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WHICH TAX REFORM PLAN IS BEST FOR AMERICA?

INTRODUCTION

Tax reform is gaining momentum. Lawmakers from both parties are proposing sweeping changes in the income tax system, such as the Armey-Shelby flat tax (the most widely known of the proposed reforms), a national sales tax, the Nunn-Domenici USA tax, the Gephardt 10 percent tax, and a value-added tax.[1] Almost every Republican presidential candidate endorses some form of radical tax reform, and House Speaker Newt Gingrich (R-GA) and Senate Majority Leader Robert Dole (R-KS) asked former Congressman and housing secretary Jack Kemp to chair a commission to recommend how best to reform the tax code.

Each of the tax reform proposals assumes that the existing income tax system is fundamentally broken and cannot be fixed without a complete overhaul. But they achieve this in significantly different ways. The question is, which approach would be best for taxpayers and the economy?

TAXPAYERS AND THE ECONOMY
Grading Tax Reform Proposals

Armey/Shelby flat tax	A
Specter flat tax	A-
Value-added tax*	B+
National sales tax*	B
Nunn-Domenici USA tax	C+
Gephardt 10 percent tax	C

*Grade contingent on permanent repeal of the current federal income tax

1 Other bills have been introduced which are variants of the major reform proposals. Senator Arlen Specter (R-PA), for instance, has introduced a flat tax which maintains certain deductions.

When evaluated based on nine different criteria, including the degree to which they lower tax rates, simplify the system, address the bias against savings and investment, and treat taxpayers fairly, the plans based on the flat tax model developed by Stanford University Professor Robert Hall and Hoover Institution Senior Fellow Alvin Rabushka score highest.[2] Direct consumption taxes also fare well, but proposals that more closely resemble the current system are graded the lowest.

Since no tax system is perfect, this grading scale is somewhat subjective: A for reform as close to the ideal as possible,[3] B for significant improvement over the current system, C for no significant effect one way or the other, D for a plan (or a feature of a plan) demonstrably worse than today's tax code, and F for significantly worse than today's tax code.

In order to understand these grades, it is necessary to identify what is wrong with the current system and then to determine how each reform plan addresses each of these flaws.

WHAT IS WRONG WITH THE CURRENT SYSTEM

Today's tax code has few defenders. Former Internal Revenue Service Commissioner Shirley Peterson states that there is nothing logical about the way the code is constructed now.[4] As House Minority Leader Richard Gephardt points out:

> It has become a test of legal brainpower, an accountant's decathlon, a treasure hunt for hidden deductions and buried tax breaks. Our tax code has become a dense fog of incentives, inducements, and penalties that distort the most basic economic decisions, constrain the free market, and make it hard for Americans to run their own lives. The Internal Revenue Service has become a symbol of what is wrong with American government.[5]

And Senate Majority Leader Bob Dole has summed up many of the problems with the current system, noting:

> During much of the past century, tax policy has been a primary tool with which government has wielded power, fed the bureaucracy, and redistributed wealth....Any fair system would not penalize, but instead reward people for working harder, investing wisely, and saving more. It would eliminate the lobbyist-drafted loopholes that benefit the few, but force the rest of us to pay.[6]

The current income tax system is both anti-growth and discriminatory. Its problems, while seemingly endless, fall into several broad categories:

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2 Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Cal.: Hoover Institution Press, 1995).

3 For example, a flat tax with a 10 percent rate is superior to a flat tax of 17 percent. Such a proposal, however, implicitly assumes a decline in the size of government that is not likely to occur in the near future. The Armey/Shelby flat tax earns high grades within the context of what is practical, at least in the short term.

4 Andrew Ferguson, "Postcard from Heaven," *The Washingtonian*, April 1995.

5 Remarks by House Democratic Leader Richard Gephardt, Center for National Policy, July 6, 1995.

6 Senator Bob Dole, remarks prepared for delivery before the Economic Club of Chicago, Illinois, September 5, 1995.

- ✘ **High tax rates** —Under present law, a successful entrepreneur will pay more than 40 cents of each additional dollar earned to the federal government. This burden can rise to over 50 cents when state income taxes are included and to more than 80 cents when estate taxes are added. These excessive rates penalize productive economic behavior and reduce incentives to work, create wealth, and take risks.

- ✘ **Complexity** —The large number of forms, regulations, and rulings forces many Americans to pay professionals to fill out their tax forms. According to the Tax Foundation, annual compliance costs total nearly $200 billion (in addition to the taxes paid to Washington and the loss in economic growth caused by excessive rates).[7]

- ✘ **Multiple taxation** —Some forms of income, particularly from savings and investment, are subject to as many as four levels of tax. For example, a dollar of capital income could be subject to corporate income, personal income, capital gains, and estate taxes. This combined burden becomes confiscatory and undermines incentives to save and invest.

- ✘ **Social engineering** —Politicians have turned the tax code into a bewildering system of special preferences, penalties, and deductions. Some income is taxed more than once, while other income is not taxed at all. Such complexity is inevitable in a tax system that rewards those with expensive lawyers and accountants and allows lawmakers to micromanage the economy while collecting large campaign contributions from donors seeking to change or preserve sections of the tax code.

THE COMPETING TAX PLANS

While there is widespread agreement on what is wrong with the tax system, there is considerable debate over which plan best solves these problems. The following are the key features of the major tax reform proposals currently under consideration:

Armey/Shelby flat tax — Based on the Hall/Rabushka flat tax, H.R. 2060 and S. 1050, sponsored by House Majority Leader Richard K. Armey (R-TX) and Senator Richard Shelby (R-AL), would replace the current personal and corporate income tax system with a simple 17 percent tax on all income. With the exception of a generous family allowance, all labor income is taxed at the individual level. Taxes on business income (such as interest, dividends, capital gains, and rents) are withheld and paid at the business level. Both businesses and individuals would fill out postcard-sized returns.

7 Arthur Hall, "Compliance Costs of Alternative Tax Systems," *Special Brief*, The Tax Foundation, Washington, D.C., June 1995.

Chart 1

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

Form 1	**Individual Wage Tax**	**1998**
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) $22,700 for married filing jointly	2(a)	
	(b) $11,350 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**	**1998**
Business name	Employer Id. 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 pensions	2(b)	
	(c) Purchases of capital equipment, structures, 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.

National retail sales tax —This proposal would replace the personal and corporate income taxes with a sales tax. Many details remain unknown, such as what tax rate would be applied and what goods and services, if any, would be exempted. As of publication, there is no legislation to create a national sales tax, although Representatives Dan Schaefer (R-CO) and Billy Tauzin (R-LA) may introduce a bill shortly.

Value-added tax —This tax, known as the VAT, is similar to a national sales tax, except that it is levied on the additional value created at each stage of production. For example, instead of a 25 percent retail sales tax on purchases at a furniture store, the VAT would tax the logs as they go to the sawmill, the lumber as it goes to the furniture manufacturer, the furniture as it goes to the store, and the same furniture as it is sold to the consumer. The net effect, however, is the same: a 25 percent tax on the value of the retail sale. There currently is no legislation to replace income taxes with a VAT, although House Ways and Means Committee Chairman Bill Archer (R-TX) intends to introduce some type of direct consumption tax.

Nunn/Domenici USA tax —Sponsored by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM), the Unlimited Savings Account tax (S. 722) creates the equivalent of an unlimited Individual Retirement Account (IRA) and replaces the current rate structure with a three-rate structure that includes a top rate of 40 percent. Some deductions are lost or curtailed, and at least one new deduction is created. The corporate income tax is replaced by a VAT.

Gephardt 10 percent tax —This plan, introduced by House Minority Leader Richard Gephardt (D-MO), broadens the tax base by eliminating such preferences as deductions for charitable contributions and state and local taxes and taxing the value of fringe benefits. The proposal also replaces the five current tax brackets with five new brackets ranging between 10 percent and 34 percent.

Specter flat tax —Using the same model as the Armey/Shelby flat tax, Senator Arlen Specter (R-PA), in S. 488, proposes a slightly higher rate and lower personal allowance in order to maintain limited deductions for charitable contributions and the full deduction for home mortgage interest.

Other tax reform proposals are expected in coming months. Senator Connie Mack (R-FL) may introduce a version of the flat tax which presumably will have many of the same economic benefits as the Armey/Shelby legislation. Senator Bill Bradley (D-NJ) is rumored to be preparing a tax reform bill, though no details are available and his decision to retire may alter those plans. Finally, as the tax reform debate heats up, the Administration might introduce its own plan. The President has said that he finds the flat tax appealing, and Chief of Staff Leon Panetta introduced flat tax legislation as a Member of Congress in 1983. The White House also has expressed interest in the value-added tax,[8] although it is unlikely that the Administration would support a VAT as a replacement for the income tax.

8 Clay Chandler, "Clinton May Jump Into Tax Reform Fray," *The Washington Post*, August 2, 1995.

GRADING THE TAX PLANS

While each reform has an overall grade, it is particularly useful to see how the different proposals address specific flaws in the current system. The grades in the following section indicate the extent to which different tax plans reflect nine important principles of sound tax policy.

Low Rates

Low tax rates ensure that taxpayers have little incentive to hide, shelter, and underreport income. Because willingness to work, save, invest, and take risks is tied to the expected rewards of such behavior, the lower the tax rate(s), the higher the level of economic growth.

Armey/Shelby flat tax A

The flat tax popularized by the House Majority Leader begins with a 20 percent rate that phases down to 17 percent in the third year.

National retail sales tax A

Assuming a low rate and with income not taxed directly, the penalty on the creation of wealth would be minor.[9]

Value-added tax A

As with the national sales tax, a VAT with a low rate would have minimal impact on working, savings, and investment.

Nunn/Domenici USA tax D

The top tax rate in the USA tax is 40 percent, even higher than in current law. To make matters worse, it applies to taxable incomes as low as $24,000 for a family of four.

Gephardt 10 percent tax C

Like the current system, the Minority Leader's plan has five separate rates. These rates are slightly lower than in current law, but the expansion of taxable income and the income levels at which the different rates apply offset this minor improvement.

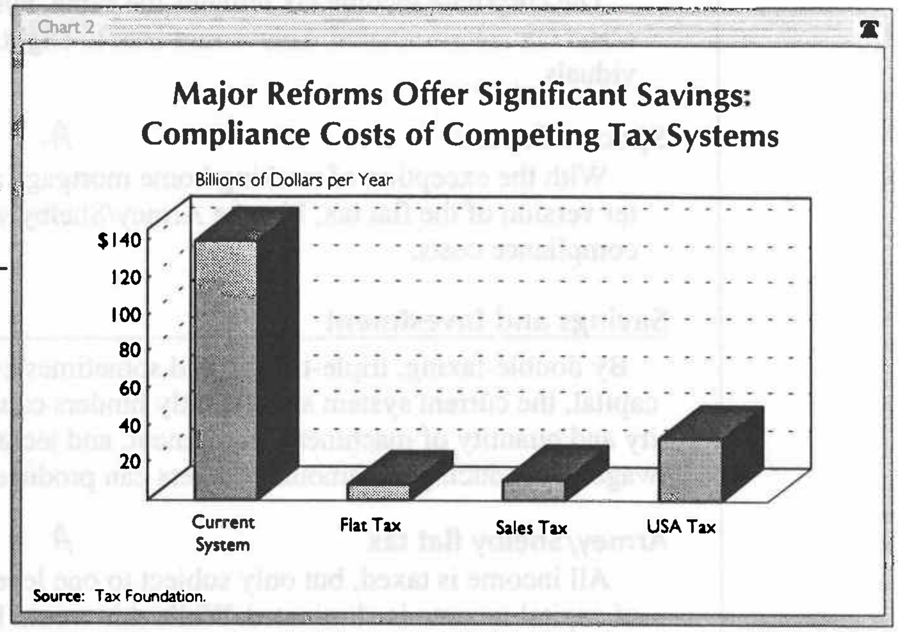
Specter flat tax A-

The Specter plan's low 20 percent flat rate would stimulate increased work, savings, and investment when compared with current law, although it could be even lower if the remaining deductions were scrapped.

9 All taxes, including the sales tax and VAT, are paid out of income. The difference between these taxes and a flat tax is that the flat tax collects revenues when the income is earned, while direct consumption taxes collect the revenue when income is spent. Either way, a key to economic growth is keeping the rate as low as possible.

Simplicity

The current income tax has more than 400 different forms, requires more than one billion 1099 forms (tracking interest and dividend income), and necessitates more than five billion hours of effort each year.[10] While individuals rightly complain about the costs of simply compiling information, calculating their taxes, and understanding forms, compliance costs for business are twice as high.



Armey/Shelby flat tax A

The current system's plethora of documents, paperwork, and complex record-keeping would be greatly simplified by two postcard-sized forms, one for individuals and one for business.

National retail sales tax B

Compliance costs for individuals would disappear, though retail businesses would bear an increased burden because they would be responsible for collecting the tax and complying with reporting requirements.

Value-added tax B+

Individual compliance costs would vanish, as would the daunting complexities of the corporate income tax, but businesses would have to maintain detailed records to calculate their share of tax liability as goods and services travel through the production process.

Nunn/Domenici USA tax B-

Since the burden of the corporate income tax is even worse than a VAT, compliance costs for business would fall under a USA tax. Individual compliance costs could rise relative to the current system, however, because of requirements for tracking deposits and withdrawals into the unlimited IRA.

10 James Payne, *Costly Returns: The Burdens of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies Press, 1993).