Backgrounder
Published by The Heritage Foundation
No. 1866
July 7, 2005

A Brief Guide to the Flat Tax

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There is widespread consensus that the current tax system is a complicated failure that hinders the nation's growth while allowing the politically well-connected to manipulate the system to get special breaks that are not available to average workers and businesses. This is stimulating a great deal of interest in shifting to a simple and fair flat tax. For instance, President George W. Bush has appointed the President's Advisory Panel on Tax Reform to recommend options for fundamental tax reform,[1] the Department of the Treasury has produced extensive analysis of the flat tax and other reform options,[2] and lawmakers on Capitol Hill are exploring various ways to reform the tax code.

The United States should move quickly to reform its tax system. In a competitive global economy, jobs and capital flow to jurisdictions with better tax law. Traditionally, this process of "tax competition" has benefited the United States, but there is growing evidence that America is falling behind. Nations around the world are lowering tax rates and reforming their tax systems. Indeed, nine countries that were part of the former Soviet Bloc have adopted versions of the flat tax.[3] These pro-growth reforms are yielding impressive results and are a road map for U.S. policymakers.

What Is a Flat Tax?

Unlike the current system, a flat tax is simple, fair, and good for growth. Instead of the 893 forms required by the current system,[4] a flat tax would use only two postcard-sized forms: one for labor income and the other for business and capital income. Unlike the cur-

Talking Points

- A flat tax eliminates special-interest favoritism. Under a flat tax, all taxpayers are treated equally. A taxpayer would no longer be able to scam the system by hiring enough lawyers, accountants, and lobbyists.
- A flat tax will make America more competitive in the global economy, attracting jobs and capital from around the world.
- A flat tax will boost economic growth by reducing the tax burden on work, saving, and investment. A low tax rate and elimination of double taxation will increase incentives to be productive.
- A flat tax will reduce political corruption by creating a simple and transparent system, making it harder for politicians to swap special-interest tax breaks for campaign cash.

This paper, in its entirety, can be found at:
www.heritage.org/research/taxes/bg1866.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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rent system, which discriminates based on the source, use, and level of income, a flat tax treats all taxpayers equally, fulfilling the "equal justice under law" principle etched above the main entrance to the U.S. Supreme Court building. And unlike the current system, which punishes people for contributing to the nation's wealth, a flat tax would lower marginal tax rates and eliminate the tax bias against saving and investment, thus ensuring better economic performance in a competitive global economy.

There have been several flat tax proposals over the years, all of them based on the pathbreaking proposal developed by two Hoover Institution economists.[5] While no two plans are identical, they all share common features that fix the major flaws of the current Internal Revenue Code. Simplicity and fairness are also natural consequences of these component features of tax reform.

These major features of a flat tax are:

A Single Flat Rate. All flat tax proposals have a single rate, usually less than 20 percent. The low, flat rate solves the problem of high marginal tax rates by reducing penalties against productive behavior, such as work, risk taking, and entrepreneurship.

Elimination of Special Preferences. Flat tax proposals would eliminate provisions of the tax code that bestow preferential tax treatment on certain behaviors and activities. Getting rid of deductions, credits, exemptions, and other loopholes also helps solve the problem of complexity, allowing taxpayers to file their tax returns on a postcard-sized form.

No Double Taxation of Saving and Investment. Flat tax proposals would eliminate the tax code's bias against capital formation by ending the double taxation of income that is saved and invested. This means no death tax, no capital gains tax, no double taxation of saving, and no double tax on dividends. By taxing income only one time, a flat tax is easier to enforce and more conducive to job creation and capital formation.

Territorial Taxation. Flat tax proposals are based on the commonsense notion of "territorial taxation," meaning that governments should tax only income that is earned inside national borders. By getting rid of "worldwide taxation," a flat tax enables U.S. taxpayers and companies to compete on a level playing field around the world.

Family-Friendly. All flat tax proposals have one "loophole." Households receive a generous exemption based on family size. For instance, a family of four would not begin to pay tax until its annual income reached more than $30,000.[6]

Consumption-Based. A tax code that does not discriminate against saving and investment is considered a consumption-based tax system, regardless of whether taxes are deducted from the paycheck or collected at the cash register. In this respect, a flat tax is a type of consumption tax. The difference between a flat tax and a national sales tax is where the tax is collected. A flat tax is levied on income—but only once and at one low rate—as it is earned. A sales tax is levied on income—but only once and at one low rate—as it is spent.

Both the flat tax and the sales tax differ dramatically from the U.S. Internal Revenue Code. The current tax code has numerous forms of double taxation, such as its treatment of saving and corpo-

1. For more information, see President's Advisory Panel on Federal Tax Reform Web site, at *www.taxreformpanel.gov* (June 16, 2005).
2. Pamela F. Olson, "Tax Reform Materials," memorandum for Secretary Paul O'Neill, U.S. Department of the Treasury, November 7, 2002, at *thepriceofloyalty.ronsuskind.com/thebushfiles/archives/000093.html* (June 16, 2005).
3. For the latest updates on the global shift to flat taxes, see Hoover Institution, "The Russian Economy: Comments and Articles," at *www.russiaeconomy.org/comments.html* (June 16, 2005).
4. Based on a search of Internal Revenue Service "Forms and Publications" Web site, at *www.irs.gov/formspubs/index.html* (April 19, 2005).
5. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, Calif.: Hoover Institution Press, 1995), at *www-hoover.stanford.edu/publications/books/flattax.html* (June 29, 2005).
6. For instance, see H.R. 1040, introduced by Representative Michael Burgess (R–TX).

rate income. The current tax code also has several forms of wealth taxation or asset taxation, such as the capital gains tax and the death tax. (These also are forms of double taxation since the assets were acquired with after-tax dollars.) The current tax code even has provisions that force taxpayers to overstate their income, such as forcing businesses to "depreciate" the cost of new investment instead of allowing immediate and full deduction (a policy known as "expensing") when costs are incurred.

None of these forms of double taxation, wealth taxation, or overtaxation exist in either a flat tax or a national sales tax, which is why public finance economists categorize both systems as consumption-based taxes.

How a Flat Tax Would Work for Individual Taxpayers

Compared to the current system, a flat tax is extremely simple. Households pay tax on their labor income using a 10-line individual postcard. (See Form 1 in Figure 1.) They do not need to worry about reporting dividends, interest, and other forms of business/capital income. Those forms of income are taxed at the business level, thus obviating any need to tax them at the individual level since that would violate the principle of no double taxation.

The individual postcard is so simple that a third-grader could file a family's tax return in about five minutes. Each household would report wage, salary, and pension income on Line 1, which should be easily available from W-2 forms. Using Lines 2–5, the household then would calculate its personal allowance, which is based on family size. The personal allowance on Line 5 is then subtracted from Line 1 to determine taxable income. This amount is reported on Line 6. The amount of tax is calculated on Line 7. This amount is then compared to the amount of tax withheld on Line 8, which then leaves either a tax payment (Line 9) or a refund (Line 10).

How a Flat Tax Would Work for Businesses

Like the individual postcard form, the business postcard form is very simple. (See Form 2 in Figure 1.) All businesses, from Microsoft to a hot dog stand, would play by the same rules. There no longer would be separate tax rules for partnerships, sole proprietorships, S corporations and regular corporations. All business operations in America, whether owned by a U.S. company or owned by a foreign company, would pay tax on the income that they earn in the United States.

All business taxpayers would put their total receipts on Line 1. They would then add together their labor costs, their input costs, and their investment costs on Lines 2 and 3. These costs are subtracted from gross receipts to determine taxable income on Line 4. Line 5 is the amount of tax that is due. Lines 6–10 exist in case a company either had losses from previous years and now has an opportunity to offset taxable income or has losses this year and needs to "carry them forward" to the next tax year.

The Advantages of a Flat Tax

There are two principal arguments for a flat tax—growth and fairness. Many economists are attracted to the idea because the current tax system, with its high rates and discriminatory taxation of saving and investment, reduces growth, destroys jobs, and lowers incomes. A flat tax would not eliminate the damaging impact of taxes altogether, but by dramatically lowering rates and ending the tax code's bias against saving and investment, it would boost the economy's performance when compared with the present tax code.

However, the most persuasive feature of a flat tax for many Americans is its fairness. The complicated documents, instruction manuals, and numerous forms that taxpayers struggle to decipher every April would be replaced by a brief set of instructions and two simple postcards. This radical reform appeals to citizens who not only resent the time and expense consumed by filing their own tax forms, but also suspect that the existing maze of credits, deductions, and exemptions gives a special advantage to those who wield political power and can afford expert tax advisers.

If enacted, a flat tax would yield major benefits to the nation, including:

Faster Economic Growth. A flat tax would spur increased work, saving, and investment. By

Figure 1 B 1866

Simplicity on a Postcard: Sample Flat Tax Forms

Form 1 — Individual Wage Tax — 2005

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) $20,000 for married filing jointly	2(a)	
	(b) $10,000 for single	2(b)	
	(c) $13,000 for single head of household	2(c)	
3	Number of dependents, not including spouse	3	
4	Personal allowances for dependents *(line 3 multiplied by $6,000)*	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 — 2005

Business name	Employer identification 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 retirement benefits	2(b)	
	(c) Purchases of capital equipment 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 2004	6	
7	Interest carry-forward *(6 percent of line 6)*	7	
8	Carry-forward into 2005 *(line 6 plus line 7)*	8	
9	Tax due *(line 5 less line 8, if positive)*	9	
10	Carry forward to 2006 *(line 8 less line 5, if positive)*	10	

Source: Based on Robert Hall and Alvin Rabushka, *The Flat Tax* (Stanford: The Hoover Institution Press, 1995).

increasing incentives to engage in productive economic behavior, it would also boost the economy's long-term growth rate. Even if a flat tax boosted long-term growth by only 0.5 percent, the income of the average family of four after 10 years would be as much as $5,000 higher than it would be under current tax laws.

Instant Wealth Creation. According to Harvard economist Dale Jorgenson, tax reform would boost national wealth by nearly $5 trillion.[7] It would do this in part because all income-producing assets would rise in value since the flat tax would increase the after-tax stream of income that they generate.

Simplicity. Complexity is a hidden tax amounting to more than $100 billion. This is the cost of tax preparation, lawyers, accountants, and other resources used to comply with the Internal Revenue Code. The Internal Revenue Service even admits that the current tax code requires taxpayers to devote 6.6 billion hours each year to their tax returns.[8] Yet even this commitment of time is no guarantee of accuracy. The code is so complex that even tax experts and the IRS often make mistakes. All taxpayers, from General Motors to a hamburger-flipping teenager, would be able to fill out their tax return on a postcard-sized form, and compliance costs would drop by tens of billions of dollars.[9]

Fairness. A flat tax would treat people equally. A wealthy taxpayer with 1,000 times the taxable income of another taxpayer would pay 1,000 times more in taxes. No longer would the tax code penalize success and discriminate against citizens on the basis of income. Tax burdens would no longer depend on the number of lawyers, lobbyists, and accountants on the payroll.

An End to Micromanaging and Political Favoritism. A flat tax gets rid of all deductions, loopholes, credits, and exemptions. Politicians would lose all ability to pick winners and losers, reward friends and punish enemies, and use the tax code to impose their values on the economy. Not only does this end a major source of political corruption, but it is also pro-growth since companies would no longer squander resources lobbying politicians or making foolish investments just to obtain favorable tax treatment.

Increased Civil Liberties. Under current law, people charged with murder are presumed innocent and thus have more rights than taxpayers dealing with the Internal Revenue Service. By contrast, a flat tax would eliminate almost all sources of conflict between taxpayers and the government. Moreover, infringements on freedom and privacy would fall dramatically since the government would no longer need to know the intimate details of each taxpayer's financial assets.[10]

Global Competitiveness. In a remarkable development, former communist nations are leading a global tax reform revolution. Estonia was the first to adopt a flat tax, implementing a 26 percent rate in 1994, just a few years after the collapse of the Soviet Union. The other two Baltic republics of the former Soviet Union enacted flat taxes in the mid-1990s, with Latvia choosing a 25 percent rate and Lithuania picking 33 percent. Along with other free-market reforms, the flat tax significantly improved economic growth, and the "Baltic Tigers" became role models for the region. Learning from its neighbors, Russia stunned the world by adopting a 13 percent flat tax, which went into effect in 2001.

The Russian flat tax quickly yielded positive results: The economy prospered, and revenues poured into government coffers since tax evasion and avoidance became much less profitable. The flat

7. Dale W. Jorgenson, "Efficient Taxation of Income," *Harvard Magazine*, March–April 2002, at *www.harvard-magazine.com/on-line/030388.html* (June 29, 2005).

8. Mary Dalrymple, "Americans Spend 6.6 Billion Hours on Taxes," Associated Press, April 15, 2005, at *apnews.myway.com/article/20050415/D89FVDJ80.html* (June 29, 2005).

9. Arthur Hall, "Compliance Costs of Alternative Tax Systems," Tax Foundation *Special Brief*, June 1995.

10. Daniel Mitchell, Ph.D., "Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy," Institute for Policy Innovation *Policy Report* No. 171, February 27, 2002, at *www.ipi.org/ipi/IPIPublications.nsf/PublicationLookupFullText/C9BD6A1A962A316D06256B590025A9A9* (June 29, 2005).

tax then spread to Serbia, which in 2003 chose a 14 percent rate. Slovakia hopped on the bandwagon the following year with a 19 percent flat tax, as did Ukraine, which chose a 13 percent tax rate. Earlier this year, Romania joined the flat tax revolution with a 16 percent tax rate, and Georgia adopted a 12 percent flat tax rate, which has the honor, at least temporarily, of being the lowest rate in the world.

The flat tax revolution has been so successful that Estonia is lowering its rate to keep pace with other nations. The Estonian flat tax is now down to 24 percent and will drop to 20 percent by 2007, and Lithuania is in the process of lowering its 33 percent flat tax to a more reasonable 24 percent.[11] Poland's government just announced that it will implement an 18 percent flat tax, and lawmakers in Croatia, Bulgaria, and Hungary are also considering tax reform. Last but not least, the opposition parties in the Czech Republic have promised to implement 15 percent flat tax regimes if they win the upcoming elections.[12]

In a global economy, it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations. This means that the reward for good tax policy is greater than ever before, but it also means that the penalties for bad policy are greater than ever before. This is why so many nations are lowering tax rates and reforming their tax systems.[13] A flat tax will make America a magnet for investment and job creation.

Frequently Asked Questions

Q: Should the rich pay more?

A: Under a flat tax, the rich do pay more than the poor. A wealthy taxpayer with 100 times more taxable income than his neighbor will pay 100 times more in taxes. However, a flat tax does not impose special penalties on those who contribute the most to the nation's prosperity by subjecting them to punitive and discriminatory tax rates. For those who think the "rich" should pay a higher percentage of their income, the generous family allowance effectively creates a modest level of "progressivity." For instance, a family with an annual income of $20,000 faces a tax rate of zero. Wealthy taxpayers also benefit from the family allowance, but the effective tax rate on an income of $1 million will be only a tiny fraction below the statutory tax rate.

This approach is much fairer than the current system, which penalizes investors, entrepreneurs, and others who create wealth for the American economy while simultaneously providing myriad deductions, credits, exemptions, and other preferences that are much more likely to be exploited by upper-income taxpayers. The flat tax eliminates these special-interest loopholes, ensuring that the rich play by the same rules as other taxpayers.

Q: Would a flat tax reduce the budget deficit?

A: It depends on the tax rate, what happens to spending, and how much faster the economy grows under a flat tax. Even after taking supply-side effects into consideration, lower rates translate into less revenue at some point. The size of the family allowance also plays a key role since the decision to protect a certain amount of income generally means that the rate on income above that level has to be higher.

Q: What would happen to charitable contributions and housing markets?

A: Some worry that the transition from the current system to a new one would create problems for charities and homeowners. History suggests that these fears are misplaced. During the 1980s, the top tax rate was reduced dramatically, from 70 percent in 1980 to 28 percent in 1988. This also

11. Alvin Rabushka, "A Competitive Flat Tax May Spread to Lithuania," Hoover Institution, March 24, 2005, *www.russianeconomy.org/comments/032405.html* (June 30, 2005).

12. For more information, see Daniel J. Mitchell, Ph.D., "Viewpoints: Eastern Europe's Flat Tax Revolution," *Tax Notes International*, March 14, 2005, at *www.freedomandprosperity.org/mitchell6.pdf* (June 29, 2005).

13. For more information on the liberalizing impact of "tax competition," see Daniel J. Mitchell, Ph.D., "The Economics of Tax Competition: Harmonization vs. Liberalization," Chapter 2 in Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2004 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2004), at *www.heritage.org/research/features/index/ChapterPDFs/chapter2.pdf* (June 29, 2005).

reduced the value of itemized deductions by the same amount, but the value of housing did not drop. Similarly, charitable contributions actually rose sharply during the 1980s. This does not mean that itemized deductions have no importance; it simply indicates that the benefits generated by a robust economy more than offset any costs associated with lost deductions.

Q: Is there a risk that politicians will raise tax rates in the future?

A: As recent events demonstrate—a partial tax reform in 1986 followed by tax rate increases in 1990 and 1993—this is a real danger. However, this is not an argument against the flat tax. It is further evidence of the need for a constitutional amendment that requires a supermajority to raise taxes.

Q: Should the income tax simply be abolished and replaced by a sales tax?

A: As noted, the sales tax and flat tax are different sides of the same coin. Some have suggested that the better approach would be to replace the income tax with a national tax on consumption. However, while attractive in theory, the danger is that Americans could end up not with a sales tax *in place of* the income tax, but with a sales tax *and* an income tax. A sales tax should be considered only after the 16th Amendment, which allowed the income tax, is repealed. Otherwise, such an effort could play into the hands of those who want to impose a national sales tax or value-added tax (VAT) so that politicians get more money to spend.[14]

Q: Does a flat tax eliminate the marriage penalty?

A: There are two types of marriage penalties, and the flat tax eliminates both of them. There is only one tax rate, so it would no longer be possible for one spouse's income to push a couple into a higher tax bracket. Furthermore, since the family-based allowance under a flat tax is twice as high for a married couple as it is for those filing singly, that part of the marriage penalty also disappears.

Q: What counts as taxable income under a flat tax? Fringe benefits? Capital gains?

A: One of the key principles of the flat tax is that all income is taxed, but only once. As a result, all provisions in the current tax code that result in double taxation are abolished. The capital gains tax certainly falls in this category, as would the double tax on dividends and the death tax. By contrast, income in the form of fringe benefits is not taxed at all under the current system. This policy not only allows upper-income people to receive large amounts of tax-free income in the form of health insurance benefits, but also undermines much-needed market forces in the field of health care.

The flat tax addresses this inequity by taxing all forms of employee compensation equally. More specifically, employers would withhold tax on this type of income and remit it to the government on behalf of employees.

Q: How does a flat tax affect payroll taxes?

A: The flat tax does not address payroll taxes. Both Social Security and Medicare face significant long-term structural problems, but those problems, along with the taxes that help finance those programs, are presumably addressed most effectively as part of entitlement reform.

Conclusion

The current income tax system punishes the economy, imposes heavy compliance costs on taxpayers, rewards special interests, and makes America less competitive. A flat tax would dramatically reduce these ill effects. Perhaps more important, it would reduce the federal government's power over the lives of taxpayers and get the government out of the business of trying to micromanage the economy.

There will never be a tax that is good for the economy, but the flat tax moves the system much closer to where it should be—raising the revenues that government demands, but in the least destructive and least intrusive way possible.

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14. Daniel J. Mitchell, "Taxing Times," *Reason*, August/September 1997, at *reason.com/9708/col.mitchell.shtml* (June 29, 2005).