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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The current tax code of the United States is irreversibly broken and should be repealed.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 *Backgrounder* 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 *Backgrounder* No. 1103, February 10, 1997.

Chart 1

Tax Forms on a Postcard: The Armey-Shelby Flat Tax

Form 1 — Individual Wage Tax — 1999

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 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 *(line 3 multiplied by $5,300)*	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 — 1999

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 1997	6
7	Interest on carry-forward *(6 percent of line 6)*	7
8	Carry-forward into 1998 *(line 6 plus line 7)*	8
9	Tax due *(line 5 less line 8, if positive)*	9
10	Carry forward to 1999 *(line 8 less line 5, if positive)*	10

Source: Office of Representative Dick Armey.

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 x 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.

Chart 2

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 experienced (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.