



**BRIEF ANALYSIS**

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## The Arme y Flat Tax

Congressman Dick Arme y (R-TX) has introduced the Freedom and Fairness Restoration Act (H.R. 4585). This act would reform the U.S. tax system, slash government spending and rein in federal regulation. It is the most radical reform proposal in recent memory to receive serious consideration on Capitol Hill.

**Tax Reform: Trading Deductions for a Lower Tax Rate.** The key element of the Arme y plan is tax reform. Based on a proposal previously developed by Stanford University professors Robert Hall and Alvin Rabushka, the plan would scrap virtually all current deductions, credits, exclusions and exemptions, as well as the five current tax brackets. In their place, it would establish a single 17 percent tax rate on a much broader tax base.

The Arme y plan does not promise a free lunch. Lower tax rates are possible only if the tax base is expanded by ridding the tax code of deductions and exclusions — even such popular items as the mortgage interest deduction. This means that in return for lower rates, people will have to subject more of their income to taxes. The potential for such trade-offs is shown in Figure I on the reverse side:

- Under the current tax system, more than one-half of all personal income goes untaxed because of various deductions, exclusions and exemptions.
- If all personal income were subject to a single, flat-rate tax, a rate of less than 10 percent would bring the federal government just as much revenue as it collects today.

**A 17 Percent Tax Rate for Individuals.** Arme y isn't proposing to go all the way to a 10 percent tax. Generous personal exemptions under the plan prevent the rate from going below 17 percent. Taxes under the plan, however, would be low, flat and simple. For individuals, the tax base would consist of all wages, salaries and pensions.

- From this gross income, a married couple filing jointly could deduct a personal allowance of \$26,200.

- The personal allowance would be \$13,100 for single persons and \$17,200 for a single head of household.
- In addition, taxpayers could deduct \$5,300 for each dependent.
- *Thus a family of four would have to earn \$36,800 before it paid a penny of federal income tax.*

In addition to exempting about half the households in America from any personal income tax, the Arme y plan's tax system would be so simple that *all taxpayers could fill out their returns on a postcard.* [See the diagram.]

**A 17 Percent Tax Rate for Business.** Business taxes would be almost as simple. For them, the tax base would consist of total receipts less cash wages and purchases of goods, services and materials used in business, as well as all capital equipment. Companies would pay the same 17 percent tax rate as individuals on the remaining balance. As a consequence, even the largest corporations could file their tax returns on a postcard-size form.

**A Tax Cut.** If the Arme y plan for tax simplification were completely revenue neutral, it would require a tax rate in the range of 19 to 20 percent. Establishing a rate of 17 percent, therefore, constitutes a tax cut. The loss of revenue is paid for by capping government spending,

Dick Arme y's Flat Tax Form	
Your first name and initial; if joint return, also give spouse's name and initial	
Present home address	
Your Social Security Number	
Spouse's Social Security Number	
City, Town, or Post Office, State and Zip Code	Your occupation
	Spouse's occupation
1. Wages, Salary and Pensions.....	
2. Personal allowance.....	
a. \$26,200 for married filing jointly.....	
b. \$13,100 for single.....	
c. \$17,200 for single head of household.....	
3. Number of dependents, not including spouse.....	
4. Personal allowances for dependents (line 3 multiplied by \$5300).....	
5. Total personal allowances (line 2 plus line 4).....	
6. Taxable wages (line 1 less line 5, if positive, otherwise zero).....	
7. Tax (17% of line 6).....	
8. Tax already paid.....	
9. Tax due (line 7 less line 8, if positive).....	
10. Refund due (line 8 less line 7, if positive).....	

including so-called entitlements. Also, the 17 percent rate is phased in, starting at 20 percent and falling to 17 percent after three years. Thus the deficit would not rise under the Arme y plan.

**Abolishing the Double Taxation of Savings.** All income is taxed only once in the Arme y plan, in sharp contrast to our current tax system. Today we tax profits first at the corporate level and again when they are paid out to the company's owners, the shareholders, in the form of dividends. We also double tax saving relative to consumption by taxing income when it is earned and again when it earns a return. We also effectively double tax all capital income by imposing a capital gains tax on the increase in value of capital assets, even though we already tax the return on such assets (e.g., interest, dividends, rent, etc.). *The Arme y plan eliminates double taxation by abolishing all taxes on interest, dividends and capital gains.*

There is no convincing argument for taxing capital gains, since the value of a capital asset is only a function of the return on that asset, which we already tax. This is most clearly shown in the case of bonds, which automatically rise in value when interest rates fall and fall in value when interest rates rise. Since we are already taxing interest income, it makes no sense to levy an additional tax on the bond itself, since the bond has no value without the interest. The same is true of corporate stock and commercial real estate, whose value is entirely a function of the profits or rent they generate. The failure to index the capital gains tax for inflation creates even more distortion.

**Stimulating Economic Growth.** Our current tax system taxes capital excessively. This discourages in-

vestment, saving and capital formation, which are the foundations of economic growth. Slower growth, in turn, reduces employment, productivity and wages. Thus all Americans ultimately pay the price for our ill-designed tax system.

For these reasons, most economists now agree that the best tax system is one that taxes consumption only. Congress has before it many other proposals that would move us in the direction of an economy-wide consumption tax. However, only the Arme y plan would do so while also simplifying and reducing taxes for most Americans.

Except for those who now receive tax money from the government rather than pay it (because of the Earned Income Tax Credit), all taxpayers would pay less under the Arme y plan. Moreover, even though everyone would pay the same 17 percent tax rate, because the personal allowances do not increase with income the effect is to make the tax burden progressive, although less so than at present.

**Summing Up.** The Arme y plan is the most consistent and comprehensive tax reform proposal currently under consideration. It would eliminate the inequities of the current system, promote growth and improve fairness and simplicity. It is internally consistent and intellectually sound. It should be the starting point for all future discussions of tax reform and will, undoubtedly, be high on the agenda of the 104th Congress.

*This Brief Analysis was prepared by Bruce Bartlett of the Alexis de Tocqueville Institution.*

