National Center for Policy Analysis

BRIEF ANALYSIS
No. 195
For immediate release:
Thursday, February 8, 1996

Principles of the Flat Tax

Today's graduated income tax system is a morass of deductions, exemptions, allowances, credits and other loopholes. According to Stanford University tax specialists Robert Hall and Alvin Rabushka:

- The Internal Revenue Service has 480 tax forms and another 280 forms to tell you how to fill them out.
- The IRS sends out eight billion pages of forms and instructions to more than 100 million taxpayers every year — requiring the chopping down of 293,760 trees.
- All the IRS regulations and tax court rulings take up 336 feet of shelf space.
- An IRS study estimated that taxpayers spend 5.4 billion hours on paperwork at a cost to the private sector of 24 cents for every dollar of taxes collected.
- Other studies put the cost at 65 cents per dollar collected — even more for certain types of taxes.

There is a better way. Under a flat tax, *all* income is taxed, and it is taxed at the same rate. Furthermore, income is taxed only once, at its source, when it is realized. Let's take a closer look.

All income is taxed. Surprisingly, the amount of revenue the federal government collects from the personal income tax is only 9.5 percent of total personal income. If corporate income is included, federal income taxes take only 11 percent of income. Thus, in principle, government would have just as much money if it levied an 11 percent, across-the-board tax on all personal and corporate income. Today's deductions, exemptions and loopholes result in more than half of all personal income not being taxed at all.

Most flat-tax proposals would require a tax rate higher than 11 percent — say 17 or 20 percent — because they allow two deductions: (1) a generous personal exemption and (2) an immediate write-off of all investments in capital goods. (See the discussion below.)

All income is taxed at the same rate. Under the current tax system, a housewife can enter the labor market in a minimum-wage job and be taxed at a 40 percent marginal tax rate because of her husband's earnings. Because of the tax on Social Security benefits and the Social Security earnings penalty, some elderly workers face marginal tax rates in excess of 100 percent. Under a flat tax:

- The last dollar of income is taxed at the same rate as the first taxable dollar of income.
- A dollar of corporate income is taxed at the same rate as a dollar of personal income.

All income is taxed only once. Under the current system, investment income can be taxed two, three or even four times. Income is taxed first at the corporate level. When the remainder comes to you in the form of dividends or interest, it is taxed a second time. If you sell the business, you can be taxed a third time through a capital gains tax on income your investment is expected to generate in the future. And after you die, your investment can be taxed a fourth time through the inheritance tax.

A flat tax system would tax income only once — when it is earned.

All income is taxed at its source. Under the current tax system, businesses send out more than one billion Form 1099s reporting payment of dividends and interest. Each taxpayer is supposed to be taxed on these payments at that individual's tax rate. However, less than half of interest income actually is reported on individual tax returns. The flat tax would eliminate this leakage by taxing business income at its source:

- The corporation (or business) would pay taxes on corporate income and would not be allowed to deduct any interest or dividend payments.
- Since the tax on interest and dividends would be paid at the corporate level, individuals would receive interest and dividend income tax free.

All income is taxed when it is realized. There is no item in the national income accounts called "capital gains." Nonetheless, the capital gains tax forces people to pay taxes today on income that is expected to be earned many years in the future. For example, the expectation that a company will earn higher revenues will cause its stock price to rise. If you own shares in the company and sell them, you will be taxed on the "gain." But if expectations change tomorrow, and the stock price falls, the government doesn't give a refund to the new buyer.

Whatever the merits of the argument for capital gains, if capital gains are to be taxed, capital losses should be fully deductible. But if that were the case, government would collect very little net revenue and might even lose revenue on balance.

Dallas Headquarters: 12655 N. Central Expy., Suite 720 • Dallas, TX 75243-1739 • 214-386-6272 • Fax: 214-386-0924 • E-Mail: ncpa@onramp.net
Washington Office: 727 15th St. N.W., 5th Floor • Washington DC 20005 • 202-628-6671 • Fax 202-628-6474

For more information: Curt Erickson in Dallas at 214/386-6272 or Jan Faiks in Washington at 202/628-6671

The better approach is to stop taxing expectations, and tax all income if and when it is actually realized.

Deductions and allowances. Individuals would be able to deduct a personal allowance from their gross income. Those with gross incomes below the personal allowance would pay no income tax. For example, legislation introduced by House Majority Leader Dick Armey (R-TX) provides for an allowance of $31,400 for a family of four. This exemption means that as many as half the households in America would pay no income tax.

The only other deduction would be an immediate write-off for investment in real capital. Businesses would no longer depreciate assets by a certain amount each year, but would expense the entire investment at the time it was made.

There are only two things one can do with income: save it and spend it. Allowing full, immediate expensing of capital equipment and taxing all income only once removes savings and investment from the tax base. Thus the flat tax is truly a consumption tax.

Some flat tax proposals would continue deductions for home mortgage interest and for charitable contributions, but most would end these deductions.

No deduction for mortgage interest. Home builders and lenders fear that ending the deduction for home mortgage interest would cause real estate values to plummet. However, home mortgage interest rates are expected to fall by about 2 percentage points if a flat tax is enacted, and a family earning $50,000 a year would benefit more from a 6 percent nondeductible mortgage than from an 8 percent deductible mortgage.

- Only 27 million of the nation's 116 million taxpayers claimed a mortgage interest deduction in 1992.
- Some 40 percent of homeowners have no mortgage on their homes, and thus have no mortgage interest to deduct.
- Seventy-eight percent of families earning more than $100,000 took the deduction, but only 14 percent of those earning less than $50,000 took it.

Further, it is likely that any flat tax passed by Congress would allow homeowners to continue deducting interest for existing mortgages until they sold or refinanced.

No deduction for charitable contributions. The 1980s taught us that higher incomes are far more important than tax subsidies for charities. The top marginal tax rate dropped from 70 percent in 1980 to 28 percent in 1989 — and charitable contributions grew from $49 billion in 1980 to $107 billion in 1989.

No deduction for state and local taxes and no tax advantage for municipal bonds. The elimination of these provisions would put an end to the unwise practice of using the federal tax system to subsidize spending by state and local governments.

No deduction for (nonpension) employee benefits. Under the current system, wage and salary income is taxed but compensation in the form of fringe benefits is not. This is the big reason employee benefits have grown from 20 percent of payroll in 1953 to more than 41 percent today. The tax subsidy for such items as employer-provided health insurance is inefficient and unfair because most of the benefits go to people who least need them — families in the top fifth of the income distribution get six times as much subsidy as those in the bottom fifth. Further, current law encourages wasteful spending on health care and penalizes employers and employees who keep health costs under control.

Advantage of the flat tax: fairness. Those who complain that the rich would gain are too caught up in the politics of envy to acknowledge that others would gain even more. Every time the nation has significantly lowered the top marginal tax rate, total tax revenue and the share of taxes paid by the highest-income earners has gone up. It happened in the 1920s and during the Kennedy and Reagan administrations.

Advantage of the flat tax: simplicity. Under a flat tax, most individuals and businesses would fill out a tax return the size of a postcard.

Advantage of the flat tax: pro-growth. Because the flat tax is pro-savings and pro-investment, it would add as much as 2 percentage points to the nation's economic growth rate. And even if it only increased the annual growth rate from the current 2.5 percent to the 3.3 percent rate of the Reagan era:

- Over six years, that would add $2.3 trillion to the nation's output of goods and services.
- It would produce $550 billion of additional revenues for government — more than enough to pay for all the tax cuts in the Contract With America, including the $500 child tax credit.

This Brief Analysis was prepared by NCPA President John C. Goodman.