

A Republican Journal Of Thought And Opinion

# Commonsense

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**Editor's Note:** *Herein, two longtime advocates of fundamental tax reform discuss a proposal currently receiving increasing political and economic attention. Tax expert Norman Ture discusses the flat tax with specific focus on H.R. 4585, introduced by Representative Richard K. Armey. Mr. Armey himself explains his proposal, entitled the Freedom and Fairness Restoration Act. The two are united in their view that the flat tax would simplify and introduce fairness into our current system of taxation that is, for many, anything but simple and fair.*

## **The Flat Tax: A Guide to Constructive Tax Restructuring**

by Dr. Norman B. Ture

Thanks to the green thumb of Representative Dick Armey (R-TX), that hardy tax policy perennial, the flat tax, is blooming again. Armey's flat tax proposal, one of three titles in his Freedom and Fairness Restoration Act, H.R. 4585,<sup>1</sup> calls for a dramatic restructuring of the federal individual and corporate income taxes. His proposal joins a burgeoning list of congressional initiatives calling for drastic changes in the income taxes, reflecting a widening consensus that the existing federal tax system is woefully deficient with respect to every major criterion of tax acceptability.

The consensus is well founded. The federal individual and corporate income taxes satisfy no understandable test of fairness. They are enormously complex, entailing huge costs of compliance, administration,

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<sup>1</sup>The other two titles seek to impose real constraints on federal spending and to curb regulatory excesses.

and enforcement. They substantially increase the costs of saving and investment for individuals and businesses, impede the efficient operation of the market system, and impose barriers to effective competition by U.S. businesses in the world marketplace. They cause the nation to have lower levels of output and income than it would enjoy if taxes distorted economic activity less.

Overcoming these deficiencies is what tax restructuring should be about. A properly specified flat tax would go far toward meeting this challenge.

### What Is a Flat Tax?

Representative Arney's flat tax proposal is not a first; the advantages that might be gained from a proportional rather than a graduated income tax have been explored repeatedly in the past. Most flat tax

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proposals have aimed mainly at the individual income tax, calling for reduction in the number of tax rate brackets and broadening of the tax base. The recent and current versions have included the corporation income tax, as well, seeking to provide some significant degree of integration of business and personal income taxes.

As the name suggests, the distinguishing element of a flat tax is that only a single tax rate is imposed on whatever is to be taxed. Although literally such a tax would be a flat tax irrespective of how the tax base is defined, virtually all flat tax proposals have given at least as much emphasis to broadening the tax base as to flattening the rate structure. Indeed, a widely held view is that as long as the tax rate is low enough, there is no need to worry about whether the specifications of the tax base conform with tax principles. How the base is defined, however, has a major bearing on how well a flat tax would remedy the deficiencies in the existing income taxes.

In most flat tax proposals, revenue considerations have dictated paying for the flattening and lowering of tax rates by fashioning the broadest possible tax base, without regard for the damage that might be done by including specific receipts or denying specific deductions. In fact, in

the common view of a flat tax, taxable income is defined as gross receipts with virtually no deductions except for personal exemptions.

The Tax Reform Act of 1986 (TRA86) affords a good example of this principle-be-damned approach. While TRA86 didn't provide a single tax rate for the personal income tax, it very substantially flattened the rate structure, reducing the number of tax brackets and greatly widening them. The resulting rate structure means that many personal income taxpayers are likely to pay income tax at only one rate for much of their earning lifetimes.

At the same time, TRA86 greatly broadened both the individual and corporate income tax bases to make up for the huge revenue loss from the tax rate cuts and personal exemption and standard deduction increases. This base broadening was not guided by respect for basic tax principles or concerns for minimizing the distorting influence of taxes on household and business decisionmaking. Instead, the prime consideration was how to obtain the required additional revenue from the politically most vulnerable groups of taxpayers. The result was a huge increase in the burden of taxes on saving and investment undertaken by both individuals and corporate businesses.

The moral of the story told by TRA86 is that the potentially great advantages of a flat tax may be lost by misspecification of the tax base. Base broadening, *per se*, has little to commend it as an objective of tax restructuring. The focus, instead, should be on specifying a tax base that will facilitate attainment of the urgent goals of tax restructuring. A flat tax, no less than other tax restructuring plans, must pay close attention to the requirements in the design of the tax base that these goals demand.

### Simplification

A flat tax may offer the opportunity for substantial simplification of the tax laws and reduction in costs of compliance, administration, and enforcement. These gains, however, are not automatically provided by a flat tax. To realize these advantages, it is necessary to identify and address correctly the sources of complexity in the present law.

Simplifying the income tax laws and reducing the costs of income tax compliance and enforcement have been major goals of tax reform efforts for many years. Over the entire history of 20th century federal income taxes, however, no tax simplification effort has succeeded. In

fact, the continuing increases in the number of pages in the Internal Revenue Code and in the tax regulations and in the number of employees and payroll of the Internal Revenue Service attest to ever more complex and murky tax laws. Tax simplification remains an unrealized tax policy goal.

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example of tax simplification efforts gone grossly awry. Moreover, it affords a clear demonstration that merely flattening the tax rate structure and broadening the tax base are not all that is required for reducing tax complexity and compliance costs.

Simplification was proclaimed to be one of the Act's principal goals, and for a very large number of taxpayers, TRA86 was, indeed, the ultimate income tax simplification measure. By greatly increasing personal exemptions and the standard deduction, something like 6 million individuals were removed from the income tax rolls. For these individuals, too, substantial tax

simplification was provided.

The Act also simplified tax life for a very large number of individuals remaining on the income tax rolls. The much larger standard deduction induced many individual taxpayers to forgo itemizing their personal deductions; most of these taxpayers need only add to the wages and salaries shown on their W-2 forms any dividends or interest they receive and subtract their personal exemptions and standard deductions to find their taxable incomes.<sup>2</sup> And for most of these taxpayers, the only arithmetic they need to do is to subtract the amount of tax they've paid through withholding from the amount of the tax liability they find in a tax table. For these individuals, too, substantial tax simplification was provided.

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<sup>2</sup>The income of the vast majority of individual income tax filers consists mostly of their wages and salaries, and most taxpayers rely on the standard rather than itemized deductions. In 1992, fewer than 3 out of every 10 individual income tax returns showed itemized instead of standard deductions. On returns with adjusted gross incomes less than \$50,000, the preponderant amount of which is wages and salaries, more than 7 out of 8 used the standard deduction. Statistics of Income Bulletin, Internal Revenue Service, Spring 1994, pp. 20, 24.

On the other hand, the Act's base broadening made the income tax laws much more complex for other taxpayers, in particular for individuals with business and investment incomes and corporations. Indeed, most of the complexity in the existing income taxes arises from provisions pertaining to the definition of 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 of the TRA86 sort of helter-skelter base broadening, it will have to focus on the compliance problems of these taxpayers.

These compliance problems are concerns for the whole nation, not merely for those who must deal with them directly. Representative Arney cites an estimate that taxpayers spend 5.4 million man hours filling out tax forms, resulting in a dead weight loss to the economy of some \$600 billion a year.<sup>3</sup> As suggested above, the preponderance of these costs are incurred by businesses and investors. It is on their problems that simplification must focus.

Representative Arney'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 existing income tax provisions pertaining to inventory accounting and the determination of the cost of goods sold. The Arney plan would replace these provisions by allowing all businesses to expense all purchases from other businesses — to deduct these purchases from revenues in the taxable year in which the purchases are made. The tax life of individual taxpayers would be made easier because all of the complicated provisions and regulations dealing with tax treatment of capital gains would be eliminated. Individuals, other than unincorporated business owners, would pay tax only on the wages, salaries, and other forms of compensation they re-

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<sup>3</sup>Richard K. Arney, explanation of H.R. 4585, The Freedom and Fairness Restoration Act, p. 29.

ceive. Interest, dividends, capital gains, and all other returns on their saving and investments would not be included in their taxable incomes. These returns would not escape taxation under the Arme y plan, however,

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because no deductions would be allowed for these payments to 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. With few, if any exceptions, these earnings are subject to tax by the governments of the jurisdiction in which they are earned. They are also taxed by the U.S. federal government, subject to a credit for the income taxes paid to the foreign governments.

The U.S. tax, however, depends on a very large number of variables, such as the nature of the foreign income, the kinds of expenses incurred in its production, the relationship between the U.S. business and its foreign affiliate, etc. All in all, this part of the income tax is so complex that most corporate tax officers cannot be confident that they have filed their companies' tax returns in compliance with the law. Moreover, these provisions are the subject of most of the tax litigation and of the costs for both taxpayer and Internal Revenue Service this litigation entails.

Real progress toward tax simplification requires dealing with these problems. The Arme y plan would do so very effectively because 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.

### Fairness

One of the major advantages claimed for a flat tax is that it would be far fairer than the existing tax system. Representative Arme y 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.*"<sup>4</sup> 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.

Armev, for example, argues that under his flat tax, "...loopholes are eliminated, which removes all legal tax shelters."<sup>5</sup> It's not clear which "loopholes" and tax shelters Armev has in mind; the example he cites certainly is not a loophole or tax shelter in anyone's book.<sup>6</sup>

The fact of the matter is that as a result of its uninhibited base broadening, 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, the occasion for a flat tax or any other tax restructuring is *not* to close loopholes.

Critics of the 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, because of the very large standard deduction and personal exemptions in virtually all flat taxes,

**The fairness case that should be made on behalf of the flat tax rests on the assumption that, with few exceptions, an individual's income is a close approximation 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.**

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<sup>4</sup>Armev, *op. cit.*, p. 31.

<sup>5</sup>Armev, *op. cit.*, p. 32.

<sup>6</sup>According to Armev, "...billions of dollars that currently escape taxation will be collected under the [Armev] business tax — most of which will come from the hands of the wealthy. For example, under the current code, interest is deductible *and* taxable." *Ibid.* This tax treatment doesn't provide a loophole. The billions of additional dollars the Armev plan would raise would result from a drastic change in the tax accounting for banks' interest receipts, payments, and service charges. See Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Stanford, CA: Hoover Institution Press (1985), pp. 59-61. There is much to be said for the Hall-Rabushka recommendation on the grounds of efficiency, not on the grounds of



effective tax rates — tax liabilities as a fraction of income — would be steeply progressive.

In the Armev plan, for example, the basic standard deduction would be \$24,700 for married taxpayers filing a joint return, \$16,200 for a head of household, and \$12,350 for a single person.

**A far more appealing and acceptable view is that all individuals should stand equally before the law and should, therefore, be subject to the same statutory rate of tax on the fruits of their efforts and uses of their property rights.**

An additional standard deduction of \$5,000 would be afforded for each dependent. All of these standard deductions would be indexed for inflation. At the current price level, a married couple with two children would pay tax only on their wages, salaries, and other compensation in excess of \$34,700. If their wages and salaries amounted to, say, \$40,000, their tax liability, at a 20 percent flat rate, would be \$1,060 or 2.65 percent of their income. At \$50,000 of wages and salaries, their tax would be \$3,060, an effective rate of 6.12 percent. At \$100,000 of compensation, their tax would be \$13,060 or 13.06 percent. Meaningful progression — upward graduation of effective tax rates — is

perfectly feasible under a flat tax.<sup>7</sup>

The assertion by flat tax critics that the rich would pay less assumes that the investment income the rich receives 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 had invested in them. Unlike its treatment under present laws, however, investment income would not be taxed over and over again. 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.

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<sup>7</sup>To be sure, effective rate progression would be slight at very high levels of income. It is difficult to believe that even the most ardent advocate of steep progression would be concerned about how much higher the effective tax rate on millionaire A is than that on millionaire B.

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 and should, therefore, be subject to the same statutory rate of tax on the fruits of their efforts and uses of their property rights. A flat tax on taxable income conforms with this standard and can, accordingly, establish a sturdy claim to fairness.<sup>8</sup>

### Economic Efficiency and Growth

A major objective of any tax restructuring proposal should be to provide a tax system that will impair the efficient operation of the market system far less than the present system. A tax system that meets this criterion will, for that very reason, less erode incentives to save and invest, to innovate, to assume risks, and to undertake other activities on which economic progress and rising living standards depend. A flat tax, the base of which is properly specified, 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. Upward graduated income taxes may well be thought of as levying a set of increasing excise taxes on the efforts people make to increase their incomes. Under rate graduation, the higher one's income, the bigger 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. Rate graduation serves no useful social purpose; even if income redistribution is

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<sup>8</sup>For an excellent exposition of this view, see Roy E. Cordato, "Tax Fairness or Moral Bankruptcy?" *IRET Policy Bulletin No. 53*, Institute for Research on the Economics of Taxation, September 6, 1991.

deemed to be an important societal concern, it is pursued at least as effectively by graduating average or effective tax rates as by graduating statutory or marginal rates. By erecting major barriers to advancing economic well being, marginal rate graduation undermines pursuit of constructive economic policy objectives.

Obtaining the benefits of a flat tax rate depends critically on correct specification of the tax base. As a general rule, deductions should be

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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.

A major concern that would be effectively addressed by designing the tax base in this fashion is to avoid perpetuating the severe bias against saving and investment that characterizes the existing income taxes. This bias 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, the income one uses for current consumption is generally only taxed as it is received. The effect of this disparity in treatment is to raise the cost of saving relative to the cost of consumption.<sup>9</sup>

To avoid imposing this tax bias against saving, either of two equivalent approaches may be used. One route is to allow individuals to deduct the amount they save out of their current incomes and to require them to pay tax on all of the gross returns their saving provides. The alternative is to include saving in current taxable income but to exclude

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<sup>9</sup>For a fuller explanation and illustration of this tax-imposed distortion of the saving-consumption choice, see Norman B. Ture, "Supply Side Analysis and Public Policy," in *Essays in Supply Side Economics*, ed. David G. Raboy, Washington, D.C.: Institute for Research on the Economics of Taxation (1982).

all of the returns produced by the saving from taxable income as these returns materialize. Parallel treatment for business taxpayers should be provided.

The Armev flat tax relies on the latter method for individuals and on the former for businesses. Individuals would not be permitted to deduct their saving from their current incomes in computing their taxable incomes; on the other hand, 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.

The Armev type of flat tax would be substantially free of the provisions in the existing income taxes that distort household and business decisionmaking. Any income tax exerts a bias against market-directed and in favor of so-called leisure uses of one's time, energy, and talents. The Armev flat tax would exert this bias but to a lesser extent than the current income tax for individuals now subject to higher marginal tax rates than the 20 percent rate proposed by Armev for the first few years after enactment and the 17 percent rate thereafter. Moreover, the Armev tax would avoid the powerfully adverse excise effect of statutory rate graduation on personal efforts to enhance one's productivity and income. It would virtually eliminate the strong bias in the income taxes against saving and investment and against entrepreneurial activity.<sup>10</sup> It would afford much more 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, hence to economic progress, than the tax system that now confronts market participants.

The Armev plan is not without defects. Its major flaw is that in an effort to counter the criticism that it would favor the rich over the non-rich and the poor, it provides huge basic and additional deductions for individual taxpayers. The result would be that millions of individuals

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<sup>10</sup>By its very nature, entrepreneurial activity is risky, and the degree of risk of any such activity is intensified in the presence of a graduated income tax. The costs of entrepreneurial undertakings are likely to be deducted before the undertakings produce the anticipated, greater-than-average returns that inspire these efforts, hence are likely to be deductible against income taxed at a relatively low rate. If the hoped-for returns are realized, they are likely to be taxable at a significantly higher rate. Graduation, in other words, tips the odds against high-risk and in favor of low-risk activities, hence against innovation and entrepreneurship.

would be taken off the income tax rolls, hence relieved of any significant tax awareness. For these individuals, the income tax would fail to perform the basic function of taxes in a free society — to inform the public about the cost of government activity. People who don't pay for the services government provides are likely to demand much more of those services. There appears to be precious little by way of an economizing constraint on government spending decisions now; further weakening that constraint would bode accelerating expansion of the future size and scope of government.

Many individuals who receive dividends, interest, and other kinds of returns on their saving and investment would be unaware of the taxes they would pay on such income, because under the Armev plan those taxes would be paid only by the businesses in which these taxpayers had invested. In this respect, too, the plan would hide tax burdens and impair the performance of the basic function of taxes in costing out government.

The Armev flat tax would allow no deduction for the taxes paid by individuals or businesses to state and local governments. These taxes, especially income and property taxes, are, by their very nature, exactions imposed by these governments, exerting prior claims on the taxpayers' revenues. They are costs incurred in the production of those revenues and should, therefore, be deductible in arriving at taxable income. Sales taxes and excises paid by businesses are no less costs of producing income than are business purchases of products and services and surely should be deductible.

Putting aside these and other reservations that may fairly be addressed to the specification of the tax base in the Armev plan, policymakers should be keenly aware of the transition problems that any drastic tax restructuring would necessarily entail. A single example suffices to highlight these problems. At the time of implementing any such new tax system, the cost of a substantial amount of the business depreciable property acquired under existing law would not yet have been recovered for tax purposes. The revenues generated by the use of that property would be included in the new business tax base, however. Some method would need to be devised to allow deduction of the remaining unrecovered cost of that property if the tax liabilities of the property owners were not to be very substantially and unduly increased. Allowing the businesses to deduct the remaining uncovered cost would result in enormous revenue losses. This would impose the need for either draconian reductions in

government outlays or huge offsetting revenue increases, even accounting for the substantial expansion of the tax base produced by the higher levels of output and income resulting from the tax restructuring.

Difficulties of this sort should not blind policymakers to the great advantages that a flat tax could provide. Dick Armey has performed a valuable service by putting his plan on the policy table. His colleagues should recognize the promise in his plan for overcoming the deficiencies of the present tax system.

# The Flat Tax: Restoring Freedom and Fairness

by Richard K. Armev

Very few Americans know as much about sound tax policy as my friend Norman Ture. In fact, because of his overall brilliance in this area, he can usually find at least some defects in almost any tax proposal. With that in mind, I can only consider his relatively mild criticisms of my flat tax as high praise. I'm pleased to take this opportunity to elaborate on my plan, H.R. 4585, as well as comment on Dr. Ture's points.

The flat tax I've proposed is nothing if not simple. Our current patchwork tax code would largely be swept away and replaced with a single rate and no deductions other than highly generous personal and dependent allowances. Individuals would fill out a tax form the size of a postcard, covering their wages, salaries, and pensions. They would begin by deducting a personal allowance of \$13,100 for a single individual, \$17,200 for a single head of household, or \$26,200 for a married couple filing jointly — plus a dependent allowance of \$5,300 for each child. Then they would simply pay 17 percent of the remainder in tax.\*

A separate form would cover business income, including corporate, partnership, and rental income. In the case of a small business, the owner would subtract business expenses from gross revenue and pay an

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\*Editor's note: The tax rate is higher in the initial year of the Armev plan to prevent undue revenue loss before the economic growth factor occurs. In the articles herein, Representative Armev uses the 1997 exemption levels and the 1997 tax rate (17 percent), while Dr. Ture uses the 1995 exemption levels and the 1995 tax rate (20 percent). Under the Armev plan, exemption levels are indexed to inflation, thus Armev's 1997 exemption figures are higher than Ture's 1995 figures.

identical 17 percent of the amount left over.

The great virtue of this system is that it is neutral — it does not seek to guide the economic decisions of free Americans. Someone once said that beyond setting the tax rate, everything else in tax policy is really social policy — and that's exactly right. Today's arcane tax code is as much an exercise in social engineering and economic planning as it is a method for efficiently raising tax revenue. Through a bewildering array of deductions, exemptions, and credits, the politicians who wrote the code tell us, among other things, that investing in a municipal sewer system is better than investing in the next Microsoft, that buying rather than renting a house is a better choice for everyone everywhere, that purchasing an air compressor is better than buying computer software, and so on. I reject the idea that the tax writers are competent to make those decisions. Free Americans can certainly decide where to put their own money far more wisely than can Members of Congress.

I would even go so far as to argue that neutrality in the tax code is a moral imperative. Incompetence aside, a government does not have the right to use the tax system to massively influence the economic decisions of its citizens. But to stick with the practical benefits, neutrality will ensure that resources are directed where they are most economically useful, and that means this plan will be a boon for economic growth.

In particular, the current bias against saving will be eliminated. Currently, savings and investment are subject to double or even triple taxation. When a business makes a profit, that money is taxed once through the corporate income tax and again through the individual income tax when it is distributed to investors as dividends. This is not only fundamentally unfair, it is economically lunatic. The government is, in effect, actively discouraging savings and investment — which certainly explains the “mystery” of why we save less than the Germans and Japanese. By contrast, under this plan, all savings and investment will be taxed once and only once. Capital gains, interest income, stock divi-

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dends, and other investment income will not be taxed at all on the individual's tax form; it will be taxed exclusively through the business tax. The net result has precisely the same effect as an unlimited Individual Retirement Account.

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Can anyone imagine trying to rally public support by crying, "VAT, VAT, we need a VAT?" In short, you can't have a revolution until you get people in the streets, and the flat tax, alone among major tax reform plans, turns them out in droves.

I must admit that when I first introduced the plan, I was a little concerned that it would be seen as a retread. While the flat tax has always had strong support in the economic community, it received some national attention in the early 1980s and then fell from view. But I've been pleasantly stunned by the amount of excitement the plan generates today. Not only do I have a huge number of approving letters pouring into my office (at the rate of hundreds a month), the intensity of support is striking. Almost uniformly the letter writers use such language as, "Amen," "at last," "finally," "hooray," "wow." I've seen a lot of mail come across my desk in my time in Congress, and I can tell when an issue strikes a chord with the public. The flat tax clearly does. That convinces me that it is the only politically practical way of achieving fundamental — even radical — reform of our tax system.

One explanation for the enthusiastic public reaction, I believe, is the flat tax appeals to the Perot attitude. To the millions of Americans

The flat tax also has a powerful political virtue in that it excites the grassroots public. The crucial importance of this should not be underestimated. Any policy expert or tax analyst can sit in a room and write his concept of the ideal tax code, but it will remain a purely academic exercise if he cannot move Congress or rally public enthusiasm for the change. For instance, some Senators — concerned as I am about double-taxation of savings — are now pushing a drastic tax overhaul plan that includes a European-style value added tax. Aside from the traditional argument against a VAT (namely, that it is an insidious, hidden, easy-to-raise tax), their proposal strikes me as comically futile.

who have grown profoundly skeptical of the federal government, politicians, lobbyists, and (thanks to the President) anything billed as a “reform,” the flat tax has spectacular appeal because it offers a straightforward deal to the American people: “Take an allowance for yourself and pay a flat rate after that.” Perot voters in the end are Republican voters, and a plan like this helps bring them home. I firmly believe it can galvanize the public as no other issue has since term limits.

I’m also struck that it seems to appeal equally to the diverse elements within the Republican Party. One might have thought that a flat tax would mainly excite economic conservatives — from tax cutting activists to Wall Street-types. Not true. A huge portion of the mail I receive on it are from pro-family conservatives, and the Christian Coalition has endorsed the plan. Cultural conservatives know that restraining federal influence is central to their aims. They like the flat tax proposal for that reason, but the proposal also contains an explicitly pro-family aspect by doubling the current child deduction. I’ve long thought the divisions within our party were exaggerated, but to the extent they exist, this proposal can help unify us in the same way as did the original Reagan economic program.

What we have here, I believe, is a comprehensive plan that can strengthen the GOP coalition and appeal to those immediately outside it, whether Reagan Democrats or Perot voters. Jack Kemp has said that it could be the “Kemp-Roth of the 1990s,” and I hope and believe that analogy is correct.

Now, there are a few usual objections to the flat tax, coming mostly from liberal interest groups, that deserve to be addressed:

- Won’t this bill swell the deficit? When I began drafting the bill, I believed that any plan that lost more than \$40 billion in the first year on a static basis would be a show stopper. In other words, if the plan lost a huge amount of revenue immediately, before the economic growth effect could occur, it would not be credible among Beltway opinionmakers whose opinions (unfortunately) matter. I set the initial rate at 20 percent and adjusted the personal exemption levels in order to stay within that

**Can anyone imagine trying to rally public support by crying, “VAT, VAT, we need a VAT?” In short, you can’t have a revolution until you get people in the streets, and the flat tax, alone among major tax reform plans, turns them out in droves.**

target range, and I believe the final plan does so. Based on preliminary studies done by my staff with the help of outside economists, I estimate this tax cut would "lose" \$20-40 billion in the first year, an amount that could be paid for with spending cuts. Again, this is preliminary. If the more extensive studies I've commissioned show that these figures are off, it will be a simple matter to either raise the rate or reduce the exemption to arrive at the correct revenue figure without jeopardizing the beneficial features of the plan.

•Isn't a flat tax unfair? When people ask this, they invariably define "unfair" as "not progressive." First, I reject the soak-the-rich ideology which inspires the question, but in any case, my plan *is* progressive. Since the large personal exemptions cover a far larger portion of a middle-class taxpayer's income than a wealthy person's, the 17 percent flat rate will apply to a much smaller part of his income. In fact, a reasonable estimate is that my plan would give us a tax system as progressive as the system in place under John F. Kennedy. Remember, under this plan, the first \$36,800 of a family of four's income will be exempt from the income tax. That will likely remove as many as 10 million people from the

**One explanation for the enthusiastic public reaction, I believe, is the flat tax appeals to the Perot attitude...the flat tax has spectacular appeal because it offers a straightforward deal to the American people...**

tax rolls. And we must not forget that historically when the upper rate has been lowered, the revenue collected from the rich increases. We saw that with the Kennedy tax cut of 1963, the Reagan tax cut of 1981, and we learned the lesson in reverse with the Bush tax increase of 1990.

•How will unearned income be treated?

Some labor union activists have been suffering under the misconception that my plan does not tax capital gains and investment income at all. That's not true. Unearned income is taxed — but it is taxed at the business, not the individual, level. Why? Because it is vastly more efficient to do it that way. Today, huge amounts of

taxable income fall through the cracks of the tax system. In particular, more interest payments are claimed as deductions than are claimed as taxable income. My system will catch that revenue (which will mostly come from the "rich," by the way). If we tried to tax dividends, for example, at the individual level, we would need to retain today's army of

tax auditors to compare business receipts with personal returns. Much simplicity would be lost.

•**Won't removing the home mortgage interest deduction hurt the real estate industry?** Not as much as removing the double-taxation of savings will help it. While the targeted tax deductions for homes will be removed, we will no longer double tax capital gains and interest, causing the overall savings pool to expand significantly. This will lower interest rates, make more capital available for housing purchases, and keep housing prices at or above their current level.

•**But as a purely political matter, isn't it impossible to remove the home mortgage deduction?** Any taxpayer with a pencil can quickly see that he gets a much better deal under my system with its low rate and high personal allowances than he does under the current system's home mortgage deduction. Removing \$36,800 from taxable income (for a family of four) would more than compensate almost all taxpayers for the loss of all other kinds of deductions.

•**Okay, but surely you can't remove the deduction for charitable contributions?** Contrary to a first blush guess, almost half of all charitable contributions today are not claimed as deductions, suggesting that the tax code has less to do with encouraging generosity than one might think. Other evidence confirms this. During the 1980s, as Ronald Reagan steadily lowered the top rate from 70 percent to 28 percent, the charitable deduction became proportionally less valuable. When the Tax Reform Act of 1986 expanded the personal exemption, the number of taxpayers itemizing dramatically declined. Did charitable contributions decline? No. In the so-called "Decade of Greed," charitable contributions actually *doubled*. The moral of the story is that a growing economy gives people more money to give away. Churches and homeless shelters will thrive in the coming flat tax boom.

Let me say a word about eliminating deductions generally. While drafting the plan, some people assured me that eliminating such things as the home mortgage or charity deductions would be like strapping a gas tank to the outside of a Sherman tank: It will give the plan a huge vulner-

**Since the large personal exemptions cover a far larger portion of a middle-class taxpayer's income than a wealthy person's, the 17 percent flat rate will apply to a much smaller part of his income.**

ability from the start. But to my surprise, in four months of doing radio talk shows and giving speeches on the plan, the subject rarely comes up. By eliminating all deductions, I believe we spare ourselves huge arguments because people immediately grasp the larger benefits of a flat tax code. Were we to try to modify the bill by retaining one or two deductions, all sorts of interest groups would clamor to have their breaks retained as well. Removing all deductions (beyond a broad personal and child allowance) is good policy and good politics.

Having addressed these common objections, let me address the particular points raised by Dr. Ture.

First, Dr. Ture points out that the high personal allowances will take many individuals off the tax rolls and relieve them "of any significant tax awareness." I agree that's an important concern, but there are overriding reasons the personal allowances are necessary. In my view, any tax system, even a flat tax system, must allow citizens to earn a certain amount of money to cover basic living expenses before they begin surrendering money to the government. You should be allowed to support your family first, then the government.

Second, he argues that taxing business income at the business level would hide the burden of taxation for those taxpayers who receive large amounts of investment income. As I've mentioned above, there are powerful practical considerations for taxing business income this way. It is a necessary trade-off.

Third, he objects that my plan would not allow a deduction for taxes paid to state and local governments. A good case can be made that the current state and local tax deduction merely encourages Big Government at those levels. It is far easier for a Mario Cuomo to raise state income taxes if the taxes are deductible against the taxpayers' federal tax bill.

Finally, Dr. Ture mentions the problems involved in making the transition from the current tax system to a flat tax. That is indeed a challenge that needs to be given much consideration. Although I believe they can be ultimately overcome, these problems will loom large as the bill moves toward passage.