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THE ARMEY FLAT TAX: TAX RESTRUCTURING FOR ECONOMIC PROGRESS

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House Majority Leader Dick Armey (R-TX) is a fine, free-market economist. He is also a first-rate public policy maker who comes up with bold, innovative solutions to challenging problems. Perhaps his most audacious and constructive initiative is his flat tax proposal, introduced last year in his Freedom and Fairness Restoration Act, H.R. 4585. The proposal calls for scrapping the existing personal and corporate income taxes, replacing them with single-rate taxes imposed on income broadly defined as the taxpayer's receipts less what the taxpayer spends to obtain them. Armey's proposal reflects a widening consensus that the existing federal tax system fails every test of tax acceptability.

The consensus is well founded. The federal individual and corporate income taxes are woefully unfair. They are enormously complex, imposing huge costs of compliance, administration, and enforcement. They greatly increase the costs of saving and investment for individuals and businesses, distort markets' operations and outcomes, and impair the ability of U.S. businesses to compete in the world market place. They rob the nation of output and income we would otherwise enjoy.

The Armey flat tax would go far toward overcoming these deficiencies. It meets the most exacting demands of good economics, good politics, and — forgive the oxymoron — good taxes.

What Is the Armey Flat Tax?

As the name suggests, the distinguishing feature of a flat tax is that only a single tax rate is imposed on the tax base — whatever is to be taxed. The Armey flat tax rate would be 20 percent during the first two years after enactment and 17 percent thereafter.

Most flat tax proposals have aimed mainly at the individual income tax. The Armey flat tax, however, would apply to corporations, as well, seeking to integrate the business and personal income taxes. Both individual and corporate taxpayers would face the same tax rate.

Virtually all flat tax proposals have focused at least as much on broadening the tax base as on flattening the rate structure. The common perception is that a flat tax would be imposed on taxable income defined as gross receipts with virtually no deductions except for personal exemptions, and no tax credits.

One reason for this emphasis on base broadening is the widespread conviction that the deductions, exemptions, and credits allowed under the existing income tax are primarily devices that allow some taxpayers to avoid paying all the tax they should. In this view, these provisions should be eliminated in the interests of fairness. As a practical matter, revenue considerations seem to be more important in dictating that flat rates should be imposed on the broadest possible income base. Flattening tax rates presumably would reduce the government's tax revenues, a policy no-no in this era of huge federal budget deficits. Preventing any significant revenue loss, therefore, seems to call for paying for the flattening and lowering of tax rates by fashioning the broadest possible tax base. Unfortunately, many of these base-broadening features are proposed without adequate regard for the damage that might be done by including specific receipts or denying specific deductions.

For the most part, the Armey flat tax proposal avoids the mindless "throw-everything-into-the-tax-base" approach that has characterized most prior efforts. Instead, the proposed tax base is carefully designed to minimize tax distortions of household and business uses of the resources at their disposal.

Taxable income for individuals would consist only of their wages, salaries, other compensation, and pension income. From this income, individuals would deduct standard deductions for themselves, their spouses, and their children. These deductions would be $13,100 for a single person without children, $17,200 for a head of household, and $26,200 for a married couple filing a joint return, plus $5,300 for each child. A married couple with two children and wages and salaries less than $36,800 would pay no tax. No deduction would be allowed for current saving — no deduction for IRA contributions, for example, would be available, but taxable income would not include any of the interest, dividends, or other income earned on saving.

Businesses would pay tax on their receipts from the conduct of their trade or business in the United States minus their purchases from other businesses and the wages, salaries, and other compensation — except for fringe benefits — paid to their employees. Instead of depreciation deductions to recapture outlays for plant and equipment, businesses would deduct these outlays in the year in which they were made. On the other hand, when businesses sold or disposed of such property, they would include all of the sales proceeds in taxable income in the year of sale. Similarly, instead of the present complicated inventory accounting rules, outlays for additions to inventory, raw materials, and all other goods, services, and materials would be deducted in the year in which the purchases were made.

Except in the case of financial businesses, business income would not include receipts of dividends, interest, rents, and other returns on property not used in the taxpayer's trade or business. On the other hand, nonfinancial businesses would not be allowed to deduct payments of interest, dividends, rent, etc. These payments, as indicated, would not be included in the taxable income of either individuals or businesses that receive them.

The great virtue of Armey's definition of taxable income is that no income receipt is taxed more than once. Although the income that individuals save would be taxed, the income that saving produces would not be taxable to the savers. In contrast, the existing income tax is biased against saving because both the income that people save and the returns on that saving are taxed, sometimes many times over.

Businesses under the Armey flat tax would deduct their purchases of assets used in the production of the businesses's income, but they would not deduct any of the income those assets produced, whether paid as interest to creditors or as dividends to owners of the businesses. In other words, all of the income produced by businesses would be taxed, but only once. In itself, this would be a huge improvement over the existing income taxes.

How Does the Armey Flat Tax Stack Up Against Basic Tax Principles?

Over the years since the 16th Amendment was adopted early in this century, the Congress has "reformed" the income tax over and over again. With too few exceptions to be worth noting, each tax reform effort has made things worse. The nation should endorse another round of tax restructuring *only* if the new tax structure promises to conform much more closely than the existing tax structure with the basic requirements of an acceptable tax.

The basic function a tax must perform is to inform the public about the cost of government. A free society can't make intelligent choices about what its government should do if people don't know what they have to pay for the government's activities. When the cost of government is hidden from the public, government gets bigger than people would wish it to be if they knew how much it cost them.

To perform this function of pricing out government, a tax system must satisfy three basic conditions.

First, taxes should be imposed only on real people. All taxes are ultimately paid by individuals, no matter who writes the check to the Internal Revenue Service. Taxes paid by corporations are hidden from those who sooner or later bear their burden — the owners of the corporations, corporate employees, and corporate customers. Taxes that aren't paid directly by individuals fail this first test.

Second, people must be aware of the taxes they're paying. Hidden taxes obviously can't tell a person anything about what government costs him or her. Ask the next 100 people you encounter how much payroll tax, sales tax, or even income tax they paid last year; few if any of them will be able to answer correctly. If you're not conscious of the taxes you pay, the tax system isn't telling you what government costs you.

Third, everyone should be in on the taxpaying act. If you're not on the tax rolls, you're likely to see government services and activities as a free lunch. Not surprisingly, you're likely to want more and more of the services that other people buy for you.

Against these criteria, the Armey flat tax gets mixed reviews. On the one hand, its very large deductions for personal exemptions would remove millions of individuals from the income tax rolls. Moreover, a substantial amount of tax would be collected from corporate businesses on income that individuals would receive in their capacities as corporate shareholders, creditors, landlords, etc.; while these tax payments would actually be borne by these individuals, their awareness of these burdens would be minimal.

On the other hand, Armey would eliminate income tax withholding of his flat tax. Each month, individual and business taxpayers would file tax returns and pay their tax, with an end-of-the-year final accounting and reconciliation. Individuals would get the bad news about their taxes 12 times a year, frequent reminders of what the federal government's activities cost them.

Apart from how well a tax performs its basic function of pricing out government, there are three other major tests of tax acceptability: 1) Is it simple, imposing minimal compliance, administration, and enforcement costs? 2) Is it fair? 3) Is it "neutral," that is, does it avoid distorting the prices that would otherwise result from the operation of the market system? With respect to each of these criteria, the Armey flat tax measures up very well indeed.

Simplicity

For the several million individuals who would fall off the income tax rolls because of its very generous deductions for personal exemptions, the Armey flat tax would provide the ultimate in tax simplification. For many, but not most, of the individual taxpayers who would remain on the income tax rolls and for virtually all business taxpayers, the Armey flat tax would greatly simplify their tax lives and save hundreds of millions of man hours of compliance effort. In dollar terms, the savings would be reckoned in the hundreds of billions. These gains would not be immediately realized; until the transition from the existing income tax laws to the flat tax were substantially completed, taxpayers and tax administrators might well face even heavier work loads than at present. And because withholding would be eliminated under the Armey plan, costs of administration and enforcement might well be significantly greater than under the existing income tax system.

For the vast majority of individual taxpayers, the Armey flat tax offers little by way of simplification. The reason is that the income of most individual taxpayers consists principally of their wages and salaries and most of them — about 7 out of 10 — file returns on which they claim the standard deduction, instead of itemizing their deductions. For most of these taxpayers, in other words, complying with the existing income tax requires little more than copying information from the withholding statements their employers give them, claiming their personal exemptions, and consulting a table to find out how much the government owes them, if they were overwithheld on, or how much they owe the government because not enough tax was withheld.

Most individual taxpayers who itemize their deductions do so because they've purchased a home subject to a mortgage, and under existing law they are allowed to deduct their mortgage interest and property taxes. These deductions, along with those for charitable contributions and for state and local government income and personal property taxes, often exceed the standard deductions they might otherwise claim. None of these deductions would be allowed under the Armey flat tax; insofar as claiming these deductions is a source of complexity for these taxpayers, the Armey flat tax would afford simplification, but in many cases at the cost of paying more taxes.

The principal beneficiaries of the Armey plan's tax simplification would be individuals with business and investment incomes and corporations. Indeed, most of the complexity in the existing income taxes arises from the provisions that define the taxable income of these taxpayers. It may be difficult to generate any popular sympathy for these taxpayers, but if simplification is to be meaningful rather than merely an excuse for more helter-skelter base broadening, it will have to focus on the compliance problems of these taxpayers.

Armey's flat tax proposal would go a long way toward dealing effectively with these problems. For a great many businesses, unincorporated as well as incorporated, depreciation and other capital recovery provisions are a source of great tax complexity. So, too, are the tax provisions pertaining to inventory accounting and the determination of the cost of goods sold. Under the Armey plan, these provisions would be eliminated because businesses would deduct all purchases from other businesses in the taxable year in which the purchases are made. The tax life of individual taxpayers would be made easier because, for one thing, all of the complicated provisions and regulations dealing with tax treatment of capital gains would be eliminated.

One of the guiding principles in the Armey tax is that tax should be paid either on income that is saved or on the income that saving produces, but not on both. Individuals, other than unincorporated business owners, therefore, would not pay tax on the returns on their saving -- interest, dividends, capital gains, or any other such returns on their saving and investments -- because they would not have deducted the saving producing those returns. These returns would not escape taxation under the Armey plan, however, because no deductions would be allowed for these payments by those making them.

By all odds some of the most opaque provisions of the existing income taxes are those governing the tax treatment of income that U.S. businesses earn in their foreign operations. This part of the income tax is so complex that most corporate tax officers can't be confident that they've filed their companies' tax returns in compliance with the law. Moreover, these provisions are the subject of most of the tax litigation and litigation costs for both taxpayer and Internal Revenue Service.

Real progress toward tax simplification requires dealing with these problems. The Armey plan would do so very effectively because the tax would apply only to income produced in the United States; the results of American companies' foreign operations would be excluded from the flat tax calculations. The U.S. tax treatment of foreign-source income would conform much more closely than at present with that of many other nations. It would, moreover, greatly reduce the competitive disadvantages of many U.S. companies operating in the world marketplace.

<u>Fairness</u>

One of the major advantages claimed for a flat tax is that it would be far fairer than the existing tax system. Armey asserts on behalf of his flat tax that "The great virtue of a flat tax is its fundamental fairness. Under this system, to the greatest extent possible, *everyone is treated the same*." Ironically, the major criticism of the flat tax and many other tax restructuring plans is that they would be woefully unfair. Interestingly, both tax restructuring proponents and their critics argue from mistaken premises.

Armey, for example, argues that under his flat tax, "... loopholes are eliminated, which removes all legal tax shelters." It's not clear which "loopholes" and tax shelters Armey has in mind; the example he cites — the deductibility of interest payments and their taxability in the hands of the recipients — is *not* a loophole in anyone's book.

The fact is that as a result of its uninhibited base broadening, the 1986 Tax Reform Act (TRA86) purged the income tax bases of loopholes and tax shelters, in the process creating tens of billions of dollars of *negative* loopholes. Some tax avoidance devices may remain in the law and some new ones may have been introduced since 1986, but any such are few and far between. In today's tax environment, closing tax loopholes is not the occasion for a flat tax or any other tax restructuring.

Critics of a flat tax insist it would be unfair because it would reduce progressivity and the tax load on the rich. This criticism, however, mistakenly identifies upward graduation of tax rates as essential for progressivity. In fact, under the Armey flat tax with its very large deductions for personal exemptions, effective tax rates — tax liabilities as a fraction of income — would be significantly progressive.

In the Armey plan, a married couple with two children would pay tax only on their wages, salaries, and other compensation in excess of $36,800. If their wages and salaries amounted to, say, $40,000, their tax liability, at a 17 percent flat rate, would be $544 or 1.36 percent of their income. At $50,000 of wages and salaries, their tax would be $2,244, an effective rate of 4.49 percent. At $100,000 of compensation, their tax would be $10,744 or 10.74 percent. Meaningful progression — upward graduation of effective tax rates — is perfectly feasible under a flat tax.

The assertion by flat tax critics that the rich would pay less assumes that the investment income the rich receive would escape taxation. In fact, however, that income would not escape taxation because it would be taxed in the hands of the businesses producing it; these businesses would not be permitted to deduct the payments — interest, dividends, rents, etc. — they make to the individuals who receive them. Taking account of the business tax, it is by no means clear that the tax load on the rich relative to that of other individuals would be significantly reduced.

There is a more meaningful way to look at the fairness issue. With few exceptions, an individual's income is a pretty good measure of the value of that person's contribution to the economy's output. On this assumption, it is difficult to justify imposing taxes at successively higher rates on higher incomes. Doing so implies that the additional, more productive efforts of the rich are less worthy than the smaller, less productive efforts of the less rich, a peculiar ethical standard, indeed.

A far more appealing and acceptable view is that all individuals should stand equally before the law. In the case of income taxes, this means that everyone should be subject to the same statutory rate of tax on the fruits of their efforts and uses of their property rights.

The Armey flat-rate income tax conforms with this standard. It can, accordingly, establish a sturdy claim to fairness.

Economic Efficiency and Growth

A core objective of tax restructuring should be to provide a tax system that will far less than the present system interfere with the efficient operation of the market system. That calls for reducing, if not eliminating, tax disincentives to save and invest, to innovate, to start new businesses, to assume risks, and to undertake other activities on which economic progress and rising living standards depend. The Armey flat tax has much to commend it in this regard.

The virtue of a flat tax rate is that, in contrast with so-called progressive income taxes, it would not impose a penalty on advances in productivity. Under rate graduation, the higher is one's income, the bigger is the tax bite out of any additional income one earns. As a result, rate graduation imposes an additional tax on efforts to increase one's income, whether by working harder or more efficiently or by saving and investing some of one's current income in order to have more income in the future.

Graduated rates raise the cost of efforts to increase income, the more so the more successful the efforts. It is a fundamental truth that the more something costs you, the less of it you'll buy. The more it costs you to work harder, to save more of your income, to be entrepreneurial, to take risks, the less of those growth-generating activities you'll undertake. And the less of those activities people undertake, the slower will be the rate of increase in the work force's productivity, in real wage rates, in employment, output, and income.

Income tax rate graduation is bad economic policy that exacts a heavy price in lost jobs, lost production, and lost income from all segments of the population.

Rate graduation serves no useful social purpose; even if economic leveling is deemed to be an important social objective, it is at least as effectively pursued by graduating average or effective tax rates as by graduating statutory or marginal rates.

If a flat tax is to avoid distorting the market's cost and price signals, correctly specifying the tax base is essential. As a general rule, deductions should be allowed for all the costs that are incurred to produce the revenue that is to be included in the tax base. Thus, businesses should be allowed to deduct all of the costs of the machinery, equipment, other production facilities, supplies, and all other products and services they purchase and use in their operations and should pay tax only on the excess of their revenues over these costs. Individuals should be allowed to deduct all the costs they necessarily incur to produce the wages, salaries, and other compensation they are required to include in their tax base.

The base of the Armey flat tax conforms very closely with these specifications.

One of the greatest virtues of the Armey flat tax is that, unlike the existing income tax, it would not be biased against saving and investment and in favor of current consumption. The anti-saving bias in the existing income tax arises because both the income one saves and the income produced by the investment of that saving are taxed; indeed, investment income is often taxed over and over again. In contrast, income used for current consumption is generally only taxed as it is received. This raises the cost of saving relative to the cost of consumption. The result is that people save less than if the tax applied neutrally to both saving and consumption uses of income.

To avoid this tax bias against saving, either of two equivalent approaches may be used. One way is to allow individuals to deduct what they save out of their current incomes and to pay tax on all of the gross returns their saving provides. The alternative is to include saving in current taxable income but to pay no tax on the returns produced by the saving. Parallel treatment for business taxpayers should be provided.

The Armey flat tax relies on the latter method for individuals and on the former for businesses. Individuals would not deduct the income they save in computing their taxable incomes, but none of the returns on their saving would be included in their taxable incomes. Businesses would deduct all of their purchases from other businesses, including purchases of machinery, equipment, and other capital, but would pay tax on all of the gross earnings generated by the use of these purchases. With this tax treatment, the Armey flat tax would virtually eliminate the strong bias in the income taxes against saving and investment.

Armey's tax would afford much more nearly uniform tax treatment, virtually eliminating differences in tax loads based on differences in the sources of income or the attributes of taxpayers. It would, therefore, afford a tax environment much more congenial to efficient functioning of the market system than the present tax system.

No tax is perfectly acceptable. The Armey plan has defects, but none of them are severe or irremediable. It provides a splendid blueprint for conforming the federal tax system to the requirements of a progressive and efficient economy for a free society. Armey's flat tax should command the careful consideration of public policy makers who endorse that goal.