government \$17 ($\$100 \times 17\% = \17). With a sales tax of 17.65 percent, a taxpayer with \$100 will wind up paying the government \$15 (\$85 of pre-tax purchases + \$15 of sales tax [17.65 percent of \$85]).
 - 6 According to Burton and Matromarco, such a plan would require a tax-exclusive rate of 26.7 percent.

Business Postcard for the National Retail Sales Tax

DRAFT		H.R. 2001 National Sales Tax Form	
Indicate the month to which this report relates: _____, 200__			
1	Gross Sales	Enter gross payments received from the sale of taxable property or services	\$
2	Sales Tax	Enter 15 percent of the amount on line 1	\$
3	Administration Fee	Multiply line 2 by 0.005	\$
4	Administration Fee	Enter the larger of \$200 of line 3 (may not exceed 20 percent of line 2)	\$
5	Credits (Optional)	Enter total credits from line 13	\$
6	Total Credits and Fees	Add line 4 and line 5	\$
7	Tax Due	Subtract line 6 from line 2	\$
Remit the amount on line 7 to State X (if line 7 is negative, this amount will be refunded to you)			
8	Bad Debt Credit	Enter 15 percent of bad debts expensed (applies only to businesses electing the accrual method only)	\$
9	Business Use Credit	Enter business use credit amount (applies only to businesses with property used for both business and personal purposes)	\$
10	Used Property Credit	Enter used property credit due on sales of used property sold, if any, from line 16	\$
11	Insurance Proceeds Credit	Enter 15 percent of insurance claims paid (for insurance companies only)	\$
12	Compliance Equipment Credit	Enter 50 percent of the cost of qualified compliance equipment	\$
13	Total Credits	Add lines 8 through 12	\$
14	Sales of Appreciated Used Property	Enter sum of sales tax paid by you when the used property was purchased	\$
15	Sales of Depreciated Used Property	Enter sum of sales tax collected when used property was sold by you	\$
16	Total Used Property Credit	Add line 14 and line 15	\$

Source: Argus Group.

WHAT DO THE FLAT TAX AND A NATIONAL SALES TAX HAVE IN COMMON?

Most taxpayers assume that the flat tax and a national sales tax are radically different ways to fund the federal government. Because one tax is collected from the paycheck and the other is collected at the cash register, this assumption is understandable. Perceptions of the two taxes also may be affected by the nature and scope of existing income and sales taxes. The current federal income tax imposes significant complexity on the economy and exposes certain types of income to more than one layer of tax; most state sales taxes are relatively invisible to taxpayers. These differences between the existing federal income tax and various state sales taxes, however, are almost irrelevant. By almost every standard, the flat tax and a national retail sales tax represent two sides of the same coin.

The common features of the flat tax and national sales tax are:

- **A single flat rate.** Under both plans, income is taxed at one low rate.⁷ This would ensure that the government treated taxpayers equally and would address the problem of high marginal tax rates. The single low rate also would promote faster economic growth by minimizing tax penalties on work, risk-taking, and entrepreneurship.

⁷ Most tax reform proposals call for a rate of between 15 percent and 20 percent. Lower rates obviously are preferable to higher rates, but policymakers are constrained by how much of a tax cut, if any, they are willing to enact and how much income (either through the family allowance or the rebate) they want to protect from tax.

- **No bias against savings and investment.** Implementing either the flat tax or a national sales tax would eliminate the current tax code's bias against capital formation by ensuring that no income is taxed more than one time. Because double taxation of capital income is a pervasive problem in the current law, going to the flat tax or a national sales tax would stimulate higher incomes and faster growth by minimizing the tax penalties on savings and investment.
- **Equality.** Adoption of the flat tax or a national sales tax also would end the discriminatory treatment caused by a tax code that grants preferences or imposes penalties on certain behaviors and activities. Either reform would change the code so that all taxpayers—and all income—are treated the same under the law.
- **Simplicity.** With 480 forms and 8 billion pieces of paper, the current IRS system has become a nightmare of complexity. Even though the flat tax and a national sales tax have different collection points, both would lower the cost of compliance and generate huge savings. Under the flat tax, individuals and businesses would fill out one simple postcard-sized form. With a national sales tax, wage earners would be spared the need to interact with the tax system, and businesses simply would submit to the government a monthly form remitting the taxes they collected.

HOW DO THE FLAT TAX AND A NATIONAL SALES TAX DIFFER?

As similar as these two types of taxes are, there are differences, the most important of which center around how they would be collected.

A national retail sales tax would be added to the final selling price of all goods and services and collected at the point of sale. To avoid double taxation, the tax would not be levied on intermediate transactions or sales. For example, a lumber mill would not collect any tax on its sales to furniture manufacturers. Likewise, a furniture manufacturer would not be required to collect taxes on sales to furniture retailers.⁸ Only the retailer making a sale to the consumer would impose and collect the taxes and then remit the money to the government.

The flat tax is regarded frequently as a simplified version of the current income tax. The existing loopholes, discriminatory rate structure, and different ways the government taxes the same income more than once would disappear, but collection of the tax would be similar to the manner in which taxes are collected today. Taxpayers would file returns by April 15 and either receive a refund or pay additional taxes, depending on whether their withholding was greater or less than the tax liability calculated on the postcard-sized form.

WHAT ARE THE BENEFITS OF A SINGLE-RATE TAX SYSTEM?

Regardless of which option is chosen, both the flat tax and sales tax would yield immense benefits for Americans. Specifically, these benefits would include:

- **Fairness.** Most Americans believe the tax code is riddled with discrimination. They are right. The government either imposes tax penalties or grants tax

⁸ The only exception, of course, would be if the manufacturer had a retail sales outlet or a catalog sales program, or if there were any sales to employees.

THE FLAT TAX AS A CONSUMPTION TAX

To many Americans, consumption taxes are those collected at the cash register—such as the state sales tax—or value-added taxes like those they might encounter on a trip to Europe. Few Americans consider the flat tax a consumption tax because it would be levied on personal income. Economists and public finance experts, however, *do* consider the flat tax a consumption tax. The confusion revolves around the current tax code's policy of imposing greater penalties on income that is saved and invested than on income that is consumed. A tax code that does not discriminate against savings and investment is considered a consumption-based tax system, regardless of whether taxes are collected at the paycheck or at the cash register. In this respect, the flat tax is a version of a consumption tax.

Both the flat tax and a national sales tax also could be considered examples of an income tax, but one in which "income" is properly defined. The current tax system, by contrast, should not be referred to as an income tax; rather, it is an excessively complicated amalgamation of income and wealth taxation.

Charts 3 and 4 illustrate the ways in which the flat tax and sales tax are so similar and yet have so little in common with the current income tax structure.

preferences depending on the source, use, or level of income. All of these special provisions violate the principle that all citizens should be treated equally by the law. The flat tax and a sales tax would restore fairness in the system by ensuring that all taxpayers, all income, and all products are treated the same.⁹

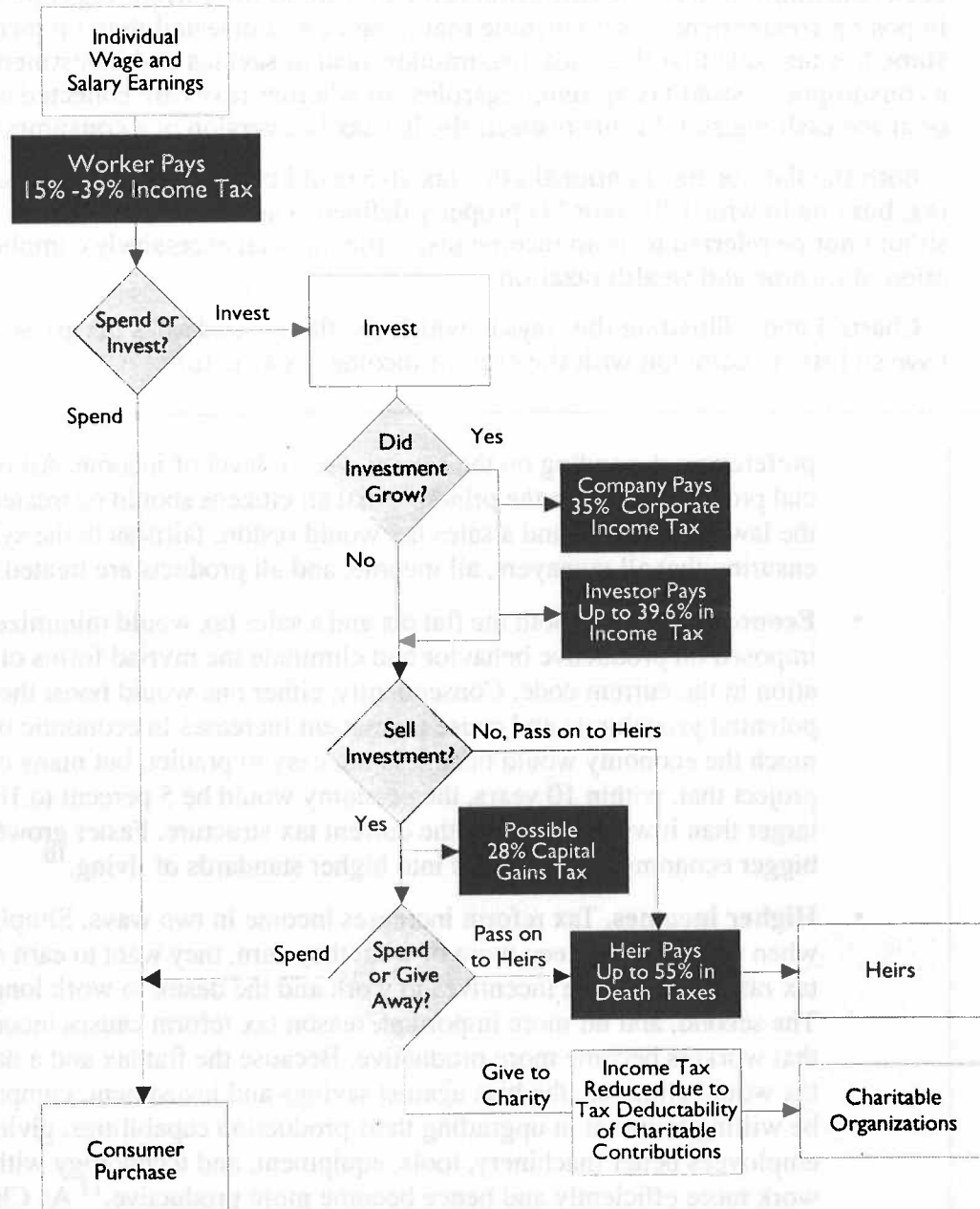
- **Economic growth.** Both the flat tax and a sales tax would minimize the tax rate imposed on productive behavior and eliminate the myriad forms of double taxation in the current code. Consequently, either one would boost the economy's potential growth rate and cause permanent increases in economic output. How much the economy would benefit is not easy to predict, but many economists project that, within 10 years, the economy would be 5 percent to 10 percent larger than it would be under the current tax structure. Faster growth and a bigger economy also translate into higher standards of living.¹⁰
- **Higher incomes.** Tax reform increases income in two ways. Simply stated, when people get to keep more of what they earn, they want to earn more. A low tax rate increases the incentives to work and the desire to work longer hours. The second, and far more important, reason tax reform causes income to rise is that workers become more productive. Because the flat tax and a national sales tax would eliminate the bias against savings and investment, companies would be willing to invest in upgrading their production capabilities, giving their employees better machinery, tools, equipment, and technology with which to work more efficiently and hence become more productive.¹¹ As Chart 6 illustrates, this capital-driven increase in productivity is tied closely to higher

9 Daniel J. Mitchell, "Why Liberals Should Support the Flat Tax," Heritage Foundation *F.Y.I.* No. 85, February 7, 1996.

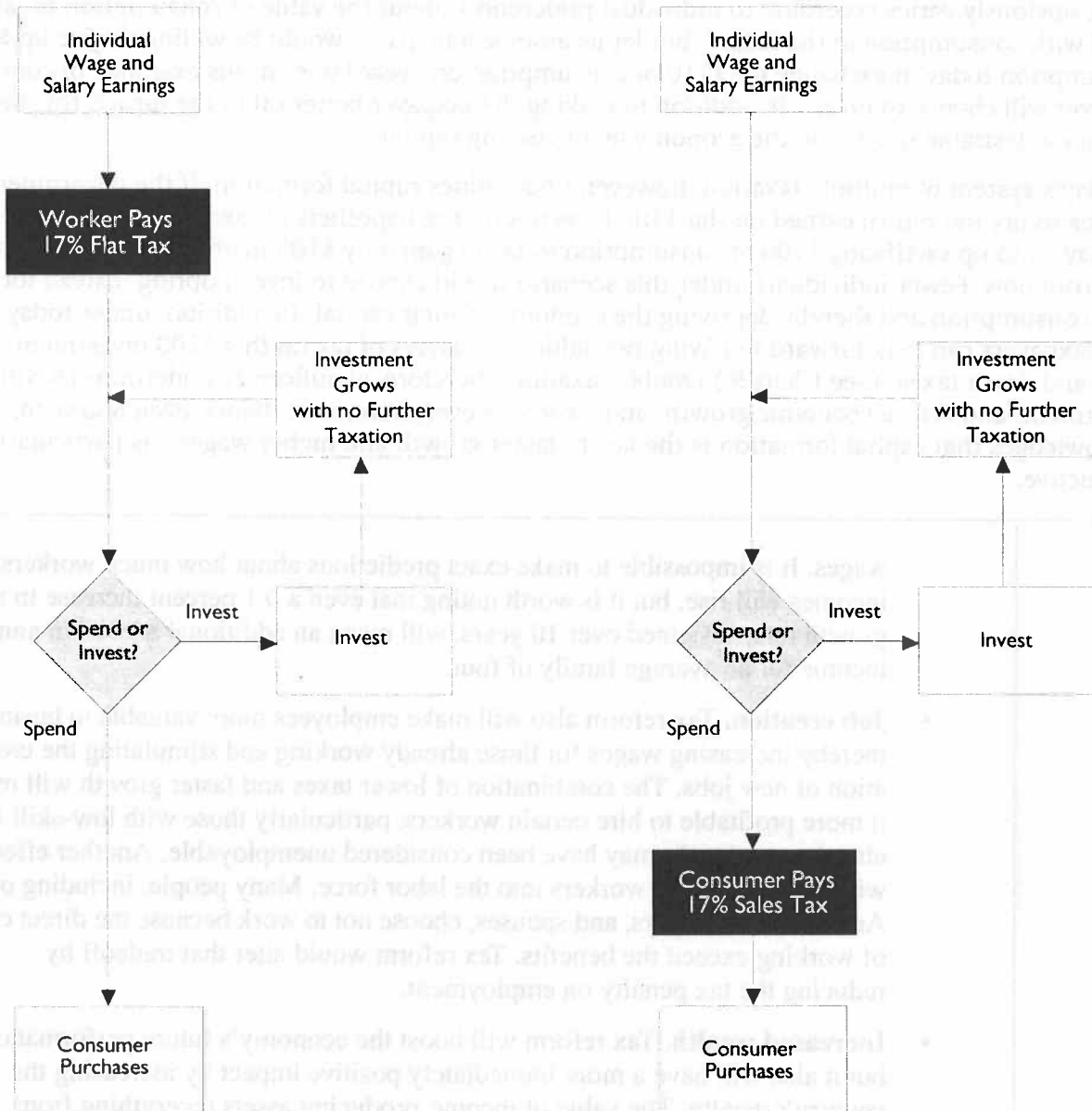
10 Daniel J. Mitchell, "Taxes, Deficits, and Economic Growth," *Heritage Lecture* No. 565, May 14, 1996.

11 Lower tax rates also encourage individuals to invest more in their own education because the returns—higher income in the future—will not be taxed as heavily.

Individuals Face Only One Layer of Tax if Income Is Spent Immediately, Up to Five Layers if Invested and Passed on to Heirs



The Flat Tax vs. a National Sales Tax: Individuals Face One Layer of Tax When Income Is Either Earned or Spent



WHY DOUBLE TAXATION IS DETRIMENTAL

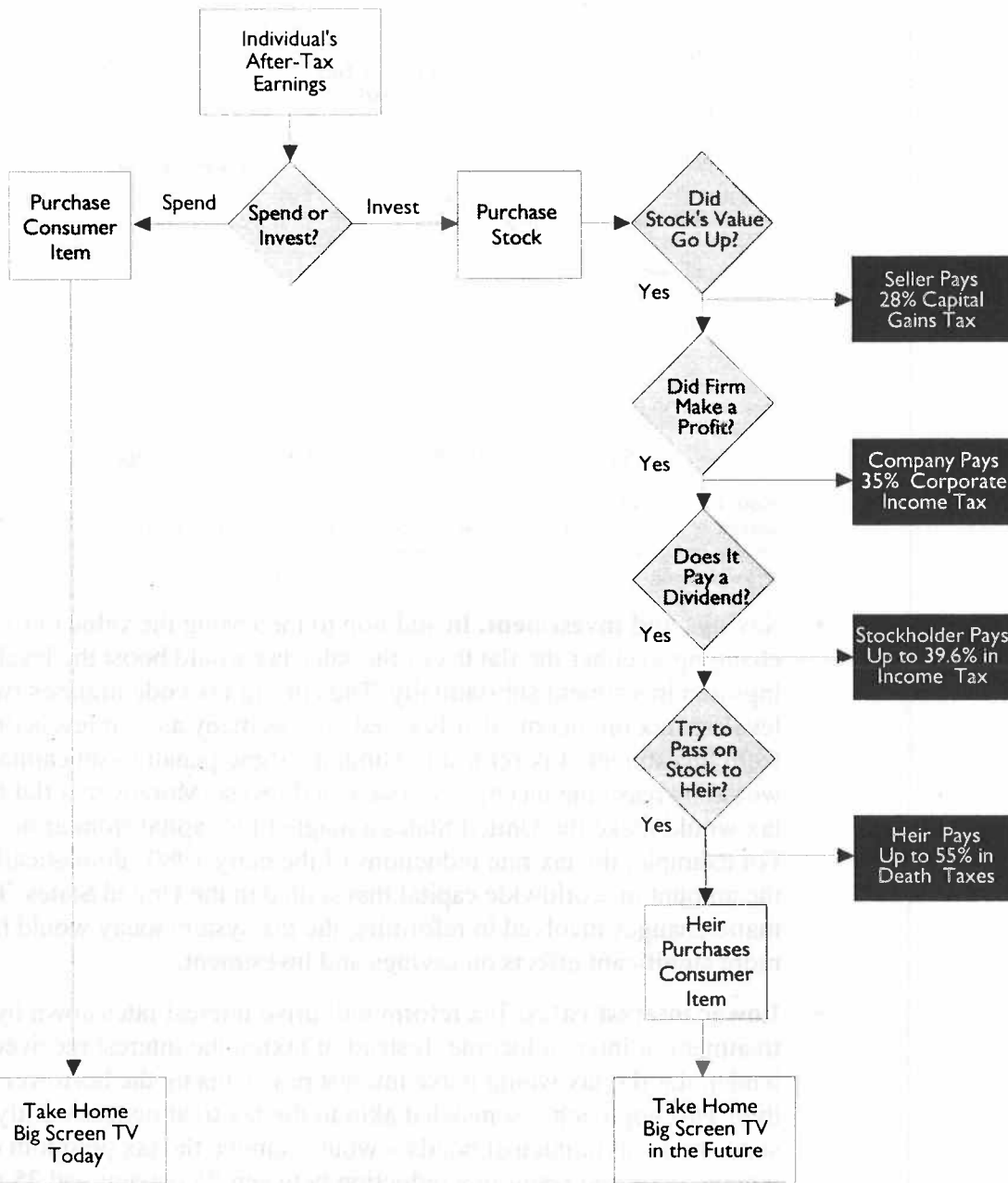
To understand double taxation, consider a taxpayer who has \$100 of disposable after-tax income. That taxpayer has a choice: either to spend the income immediately or to defer consumption by investing it. Consuming the money immediately yields \$100 of benefit immediately, but investing it would yield a return that could allow the taxpayer to consume, say, \$115 a year from now. The decision to invest obviously varies according to individual preferences about the value of consumption today compared with consumption in the future, but let us assume a taxpayer would be willing to give up \$100 of consumption today in exchange for \$110 of consumption one year later. In this example, of course, the taxpayer will choose to invest. In addition to making the taxpayer better off in the future, this decision also has a desirable impact on the economy by increasing capital.

Today's system of multiple taxation, however, undermines capital formation. If the government decides to tax the return earned on the \$100 investment, the hypothetical taxpayer in the above example may wind up sacrificing \$100 of consumption today to gain only \$105 in after-tax consumption one year from now. Fewer individuals under this scenario would choose to invest, opting instead for immediate consumption and thereby depriving the economy of their capital. In addition, under today's system, taxpayers can look forward to paying two additional layers of tax on this \$100 investment: capital gains and death taxes. (See Chart 5.) Double taxation, therefore, significantly undermines savings, investment, and future economic growth, and—because every economic theory, even Marxism, acknowledges that capital formation is the key to faster growth and higher wages—is particularly self-destructive.

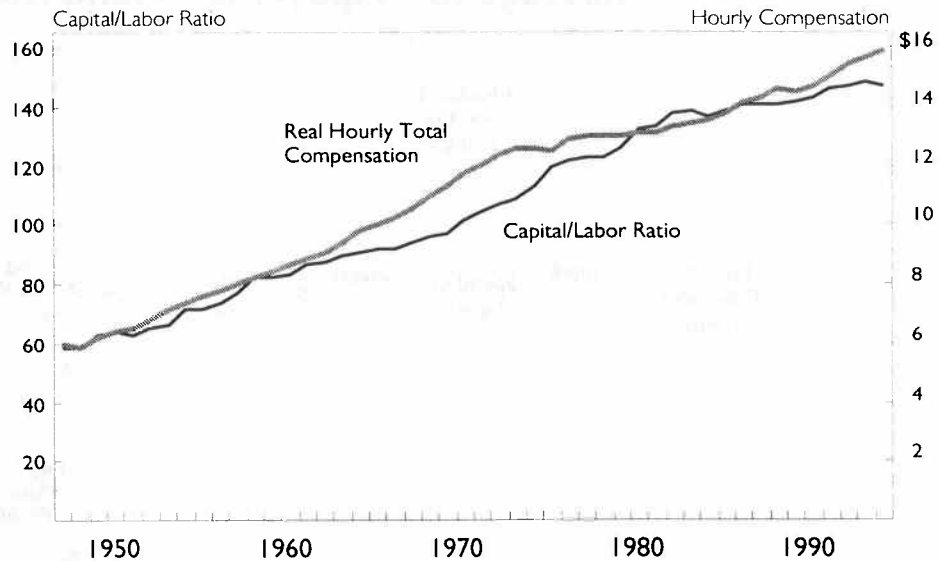
wages. It is impossible to make exact predictions about how much workers' incomes will rise, but it is worth noting that even a 0.1 percent increase in the growth rate, sustained over 10 years, will mean an additional \$5,000 in annual income for an average family of four.

- **Job creation.** Tax reform also will make employees more valuable to business, thereby increasing wages for those already working and stimulating the creation of new jobs. The combination of lower taxes and faster growth will make it more profitable to hire certain workers, particularly those with low-skill levels who previously may have been considered unemployable. Another effect will be to draw new workers into the labor force. Many people, including older Americans, teenagers, and spouses, choose not to work because the direct costs of working exceed the benefits. Tax reform would alter that tradeoff by reducing the tax penalty on employment.
- **Increased wealth.** Tax reform will boost the economy's future performance, but it also will have a more immediately positive impact by increasing the country's wealth. The value of income-producing assets (everything from stocks and bonds to office buildings and pet stores) is determined by market expectations of future income discounted by inflation, risk, and taxes. Once a lower tax rate is put in place, whether through the flat tax or a national sales tax, and double taxation is eliminated, income-producing assets will become more valuable (that is, there will be an increase in the present value of the future after-tax income stream generated by those assets). This increase in value means an immediate increase in wealth.¹²

Saving and Investment Can Be Taxed up to Four Times: Message to Taxpayer Is "Spend Now"



Worker Compensation Closely Linked to Investment



Note: Capital/Labor ratio = Amount of capital per worker.

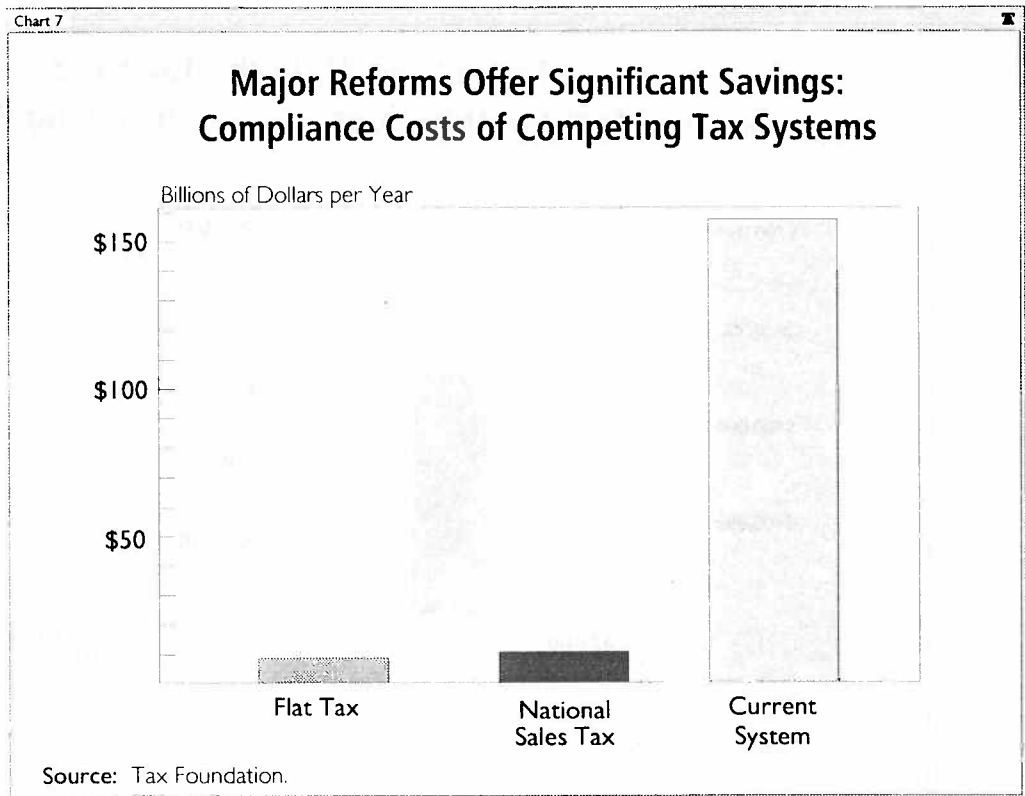
Source: Aldona and Gary Robbins. "The Truth About Falling Wages," *Economic Scorecard*, Institute for Policy Innovation, TaxAction Analysis, Third Quarter 1995.

- Savings and investment.** In addition to increasing the value of existing assets, changing to either the flat tax or the sales tax would boost the levels of new savings and investment substantially. The current tax code imposes two or three levels of tax on income that is saved, and as many as four levels on income from investment. Tax reform to eliminate these penalties on capital formation would increase the incentives to save and invest. Moreover, a flat tax or sales tax would make the United States a magnet for capital from around the world. For example, the tax rate reductions of the early 1980s dramatically increased the amount of worldwide capital that settled in the United States. The more dramatic changes involved in reforming the tax system today would have even more significant effects on savings and investment.
- Lower interest rates.** Tax reform will drive interest rates down by shifting the treatment of interest income. Instead of taxing the interest received by the lender, the flat tax would make interest payments by the borrower nondeductible. This approach—somewhat akin to the tax treatment currently granted to state and local municipal bonds—would remove the tax premium embedded in interest rates and result in a reduction between 25 percent and 35 percent.¹³ Under a sales tax, eliminating direct taxes on income would have the same effect.

12 David Burton, unpublished manuscript.

13 John E. Golub, "How Would Tax Reform Affect Financial Markets?" Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter 1995.

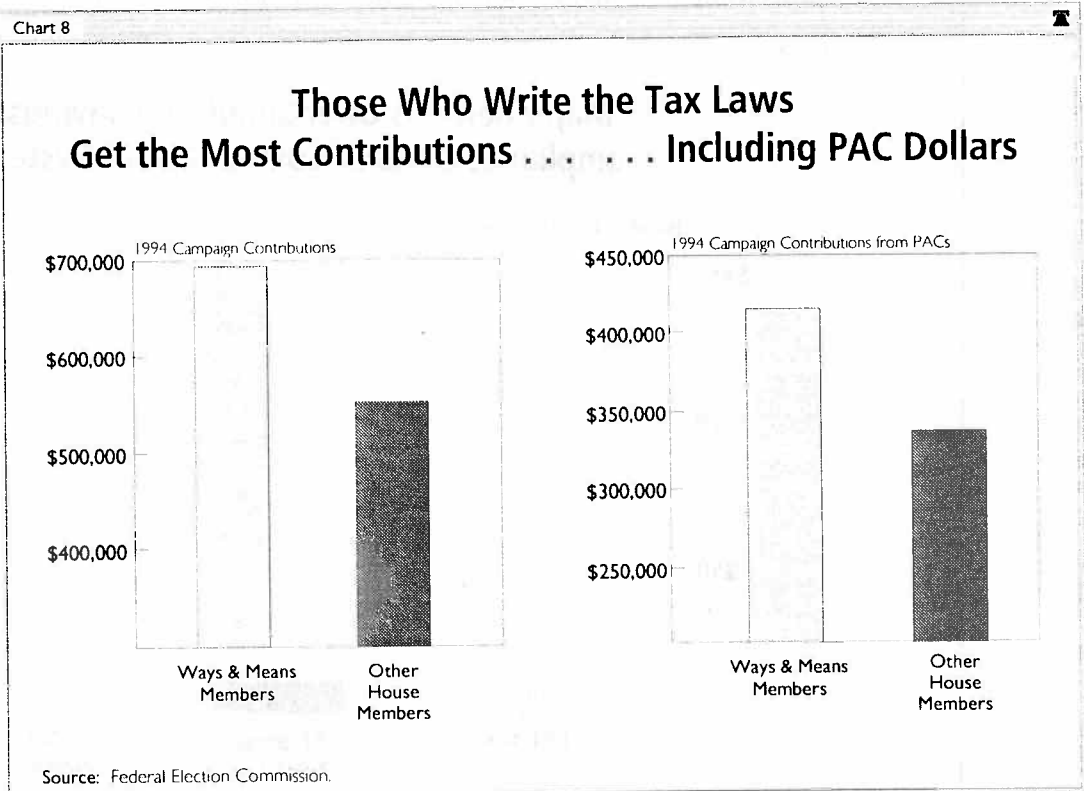
- **Lower compliance costs.** Because both the flat tax and a national sales tax would eliminate the bewildering complexity of the current system, tax reform would slash the \$157 billion annual costs of complying with personal and corporate income taxes. The current system is such a mess that even consulting expensive tax experts is no guarantee of accuracy. For example, in March 1997, *Money* reported that it had sent a hypothetical family's tax return to professional tax preparers. Of the 45 who responded, not one professional tax preparer came up with the proper solution, and fewer than 25 percent came within even \$1,000 of the correct tax liability. The business side of the tax code makes processing personal income taxes seem simple by comparison.



- **Smaller IRS, more civil liberties.** The current tax code gives the IRS sweeping, virtually unlimited power to monitor people's lives, track their assets, and review their expenditures. Moreover, the law gives the agency far-reaching authority to seize property, garnish wages, and freeze assets. Perhaps worst of all, taxpayers who have been accused by the IRS of committing fraud or tax evasion are presumed guilty and required to prove their innocence—a complete reversal of the rights guaranteed by the Constitution. Although neither the flat tax nor a national sales tax¹⁴ can be expected to rid the United States of the IRS or eliminate every possible conflict with the government, the dramatic simplification that either reform would bring about would significantly reduce the size, scope, and power of the IRS bureaucracy.¹⁵

14 The sales tax legislation could eliminate the existing Washington-based IRS bureaucracy if all states chose to be responsible for collecting the tax, in exchange for which they would receive a 1 percent fee or commission.

- **Less political corruption.** The tax code today is the result of 84 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. Although individuals, whether acting alone or through organized groups, have a constitutional right to petition their government, this does not mean their elected lawmakers should acquiesce to improper demands. The flat tax or a national sales tax would remove from the tax system the corrupting process of exchanging loopholes for political support.



- **No social engineering.** One of the most attractive features of both the flat tax and a national sales tax is that politicians no longer would be able to use the tax code for purposes of social engineering. The flat tax would eliminate all the biases and preferences in the income tax, and a sales tax is designed so that all products and services would be taxed at exactly the same rate.
- **No marriage penalty.** Despite all the rhetoric in Washington about family values, one of the most bizarre examples of social engineering in the current tax code is the marriage penalty. Today, many married couples could reduce their tax bill by hundreds or even thousands of dollars simply by divorcing and living together. Although this quirk of the tax code presumably is not causing families to break up, it violates the principle of equal treatment under the law and should be repealed. The flat tax would achieve this goal of equal treatment for married

15 Daniel J. Mitchell, "577,951.692.634 Reasons...and Counting: Why a Flat Tax Is Needed to Reform the IRS," Heritage Foundation *Backgrounder* No. 1107, February 19, 1997.

couples because it is impossible under a single-rate tax system to be bumped into a higher bracket. A national sales tax, meanwhile, would make the concept irrelevant because income no longer would be subject to direct taxation.

RESPONDING TO THE CRITICS OF TAX REFORM

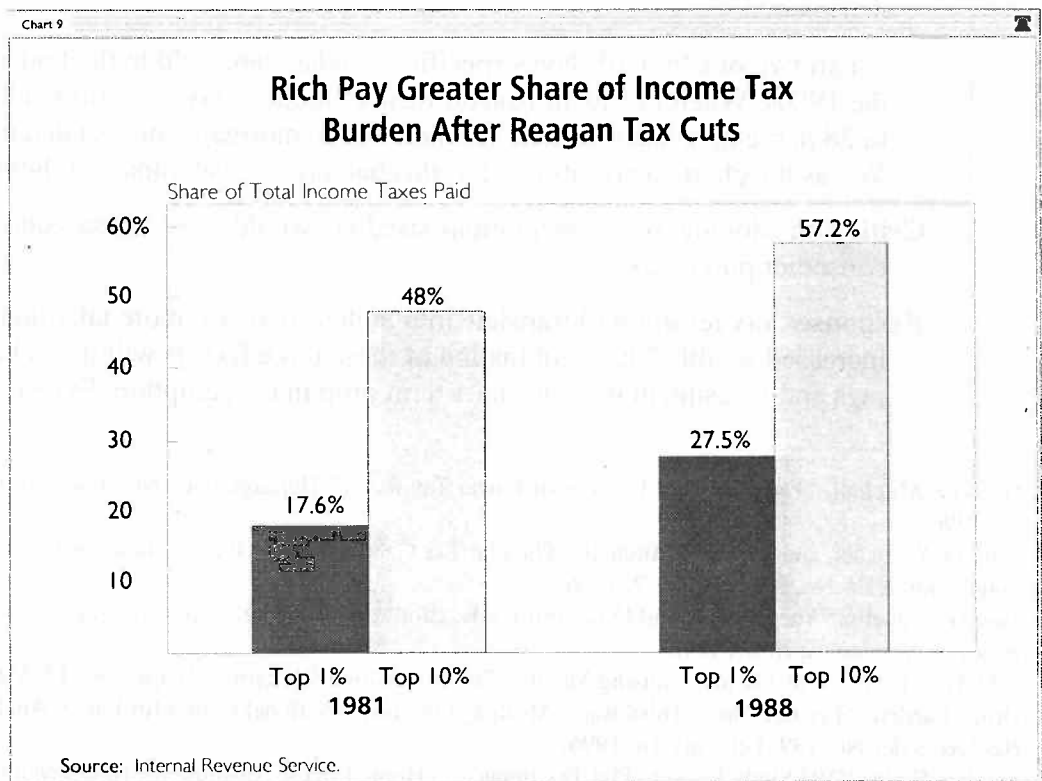
Notwithstanding these many benefits, some people continue to oppose tax reform. Their assertions, however, are not supported by the evidence. For example:

Criticism: Both the flat tax and a national sales tax are unfair because the rich and poor would pay the same rate.

Response: The only reasonable definition of fairness is that everyone should play by the same rules—the very principle that underlies both flat tax and sales tax reform plans. Under the flat tax, a person who has ten times the taxable income of another would pay ten times as much in taxes. Likewise, under a sales tax, the rich person who consumes ten times as much as a poor person would pay ten times as much in sales tax.¹⁶

Criticism: Tax reform would give the rich an undeserved tax cut.

Response: The tax system should be designed to collect the money needed to run the government in the fairest and least destructive manner possible. For those who currently face confiscatory tax rates to receive a tax cut is eminently fair. It is worth noting that there is a big difference between tax rates and amount of taxes paid. In all likelihood, upper-income taxpayers would pay even more in taxes after tax reform because the incentives to hide, shelter, and underreport income would be reduced significantly.



16 Because of the family allowance in the flat tax and the universal rebate in the sales tax, there actually would be a modest level of progressivity after tax reform. But, unlike the current system, all taxpayers would be treated identically.

As Chart 9 illustrates, this is precisely what happened in the 1980s. The wealthy, whose tax rates were reduced from 70 percent to 28 percent, reported so much more income on their tax returns than before that they wound up paying a significantly higher share of the total income tax burden.¹⁷

Criticism: The poor would pay more.

Response: Because of the generous personal allowances in the Arme y flat tax proposal, a family of four would pay no income tax on its first \$33,800 of income. By contrast, the personal exemptions and standard deductions in the current tax code protect only about \$17,000 of income from income tax. The sales tax proposal includes a universal rebate that would send all taxpayers a check to offset their purchases up to the poverty level.¹⁸

Criticism: Loss of the home mortgage interest deduction would reduce home values and harm the housing industry.

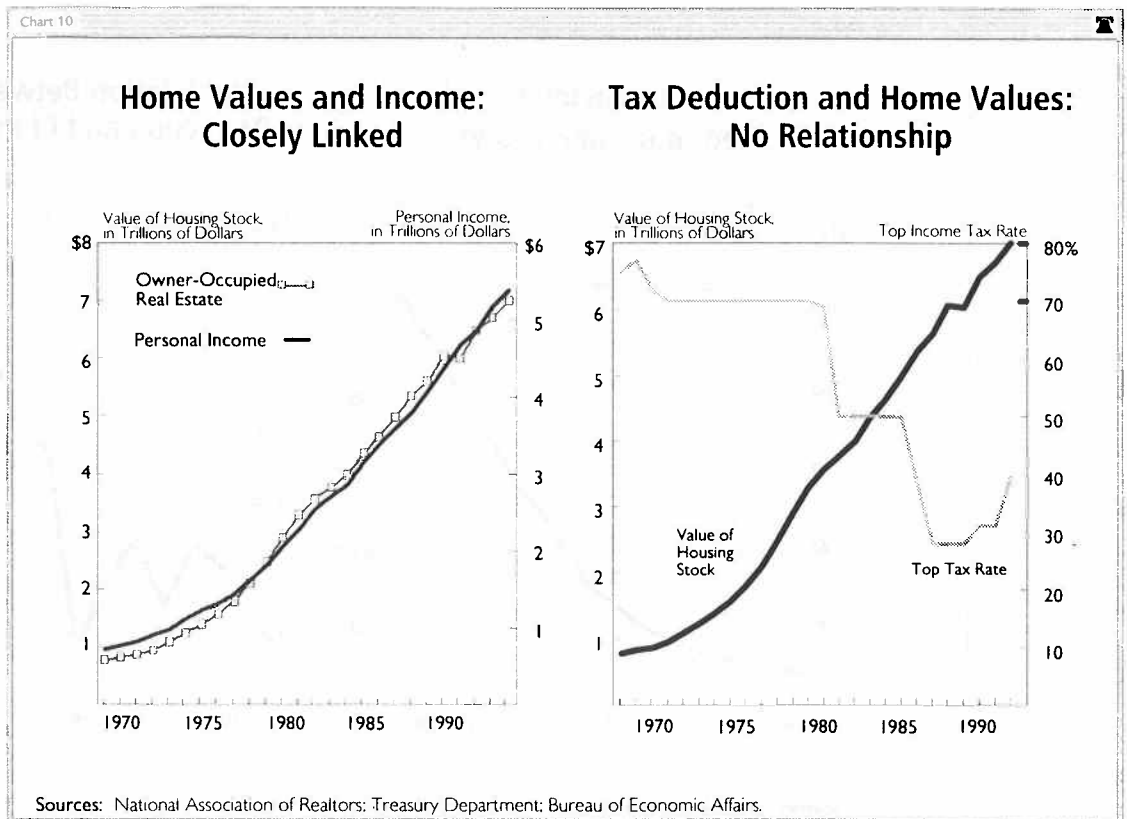
Response: In reality, fewer than 30 percent of taxpayers use itemized deductions. This group is comprised disproportionately of higher-income taxpayers who presumably would be glad to give up deductions in exchange for a simple, low-rate tax system. Numerous studies by such nonpartisan organizations as the Congressional Research Service,¹⁹ Tax Foundation,²⁰ National Center for Policy Analysis,²¹ and Institute for Research on the Economics of Taxation²² have demonstrated conclusively that tax reform will not have an adverse impact on home values. Above all, home values and home sales are tied to the overall health of the economy. As the first part of Chart 10 illustrates, home values are closely correlated to the growth of income. Because tax reform will boost income, the impact on the housing market would be beneficial, not detrimental.²³

Part two of Chart 10 shows specifically what happened to the housing market during the 1980s. When President Ronald Reagan reduced tax rates from a high of 70 percent to 28 percent, he also slashed the value of the mortgage interest deduction dramatically. Yet, as the chart clearly illustrates, this had no adverse impact on home values.

Criticism: Moving to a consumption-based tax would cause a recession by depressing consumer purchases.

Response: Tax reform will translate into higher incomes, more take-home pay, and increased wealth. The combination of these three factors will mean higher levels of savings and investment with no short-term drop in consumption. Even critics admit that

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- 17 Daniel J. Mitchell, "The Historical Lessons of Lower Tax Rates," Heritage Foundation *Backgrounder* No. 1086, July 19, 1996.
 - 18 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.
 - 19 Jane G. Gravelle, "The Flat Tax and Other Proposals: Effects on Housing," *CRS Report for Congress*, Congressional Research Service, April 29, 1996.
 - 20 J. D. Foster, "The Flat Tax and Housing Values," Tax Foundation *Background Paper* No. 15, May 1996.
 - 21 Bruce Bartlett, "Tax Reform's 'Third Rail': Mortgage Interest," National Center for Policy Analysis *Policy Backgrounder* No. 139, February 16, 1996.
 - 22 Stephen Entin, "DRI Study Distorts Flat Tax Impact on Home Prices," Institute for Research on the Economics of Taxation *Congressional Advisory* No. 50, September 5, 1995.
 - 23 William W. Beach and Daniel J. Mitchell, "Worst Case Scenario: Flat Tax Would Boost Home Values by 7 Percent or More," Heritage Foundation *F.Y.I.* No. 87, February 12, 1996.



consumption levels will be higher in the long term because of additional economic growth. Opponents of the sales tax have charged that a short-term downturn would occur when consumers rushed to make immediate big-ticket purchases before the tax went into effect. Such an effect (if it did materialize) would be only a temporary phenomenon, however, completely offset by additional economic growth.

Criticism: The loss of a tax preference for charitable giving would undermine churches, human service providers, and other nonprofit organizations.

Response: Evidence from the 1980s demonstrates clearly that the level of charitable contribution is tied to personal income, not to the value of a tax deduction.²⁴ When the tax rates fell in the 1980s, so did the value of the tax break. Yet, as Chart 11 shows, charitable giving skyrocketed.²⁵ The reason: incomes increased. The faster growth and higher income brought about by tax reform also would boost the level of charitable giving, not reduce it.²⁶

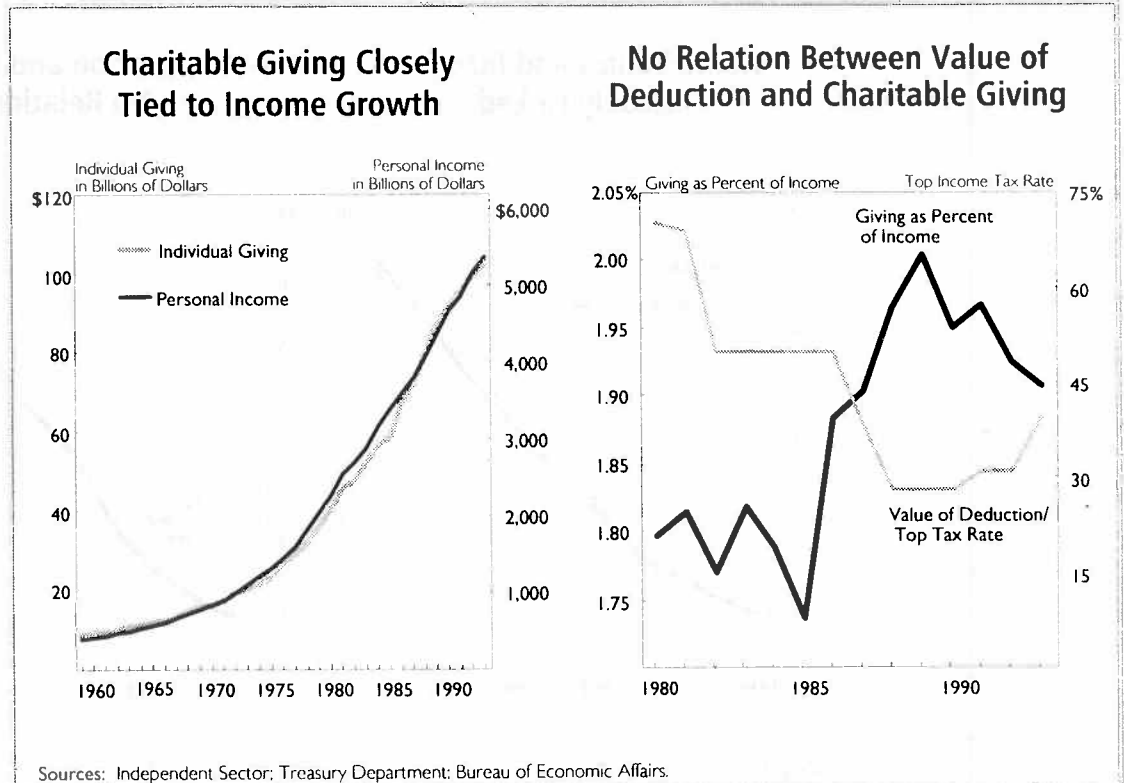
Criticism: Implementing a national sales tax would create the risk that the United States might end up like Europe, with both income and consumption taxes.

Response: Advocates of a national sales tax properly vow that complete and irreversible elimination of the income tax must occur before the plan can be enacted. The only certain way to prevent future politicians from pulling a bait-and-switch on a trusting public, however, would be to amend the Constitution by repealing the 16th Amendment, which

24 Robert J. Breshock. "Would a Flat Tax Flatten Philanthropy?" *Philanthropy*, Spring 1996.

25 John S. Barry. "How a Flat Tax Would Affect Charitable Contributions," Heritage Foundation *Backgrounders* No. 1093, December 16, 1996.

26 Stephen Moore. "Less Than Charitable Tax Report." *The Washington Times*, June 18, 1997.



gives Congress the power to impose an income tax, and expressly forbidding direct taxes on income. This presumably would mean the abolition of Social Security and Medicare payroll taxes as well.

Criticism: The flat tax allows people living off dividends and interest to escape all taxes.

Response: Under the flat tax, businesses withhold and pay taxes on dividends and interest before sending the money to individuals. Thus, income from interest payments and dividends would be treated the same as the income in a worker's paycheck—as an after-tax payment. Taxing dividends and interest a second time at the individual level is as unfair as requiring workers to file tax returns based on their net pay.

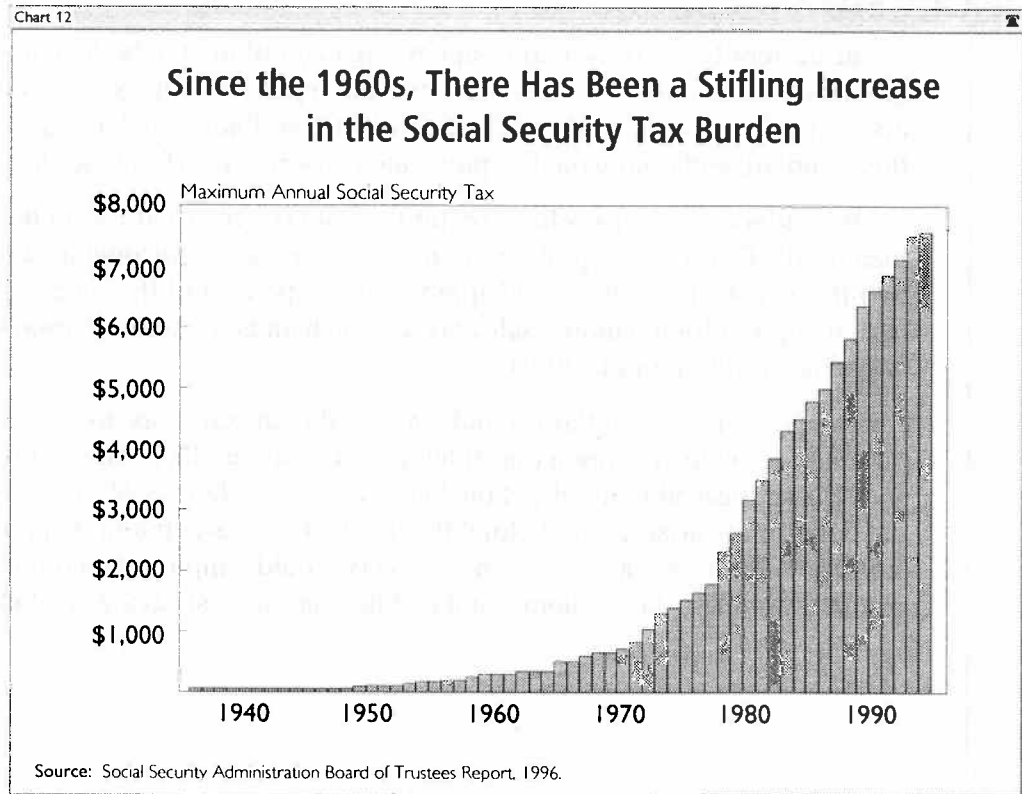
Criticism: Neither the flat tax nor the sales tax will capture the entire underground economy.

Response: This is true but meaningless. A drug dealer is not going to report his income under the flat tax and certainly will not collect taxes on the "products" he sells under a national sales tax system. But the current system does not capture this money either, so this argument hardly serves as a reason to reject tax reform. At the very least, the flat tax and a national sales tax would reduce the level of tax evasion by people who are trying to protect their income from unfair and excessive taxation today.

Criticism: Tax reform would do nothing to relieve the burden of payroll taxes.

Response: By and large, this criticism is true. As Chart 12 illustrates, payroll taxes have climbed dramatically in the past two decades. Combined with the fact that both Social Security and Medicare—the programs funded by these taxes—face severe financial problems, there can be little doubt that reform is needed.²⁷ For better or worse, income

and payroll taxes are different revenues funding different programs and, therefore, probably will be addressed separately. Americans for Fair Taxation has proposed a sales tax to replace payroll taxes as well as income taxes. This proposal has not yet been introduced in Congress.



Criticism: Regardless of the type of tax, taxpayers will not be safe so long as lawmakers can raise taxes in the future.

Response: Any tax reform should be accompanied by legislation, even constitutional reform, that requires a supermajority to approve any future increase in tax rates.²⁸

Criticism: Tax reform would reduce government revenues.

Response: The current tax burden is much too high. Moreover, it is economically desirable and, by most estimates, politically necessary for tax reform to lower the overall burden of taxation on Americans.²⁹ Even though faster growth, lower unemployment, and higher income probably would offset most or all of the foregone revenue as time passed,³⁰ it is conceivable that there could be some short-term decline in government

- 27 Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation *Backgrounder* No. 1109, April 23, 1997.
- 28 Daniel J. Mitchell, "The Case for a Tax Supermajority Requirement: A Look at the States," Citizens for a Sound Economy *Issue Analysis* No. 25, April 12, 1996.
- 29 The political argument for making tax reform a tax cut, rather than revenue-neutral, is to minimize the number of taxpayers who would face increased tax liabilities after reform and therefore might have an incentive to lobby against the legislation.
- 30 Daniel J. Mitchell, "How to Measure the Revenue Impact of Changes in Tax Rates," Heritage Foundation *Backgrounder* No. 1090, August 9, 1996.

revenue collections. If this decline became an obstacle to passage of a flat tax or national sales tax plan, lawmakers should use it as an opportunity to eliminate or scale back as many federal programs as possible.

CONCLUSION

The current U.S. tax system is an unmitigated failure. On both economic and moral grounds, the tax code should be repealed and replaced with a system that treats all taxpayers—and all income—fairly and equally. Both the flat tax and a national sales tax satisfy this standard, and both would improve the economy's performance substantially.

Many advocates of tax reform prefer the flat tax because it would not require an amendment to the Constitution prohibiting income taxes. Such an amendment would require a two-thirds vote in Congress and approval by 75 percent of the state legislatures. Nonetheless, if support for a national sales tax and such an amendment grows, flat tax partisans would do well to join the effort.

Because plans for the flat tax and a national retail sales tax are so similar, lawmakers have no reason to champion one at the expense of the other. Advocates of tax reform should seek instead to highlight the benefits and similarities of the two plans and, when the opportunity arises, rally behind the one that has garnered more political and popular support.³¹ Both the flat tax and the sales tax would simplify the current tax code, boost income, stimulate the economy, and end the bias against savings and investment.

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31 The author's personal assessment is that the flat tax is more viable politically. See Daniel J. Mitchell, "Taxing Times," *Reason*, August/September 1997.