

BACKGROUND

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The New Flat Tax: Easy as One, Two, Three

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Abstract

The current tax system discourages saving. It discourages investment. It discourages entrepreneurship. It causes decision makers to misallocate the nation's resources, limiting productivity gains, wage gains, and the nation's overall level of international competitiveness. And, it is far, far too complicated. The New Flat Tax is the remedy. It replaces every major tax collected by the federal government. For non-seniors, it is as easy as one, two, three—one rate, two credits, three deductions. For seniors on Medicare, one of the two credits—for health insurance—is replaced by an extra deduction. The New Flat Tax is simple, revenue-neutral, and will allow America to achieve its full economic potential.

THE EXISTING TAX SYSTEM IS manifestly indefensible, especially in its complexity and its drain on economic vitality. The tax system's complexity is inflicted on taxpayers of all walks of life. Low-income citizens must navigate the enormously complex Earned Income Credit. Those who save must overcome the system's inherent discouragements and sort through a passel of tax rates and regimes for different forms of saving. Businesses investing in new plant and equipment must pay extra to obtain equity capital and must then overcome extra tax hurdles on their investments. The net result is a chaotic tax system and a much smaller economy.

The need for comprehensive, fundamental tax reform is clear. Yet typically, tax reform proposals, such as the traditional Flat Tax, solve only a piece of the problem by reforming or replacing the federal individual and corporate income taxes. The New Flat Tax replaces both income taxes, as well as the death tax, payroll taxes, and all excises not dedicated to a trust fund. Under the New Flat Tax, American taxpayers will deal with a single, simple tax.

The design of the New Flat Tax is based on the need for a more coherent tax system. An even greater

TALKING POINTS

- The existing tax system is manifestly indefensible, especially in its complexity, its burdens on the poor and rich alike, and its drain on economic vitality.
- Typically, tax reform proposals, such as the traditional Flat Tax, solve only a piece of the problem. The New Flat Tax offers a more coherent, more comprehensive reform.
- Under the New Flat Tax, American taxpayers will pay a single, simple tax rate—roughly 28 percent. It replaces all federal income taxes, as well as the death tax, payroll taxes, and all excises not dedicated to a trust fund.
- For non-seniors, it is as easy as one, two, three—one rate, two credits, three deductions. For seniors on Medicare, one of the two credits—for health insurance—is replaced by an extra deduction.
- The New Flat Tax is simple, revenue-neutral, roughly distributionally neutral, and will allow America to achieve its full economic potential.

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priority than policy coherence is the need to eliminate, insofar as possible, any loss of economic performance due to federal taxation. Unnecessarily high tax rates combined with ill-advised tax rules distort the economic decisions of businesses and families. In turn, the economy is left much weaker by these distortions. A stronger, larger economy is the primary goal of the New Flat Tax, which would achieve this goal by implementing an economically neutral tax base and by lowering rates as much as possible.

The New Flat Tax also adheres to the primary dictum of all sound tax reform proposals—it is revenue neutral. For tax reform to succeed, policymakers must scrupulously distinguish two debates—the level of taxation and how to levy tax. Tax reform should therefore seek neither to raise nor lower aggregate revenues. Under the New Flat Tax, federal receipts rise to the historical average of 18.5 percent of gross domestic product (GDP), and are capped at that share of the economy.¹

THE LEVEL OF TAXATION AND THE EXTENT OF REDISTRIBUTION ARE ULTIMATELY POLITICAL QUESTIONS TO BE KEPT SEPARATE FROM THE PRIMARILY ECONOMIC QUESTION OF THE FORM OF TAXATION.

The New Flat Tax is not intended to alter the distribution of the federal tax burden materially, making the distribution across income levels neither more nor less progressive. Just as the tax reform debate should remain separate from the debate

over the level of taxation, so, too, tax reform should remain separate from debate over the redistribution of the tax burden or the redistribution of income and wealth through tax policy.

The *level* of taxation and the extent of redistribution are ultimately political questions, separate from the primarily economic question of the *form* of taxation. Initial simulations suggest the New Flat Tax meets this test of rough distribution neutrality—it appears to leave the overall distribution of the total federal tax burden essentially unchanged.

A strong economy produces better jobs, higher wages, more opportunities, and greater economic security. America's economy has enjoyed periods of economic strength in recent decades, as well as too many periods of recession and high unemployment. At the same time, some of America's toughest competitors, such as China and India, are steadily gaining strength, and America must act decisively to match their rise. Fundamental tax reform will be central to gaining and maintaining America's economic strength in the years and decades ahead.

The Deep and Growing Need for Tax Reform

America's federal tax code is complicated beyond imagining. The arrival of personal computers and tax software has permitted the creativity of policymakers in Washington to run amok, creating tax complexities far beyond what even tax professionals could manage unaided by electronics. There are a multitude of credits, exemptions, and deductions, many of which are

subject to special rules and phase out over different levels of income. As if this was not bad enough, there is a parallel tax called the Alternative Minimum Tax, and yet another in the payroll tax that funds Social Security and part of Medicare. And, all of this complexity imposed on individual taxpayers is relatively minor compared to the torturous rules and exceptions businesses great and small must suffer.

As bad as is the complexity, the drain inflicted on economic vitality by the federal tax system is arguably worse. High marginal rates discourage all manner of productive activity. The United States corporate income tax rate, for example, is nearly the highest in the industrialized world and far, far higher than the average of international competitors.

The economy is further weakened by the current system's tendency to overtax saving, a tendency relieved in only limited circumstances, which means citizens are actively discouraged from saving enough for retirement, emergencies, or the large purchases in life. This bias drives consumers toward debt and all citizens toward diminished economic security. In turn, these reactions lead to an artificially depressed level of national savings, so domestic investment often depends on importing savings from abroad. Ironically, the only mitigation for importing savings is that the tax system punishes business investment as well, thus lessening the amount of investment to be financed by depressed levels of domestic saving, hardly a selling point.

The federal tax system need not be so complex or damaging to the

1. This is the average tax share in the post-war era excluding periods of recession and extreme economic weakness. The overall average including these periods is closer to 18 percent.

U.S. economy. It is so because for decades Congresses have tweaked and twisted a fundamentally flawed system into knots, often creating two new problems while attempting to solve one old one (arising from yet another past act of economic fine-tuning). The income tax was a poor choice from the outset; Congress after Congress has made it worse almost without exception.

A stronger economy is not a transcendent aspiration like virtue and beauty. It is a concrete phenomenon with real benefits. It means higher wages for American workers and better returns for America's savers. A stronger economy means better opportunities for college graduates and better economic security for young families and seniors alike. It means American companies and workers can compete better and win more often in the global economy. A stronger economy is also a more resilient economy, able to withstand and overcome the certain economic shocks of tomorrow.

A stronger economy also plays a vital role in improving federal finances. It means better sustained, normal levels of tax revenues, and less spending needs for those temporarily distressed from unemployment. A stronger economy offering better wages and better job opportunities is also the most powerful antidote to persistent poverty; and with less poverty comes fewer demands for anti-poverty spending.

The simple fact on which all can agree is that a stronger economy alone cannot solve America's long-term fiscal problems, but solutions will be more constrained, more wrenching, and unnecessarily painful without a stronger economy. Thus, tax reform to spur economic growth

is a critical component of both economic policy and budget policy.

Guiding Principles

If it is to promote economic growth, reform of the tax system needs to be generally consistent with the following principles:

1. The tax system should have a single, low rate to collect needed revenues without unnecessarily distorting economic decision making.
2. The tax system should be simpler and far more transparent. Transparency is needed so taxpayers can anticipate and plan for the tax consequences of their actions and can easily understand the full extent of their tax burden. Simplicity and transparency provide greater confidence that other taxpayers are not exploiting tax complexities to pay less tax than is their due share. Transparency also means that citizens have a clearer understanding of what they are paying in exchange for the government services they are receiving.

A STRONGER ECONOMY IS NOT A TRANSCENDENT ASPIRATION LIKE VIRTUE AND BEAUTY. IT IS A CONCRETE PHENOMENON WITH REAL BENEFITS.

3. A sound tax system is neutral toward saving and investment. Unlike the current system, it should not impose multiple layers of taxation on saved income or multiple discouragements to business investment. Following this principle grants individuals

greater control over their own economic security. And, it ensures the economy has more raw financial material on which to grow while encouraging American businesses to invest where their savings will be most profitable.

4. Taxes should be levied so as to avoid all other forms of tax distortions and perverse incentives. This feature allows prices and market forces to determine how best to grow the economy, rather than permitting intentional or inadvertent government meddling to allocate resources. It also helps keep the tax system simple. Combined with a tax's neutrality toward saving and investment, this feature makes the tax system economically neutral.
5. The tax system should ensure the lowest-income citizens do not see their limited resources depleted by taxation; the tax system should also ensure that everyone else is paying in to cover the cost of government. Too many taxpayers today pay little or no income tax, placing an ever-greater—and unjust—burden on those who do pay tax and creates a dangerous dynamic in which large numbers of citizens receive government services they perceive to be free. Many previous and otherwise fine tax reform proposals, such as the well-known traditional Flat Tax, which achieve other worthwhile goals, would have the unfortunate effect of increasing the number of citizens outside the tax system.
6. The tax system should be able to collect revenues equivalent to 18.5 percent of the economy—the

modern average under normal economic conditions. Revenues collected by the tax system should also be capped at this amount to ensure both a strong economy and to act as a binding constraint on the growth of government.

New Flat Tax Essentials

Following these guiding principles, the New Flat Tax would replace the current tax system with a simple, modern, single-rate system that taxes individual income only once, presents businesses with an economically neutral, investment-friendly tax, and replaces all federal income taxes, all of today's payroll taxes, and nearly all excises.

For individuals, the New Flat Tax is as simple as one, two, three—one rate, two credits, three deductions. The New Flat Tax applies a single tax rate, about 28 percent, to wages and salaries and related benefits after subtracting all net saving. Taxable income is reduced by the net amount contributed to savings, and savings will be taxable only when spent. This eliminates the current-law bias against saving and ensures tax is paid only on what individuals withdraw from the economy—not on the savings they make available for investment by others.

The individual tax contains two non-refundable credits—a new credit for purchases of health insurance, and the existing Earned Income Credit for low-wage workers. These are the only features of the New Flat Tax that intentionally violate economic neutrality and are discussed at greater length below. The New Flat Tax has only three deductions,

which are necessary for maintaining economic neutrality—for charitable contributions, for higher-education expenses, and for home mortgage interest.

Today's business tax code is replaced with a tax on the sales of domestic goods and services with deductions for labor costs and business costs, including expensing of capital purchases. After a brief transition period all business activity, including corporate, will be taxed at the same, low rate that applies to individuals.

The New Flat Tax adheres many of the principles that have guided tax reform for decades. Proponents of the traditional Flat Tax will recognize the importance—to fairness as well as economic performance—of having a single-rate tax system. Proponents of traditional income tax reform will recognize the general pattern of broadening the tax base to achieve an economically neutral tax base and a lower tax rate. Proponents of any of a variety of sales tax proposals will recognize the importance placed on personal and national saving, and the need to focus taxation on consumption.

Where the New Flat Tax differs most from its predecessors is in its comprehensiveness—it eliminates all other taxes, including excise taxes, such as those on tobacco and alcohol, properly leaving that tax base for state and local government use. Only excises dedicated to trust funds would remain. Also, rather than allowing the tax burden to rise indefinitely, the New Flat Tax is designed to raise the traditional level of revenues as a share of our economy and

no more. Finally, the New Flat Tax is also careful to make not only the tax itself transparent to taxpayers individually, but also the level of taxation transparent to all taxpayers by ensuring that only truly low-income earners fall out of the tax system.

New Flat Tax: The Details

The New Flat Tax is far more comprehensive than previous, well-known tax reform proposals. Typical of many proposals, the New Flat Tax replaces today's individual and corporate income tax systems and eliminates the death tax. In lieu of the current, motley collection of taxes, the New Flat Tax institutes a simple, single-rate tax on individuals and businesses. But it also folds in today's federal payroll taxes that finance Social Security and part of Medicare, achieving a single tax rate for all taxpayers. In addition, it replaces all federal excise taxes except those dedicated to specific trust funds, such as the gasoline tax.

A Single Tax Rate for All. The tax system is designed to raise up to, and no more than, 18.5 percent of the economy as measured by GDP. The Center for Data Analysis at The Heritage Foundation estimates that the statutory individual and final business tax rate will likely be about 28 percent, a calculation that was confirmed by outside experts as part of a broader effort called the Solutions Initiative organized by the Peter G. Peterson Foundation.²

A rate of 28 percent is comparable to or significantly below the typical rate facing an individual or family today. A working family today is subject to a 15.3 percent payroll tax

2. Peter G. Peterson Foundation, "The 2011 Fiscal Summit: The Solutions Initiative," May 25, 2011, at <http://www.pgpf.org/solutionsinitiative> (December 7, 2011).

rate, plus either a 15 percent or 25 percent individual income tax rate, for a combined rate of 30.3 percent or 35.3 percent.

THE NEW FLAT TAX IS MUCH MORE COMPREHENSIVE THAN ITS PREDECESSORS.

So the New Flat Tax offers taxpayers a comparable or lower tax rate, and vastly improved savings incentives to build wealth and ensure their own financial security, while improving the ability of the economy to raise their wages and provide more job opportunities in the future.

A Simplified System for Taxing Individuals. The basic structure of the New Flat Tax is truly simple. It is essentially a tax on personal expenditures. With its single rate, it taxes uniformly nearly all current income sources spent on consumption. This means taxable income includes all labor compensation and all net borrowings. The net amount put aside in savings is then subtracted to determine net taxable income. Thus, the more an individual or family saves, the less they pay in taxes, paying future tax only when savings are cashed in to buy goods and services.

An Alternative Option for Saving.

Some taxpayers today prefer to save after-tax dollars, as permitted through the current-law Roth IRA, rather than contributing in pre-tax dollars and paying tax when funds are withdrawn as under today's traditional IRA. The New Flat Tax permits taxpayers to contribute after-tax dollars to a Roth-style account. They may contribute as much as they choose until the balance reaches \$100,000, with a limit of one account per adult taxpayer. Withdrawals are tax-free for any purpose without penalty. This Roth-style alternative maintains the principle of a single incidence of taxation, and may result in further saving by giving savers an additional option.

Two Credits, Three Deductions. The New Flat Tax includes a non-refundable credit for health insurance purchases and retains an existing credit that supplements the income of low-wage families:

■ **Health Insurance.** To preserve roughly the current level of tax support to encourage the purchase of health insurance the New Flat Tax includes a \$3,500 health insurance tax credit (\$2,000 for singles) for low-income and middle-income families who purchase

a health insurance policy either through their employer or outside the workplace.³

■ **Anti-Poverty Credit.** The New Flat Tax also retains the current-law Earned Income Credit to preserve the current level of income support for low-wage workers.⁴

The New Flat Tax has only three deductions:

■ **Higher Education:** Taxpayers may deduct tuition and expenses related to higher education up to the average of the annual cost at a four-year public college or university. All education is a form of saving and investment. The tax system should treat human capital formation the same as it does physical capital formation.⁵

■ **Charitable Contributions.** Taxpayers may deduct any gifts or contributions made to another adult or tax-exempt entity.⁶ The system taxes one's expenditures or consumption. Gifts represent resources that are no longer available to the giver, but are then available to the recipient. Thus, gifts to individuals and transfers through inheritance are

3. The health insurance tax credit is non-refundable. For low-income citizens who typically have little or no tax liability, the current exemption for employer-sponsored health insurance is equally unavailable. This is a serious problem for current law and would, if unattended, be a problem under The Heritage Foundation's *Saving the American Dream* plan of which the New Flat Tax is one element. A companion to the tax reform proposal presented here is a proposal to reform Medicaid so low-income families receive financial support at least equal to the credit amount (and very low-income families would receive far more) to purchase health insurance.

4. The Earned Income Credit (EIC) is a refundable credit available to low-wage workers who are over 25 years of age, under 65, and not a dependent of another taxpayer. It is especially designed to increase in value with each additional child in the family, and the credit phases out at moderate income levels. The EIC is rife with problems, but it remains perhaps the nation's most effective anti-poverty program. As tax reform progresses, identifying suitable reforms specific to the EIC should be high on the priority list.

5. The New Flat Tax does not allow a deduction for state and local taxes used to fund education, even though these taxes also cover a form of saving and investment. There are two reasons for this: (1) it would prove extremely difficult to identify state-by-state, locality-by-locality the taxes paid that go to education, and (2) these taxes are levied irrespective of whether the taxpayer has a child in school. Thus, there is no direct linkage between the taxes paid and the saving and investment performed. An issue for future consideration is whether to allow taxpayers who pay private tuition and fees to deduct those costs.

6. For example, a gift to one's child would not be deductible unless the child was of age to file a separate tax return. However, gifts to grown children, parents, or unrelated individuals or organizations would be deductible to the giver and added to the recipient's taxable income.

deductible and become taxable to the recipient only if and when they are spent on consumption. Gifts to tax-exempt entities remain tax exempt at the entity level as per the current rules.⁷

- **Optional Home Mortgage Interest Deduction.** As per current law, homeowners may deduct mortgage interest, in which case the lender would be taxed on mortgage interest income, thus preserving symmetry and tax neutrality. Alternatively, homeowners may opt to forego the deduction, in which case the lender would not be taxed on mortgage interest income and would then offer a lower mortgage interest rate. This latter option also preserves symmetry and tax neutrality, and also lets the taxpayer self-simplify his tax filing at no cost.

Protections for Low-income Working Households. Current law hits low-income workers with the full weight of the Federal Insurance Contributions Act (FICA) payroll taxes. The New Flat Tax folds FICA into the single tax system. It then eliminates all income tax on low-income workers through the health insurance tax credit described above (a \$3,500 non-refundable tax credit for families, \$2,000 for singles) and the current-law Earned Income Credit as part of the overall system of financial support for low-income

Americans. Further, the calculation of taxable income excludes all other cash and non-cash benefits provided by the federal government as part of its anti-poverty programs, such as food stamps. The net effect is that this plan provides substantial tax relief to low-income workers and families compared to current law.

Protections for Low-Income Seniors. The New Flat Tax was designed to be enacted as part of an overall reformation of federal budget policies as described in The Heritage Foundation's *Saving the American Dream* plan. This plan includes fundamental changes to Social Security and Medicare, and any tax system must integrate with these reforms.⁸

The New Flat Tax is designed to reflect seniors' taxable income in a manner consistent with the taxation of non-seniors. When the new Social Security and Medicare reforms are fully phased in, Social Security benefits and Medicare defined contributions will be taxable. However, the measure of taxable income is modified for Medicare-eligible senior citizens. Operating together, the flat benefit amount for Social Security and the Medicare defined contribution are designed to ensure that no senior is left in poverty. The New Flat Tax is designed to ensure that seniors are not pushed back into poverty through the tax system.

The New Flat Tax includes three important senior-specific features. First, all seniors have a "senior's

standard exclusion" amount equal to the sum of the flat Social Security benefit amount plus the value of the Medicare defined contribution. The amount of this exemption will be about \$22,510 per senior in 2015. This ensures that seniors protected from poverty by the Social Security and Medicare reforms are not then placed at risk again by taking some benefits away through taxation.

Under *Saving the American Dream*, a senior's Social Security and Medicare benefits begin to phase out above a certain level of income. The senior's standard exclusion then phases out as well, set equal to the actual Social Security benefit and Medicare defined contribution received.⁹

Second, it is important to encourage seniors to stay in the workforce longer, for their own financial security and for the health of the economy. To achieve this policy, the first \$10,000 of a senior's wages and salary would be excluded from tax. This provision is especially important for low-income and middle-income seniors.¹⁰

Third, because they are enrolled in Medicare and have the senior's standard exclusion, seniors would not qualify for the health insurance tax credit described above.

The taxation of seniors under the New Flat Tax follows the same basic principles if tax reform is considered separately from the Social Security and Medicare reforms described in

7. The determination of entities qualifying for tax exemption is another area in need of further examination as tax reform proceeds. Too many businesses are able to gain an undue competitive advantage by calling themselves non-profits and obtaining tax-exempt status, while others receive such status while providing little or no social benefit meriting tax exemption.

8. Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, at <http://savingthedream.org/about-the-plan/plan-details/>.

9. *Ibid.*

10. This special exclusion of a senior's wage and salary income is an exception to strict tax neutrality. Its inclusion in the New Flat Tax arises from considerations outside tax policy.

Saving the American Dream. However, thoughtful attention is still required to address the nexus of seniors' benefits under Social Security, Medicare, and the New Flat Tax. Seniors would still receive the seniors' standard exclusion and would still be able to exclude the first \$10,000 of wage and salary income; they would also still not be able to take the health insurance tax credit because they are on Medicare.

In addition, if the New Flat Tax is adopted separate from Social Security and Medicare reform, the New Flat Tax will then preserve the current-law inclusion of half of a senior's Social Security benefits in taxable income—because income tax was paid on one half the payroll tax paid while working. The New Flat Tax does not, however, continue the flawed current-law practice of including 85 percent of a senior's Social Security benefit for higher-income seniors.

IT IS IMPORTANT TO ENCOURAGE SENIORS TO STAY IN THE WORKFORCE LONGER, FOR THEIR OWN FINANCIAL SECURITY AND FOR THE HEALTH OF THE ECONOMY.

Seniors who are on Medicare today typically receive a large annual subsidy. Though they paid payroll tax during their working years to qualify for Medicare Part A, the Hospital Insurance (HI) program, they pay premiums today to cover part of the cost of Medicare Parts B and D, known as Supplemental Medical

Insurance (SMI). Medicare thus raises two distinct tax issues not dealt with in current law. First, the Medicare payroll tax raises the same issues as the Social Security payroll tax, and calls for the same treatment. Thus, an amount equal to half the benefits received under Medicare HI should be included in a senior's taxable income.

Second, the premiums paid under Medicare SMI cover only a portion of the cost of insurance, the balance being paid from the general fund of the Treasury and amounting to an annual average per beneficiary subsidy of about \$4,600 in 2010.¹¹ This subsidy under current law amounts to a classic tax expenditure. Therefore, consistent with the inclusion of defined-contribution benefits described above, these current-day Medicare subsidies are included in seniors' income under the New Flat Tax.

The purpose of correcting the tax treatment of Social Security and Medicare as these programs operate today, either in the context of current tax law or through the New Flat Tax, is not to raise taxes on America's seniors. It is to ensure a fairer, more transparent tax system. As noted, tax reform should not substantially or systematically alter the distribution of the tax burden.

Protecting the Social Security and Medicare Trust Funds. The New Flat Tax leaves the existing wage-income reporting systems for FICA in place. So, even though the FICA payroll tax itself is eliminated, the revenues it would have raised are credited appropriately as per current law to the Social Security and

Medicare Trust Funds.

A Simplified System for Taxing Businesses

The New Flat Tax levies a simple tax on businesses' domestic net cash flow so all compensation provided to employees and all purchases from other businesses are deducted from gross domestic receipts. This treatment applies to all business entities. In addition to the great simplification this system provides over the income tax, it also means businesses can deduct purchases of new equipment immediately, thus eliminating a crucial tax bias against business investment.

The Tax Rate. Except for a brief period of transition, the business tax rate will equal the individual tax rate. In the first year of transition, the business tax rate will remain at the current-law 35 percent applicable for corporations, and then decline one percentage point per year until it equals the individual tax rate, roughly seven years later.

Full Elimination of Double Taxation. The New Flat Tax eliminates the tax bias against investment in new domestic plant and equipment in two keys ways: (1) by eliminating the tax bias against personal saving, and (2) by allowing businesses to expense their capital purchases. One particularly unfortunate element of double taxation remains, however, in the residual tax on business profits. Even after deducting all labor costs and all purchases from other businesses, companies will generally still earn some taxable profits and owe some amount of tax.

In economic terms, expensing

11. Heritage Foundation calculation based on Centers for Medicare and Medicaid Services, "2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," May 13, 2011, at <https://www.cms.gov/reportstrustfunds/downloads/tr2011.pdf> (November 30, 2011).

eliminates the tax on the risk-free return on investment. What remains is a tax on pure economic profit. Under economically pristine conditions, such economic profits should be exceptional returns businesses hope for but neither expect nor require to make a particular investment. In the real world, businesses often expect and require substantial levels of pure profit before making an investment. Indeed, the hope of these exceptional returns is often what drives investment, and the realization of these exceptional returns is often what propels an economy forward. It is important, therefore, to eliminate the double taxation on these key returns.

The New Flat Tax solution to this aspect of double taxation is to allow an imputed dividend credit, a popular device used in many countries to integrate their personal and corporate income taxes. In effect, when a business earns income, pays tax, and makes a dividend distribution, the business owner receives the dividend, plus a credit reflecting the *pro rata* proportion of tax paid at the business level on the income giving rise to the dividend. This imputed credit is then available to be taken against the business owners' tax liability. In effect, the business pays tax on its income, the individual pays tax on the dividend if consumed, but the individual also receives a credit for the tax paid at the business level, thus fully eliminating double taxation. If the dividend is saved, the credit is carried forward with interest.

A reasonable question to ask at this point is why the tax system should go to the trouble of taxing businesses at all. To be sure, one could just as well propose the New Flat Tax without an extra tax on businesses. The reason for taxing

businesses is that, all economic arguments notwithstanding, it is difficult to imagine the American people accepting a tax system without a broad-based business tax.

Credit for Research and Experimentation. All other special provisions and tax credits in existing law are repealed except the Alternative Simplified Credit (ASC) for research and experimentation, which is retained in its current form. The justification for having such a credit under current law and under the New Flat Tax arises from the fact that knowledge and information disseminate. Therefore it is typically very difficult to capture the full economic return of the knowledge gained from investments in research and experimentation. Consequently, unable to capture the full return, those who fund these activities would under normal circumstances under-invest in private research.

WHILE IT IS IMPORTANT TO AVOID RETROACTIVE TAXATION, IT IS EQUALLY IMPORTANT TO AVOID CREATING TAX WINDFALLS IN TRANSITIONING FROM ONE TAX SYSTEM TO ANOTHER.

A credit for research and experimentation socializes this dispersed benefit and returns more of the value to the entity funding the research, thereby achieving a more optimal level of private research. The current ASC is much improved over previous credit versions, though no doubt further improvements are possible. The inclusion of this tax credit in the New Flat Tax does not mean the credit mechanism itself is entirely satisfactory in all its particulars—the current ASC of 14 percent may be either

excessive or inadequate—but does reaffirm the importance of a permanent, effective credit for research and experimentation.

International Commerce. The business tax base only includes income generated from domestic sales of goods and services; it excludes all foreign source income, which is taxed in foreign jurisdictions according to their laws and systems. The New Flat Tax is also border-adjustable, which means the taxation of exports and imports are adjusted with respect to federal taxation to level the tax playing field between foreign and domestically produced goods and services. Specifically, the domestic tax is lifted from exports and levied on imports, normalizing tax levels between countries much as a series of locks on a canal lifts or lowers boats to let them travel from point to point.

Transition Arrangements. Special care is needed in transitioning taxpayers from the old tax system to the New Flat Tax. It is important, for instance, that taxpayers not be subject to an extra tax burden due solely to reform, which would amount to retroactive taxation since the higher tax burden would arise from new tax consequences of actions taken prior to tax reform. Sound tax reform transition should be guided by the “grandfather principle,” which essentially says that taxpayers who took actions in the past with future tax consequences will remain subject to current tax law, that is, they are “grandfathered.” Thus, all current-law accrued tax “assets,” such as interest on pre-tax reform debt (e.g., existing home mortgages and business debt, depreciation, accrued tax credits), are applicable to taxable income or tax liability under the new tax system until exhausted.

The shift to taxing only the net cash flow businesses earn domestically is an important simplification and an important step toward improving international competitiveness. However, many businesses have accrued foreign tax credits under current law that would be inapplicable under the new tax system. To provide adequate time to adjust, businesses will have the option of being taxed under current law for a period of up to 10 years after tax reform's enactment.

While it is important to avoid retroactive taxation, it is equally important to avoid creating tax windfalls in transitioning from one tax system to another. Businesses that invested in new plant and equipment under the old tax regime, for instance, should be able to use the old regime's depreciation system; but they also anticipated earning income under the old regime's tax rates. Initially allowing much lower tax rates than current law imposes would bestow a windfall on these companies, just as disallowing depreciation on these old assets would impose a retroactive tax hike. Therefore, as an act of rough justice the initial tax rate on businesses is set to the current-law rate of 35 percent. The rate then declines by 1 percentage point per year until the business tax rate matches the individual income tax rate.

Another area of concern regarding windfall tax gains occurs with regard to savings created before tax reform ("old savings"), which is invested in various assets generating income streams and capital gains that are subject to immediate taxation at current rates. Thus, a transition system is provided to minimize tax windfalls by ensuring that old savings remain subject to current tax law for the following 10 years. These tax

windfalls, which would be similar to winning a tax lottery, would, if permitted, tend by definition to benefit the wealthiest, and would erode the tax base, necessitating a higher rate of tax.

Tax Distribution Under the New Flat Tax

The New Flat Tax is designed to improve economic performance as much as possible by reducing tax distortions as far as possible. It is also designed to be revenue neutral in the sense that it would generate the historically normal level of aggregate tax collections. Parallel to the principle of revenue neutrality, tax reform should also avoid altering the distribution of the tax burden between taxpayers at different income levels and different family circumstances.

In a revenue-neutral reform of such chaos as manifests in the federal tax system, some shifting of tax burden is inevitable. No rational tax system could reproduce the current tax distribution exactly. However, tax levels and the extent of income and wealth redistribution at the federal level are political questions that should be kept separate from the economically efficient design of a tax system. Thus, tax reform should be as revenue neutral and as distributionally neutral as possible. Preliminary modeling of the New Flat Tax suggests that it produces little change in the tax distribution as compared to current policy, though careful modeling using traditional methods is needed to identify any shifts in tax burden that would take place.

There are five aspects of the New Flat Tax in particular that tend to alleviate changes in the distribution of the tax burden. The first results from replacing the payroll tax and

individual income tax simultaneously. There is a single tax rate of 28 percent on taxable income under the New Flat Tax. Workers facing a 10 percent or 15 percent individual income tax rate today actually face a 25.3 or 30.3 percent rate when their income tax rate and the 15.3 percent payroll tax rate are combined. Thus, the change in total tax rate for low-income workers is minimal.

Second, upper-income workers today face a combined 35 percent top statutory individual income tax, plus a 2.9 percent Medicare payroll tax rate, for a combined rate of 37.9 percent. While this rate appears to be significantly higher than the 28 percent New Flat Tax rate, many upper-income taxpayers also itemize their deductions, deductions that are mostly repealed under the New Flat Tax. Thus, the 28 percent New Flat Tax rate is typically applied to a larger measure of taxable income for upper-income taxpayers.

THE NEW FLAT TAX IS DESIGNED TO IMPROVE ECONOMIC PERFORMANCE AS MUCH AS POSSIBLE BY REDUCING TAX DISTORTIONS AS FAR AS POSSIBLE.

Third, for very-low-income citizens, the New Flat Tax likely offers modest tax relief. The first and most important aspect in this regard is that the New Flat Tax replaces both the payroll tax and the individual income tax. Combined with the retention of the Earned Income Tax Credit and the inclusion of the new health insurance tax credit, the net effect is that very-low-income workers and families will pay no tax. Under current law, many of these citizens still pay net tax through the payroll tax.

Fourth, the New Flat Tax also eliminates all excise taxes not dedicated to a trust fund. Excise taxes generally are highly regressive, falling heavily on low-income citizens relative to middle-income and upper-income citizens. Replacing these excises with a more proportional tax necessarily lowers the tax burden on low-income citizens.

Finally, saving out of either capital income or labor income is tax exempt under the New Flat Tax—but tax is levied on all capital income used for consumption. Thus, upper-income citizens who spend much of their income generated from their past saving will pay a large amount of tax.

Conclusion

The New Flat Tax is a sweeping, comprehensive reform of the entire federal tax system, not just of some major parts, as is the case with most previous tax reform proposals. The New Flat Tax can be enacted as a stand-alone tax plan or as part of the more complete reformation of federal fiscal policy as laid out in The Heritage Foundation's *Saving the American Dream* plan. The New Flat Tax offers tremendous simplification for individuals and businesses; it provides much greater transparency so that taxpayers can be more confident the taxes they pay are in line with those of their neighbors, and so taxpayers can be more informed about the true costs of government. Above all, the New Flat Tax will unleash the potential of the American economy to grow, unshackled of tax-based distortions and high marginal tax rates.

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