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An Analysis of Tax Reform

Tim McHugh

Carroll College, Helena, MT

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An Analysis of Tax Reform

Tim McHugh

April 12, 1996
An Analysis of Tax Reform

Submitted in partial fulfillment of the requirements for graduation with honors to the Department of Business Administration and Accounting at Carroll College, Helena, MT.

Belle Marie Talbert, director

Dr. Charles Ericksen, reader

Gene Franks, reader

April 12, 1995
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President Jimmy Carter once called the United States tax code a "disgrace to the human race" (Ruby, 1995, p. 76). Since his presidency, the code has undergone several reforms. Nevertheless, many Americans still seem to concur with President Carter's initial assessment. Some people feel the code is unfair, burdensome, intrusive, complicated, biased towards consumption, and otherwise just a wreck. Therefore, one of the biggest issues facing voters in the upcoming presidential election will be how the candidates propose dealing with the tax code. Recently, a few presidential hopefuls have developed radically new tax code proposals. The new codes would call for the abolishment of the current income tax system and possibly the 16th amendment, which gave Congress the power to impose income taxes. Such radical changes should not be taken lightly by the voters as the tax consequences could be immense.

The purpose of this thesis is to explore why tax reform has become such a major issue. Also, the pros and cons of each proposal will be discussed. Although the proposals will affect both individuals and businesses alike, the focus will be primarily on the effects each will have on individuals (disregarding some overlapping issues) since they, not businesses, will be voting in the upcoming election. After reading this thesis, voters will be able to assess if they may be "winners" or "losers" with the different tax proposals.
CHAPTER ONE - INTRODUCTION

The upcoming presidential election has caused a new wave of interest regarding tax reform in the United States, particularly in Congress. Although this wave has surfaced before, it has never been so forceful or well founded. In the past, major tax reform proposals were usually carried on by presidential longshot candidates (i.e., Jerry Brown in 1992). Historically, the foundation the reforms were built upon were too weak to withstand the public's demand for status quo. As a result, the only changes made to the tax system have been adjustments to the current tax code. In fact, there have been some 9,371 alterations made since 1981 (Miller, 1995). However, the tax system, by some people's account, has become too complex, burdensome, intrusive, and unfair. This critique is evident by all the negative evaluations the tax code receives from the media. It has become difficult, if not impossible, to read major newspapers or business periodicals without encountering a piece about the tax code. For the most part, these articles report that the public is ready for a change from the status quo. In other words, people are sick of simply adjusting and, consequently, complicating the code. Therefore, radical tax reform is a distinct possibility and a major issue that needs to be addressed by voters. Educated citizens must learn how the different proposals supported by various presidential candidates will affect their respective tax liabilities. If they do not gain this knowledge, they may unknowingly vote for tax increases for the poor and middle class and decreases for the rich.
Evolution of the Tax Code

The United States income tax code started out relatively simple. In 1861, an income tax was levied to help finance the cost of the Civil War. The tax was then abolished in 1872. Twelve years later, the income tax was re-established in response to complaints that relying on tariffs for revenues pushed the costs of imported goods up too high. Then, in 1895, Congress ruled that the income tax contradicted the Constitution by directly taxing individuals, and the tax was barred once again. However, the 16th amendment removed this ban in 1913, and the income tax as we know it was born.

Since 1913, the tax code has been modified to the point that it is nearly impossible to recognize the original system. Nevertheless, the basic foundation of the code has remained the same: taxing individuals in direct proportion to their respective incomes. However, in 1995, the Republicans gained control of Congress for the first time in forty years. Responding to the public outcry that the tax system has become too complicated, the Republicans are proposing the elimination of the income tax code. To replace the eighty-three year old income tax, they are suggesting several different types of consumption taxes, which include the flat tax, the unlimited savings allowance (USA) tax, the national sales tax, and the value added tax (VAT).

What is a Consumption Tax?

A consumption tax, as defined in Peat Marwick's 1995 Tax Reform Update, is as follows:
A tax on the total value added that is consumed within the economy. For the purpose of this definition, value added is defined as the summation, for all economic producers, of the difference between the value of output and the cost of input. Value added is the tax base of all consumption taxes—differences in consumption taxes arise from the methods of taxing that base. (p. 11)

In short, consumption is the only thing taxed under a consumption tax; savings and investment are not taxed at all. Also, consumption can be taxed through several different methods. As mentioned earlier, the major types of methods used to tax consumption are the flat tax, the consumed income tax (which the USA tax is modeled after), the national sales tax, and the value added tax. Each of these consumption taxes is discussed in detail in Chapter 3 (The Proposals).
CHAPTER TWO- REASONS TO CHANGE THE TAX CODE

There are several reasons why tax reform has become a big issue recently. In fact, this entire thesis could probably be devoted to telling horror stories of how the tax system failed and describing specific ills of the current tax code. Since there are bound to be horror stories about any type of tax system though, this thesis will primarily examine the major, or more general, arguments presented about the current system. As mentioned above, there are several general concerns about the current tax code which are heading the reform campaign. Although a few of the complaints are based on perception and not experience, they are, at the very least, spurning interest in tax reform.

Probably the biggest criticisms the tax code receives is how burdensome and complex it is. When initially established in 1913, the tax code was relatively simple. The rate started at 1% for the poor and rose to only 7% for the wealthy (Norton, 1995). However, over the years the code has grown immensely. In fact, the code is now four inches thick and contains over 4000 pages (Ruby, 1995). In addition, due to the complexity of the code, an additional nine inches of paper is used for explanations and regulations (Ruby, 1995). In total, the code, with all its regulations, is about 17,000 pages (McNamee, 1995). Likewise, the IRS estimates that individuals average about 2.1 billion hours at a total cost of $57 billion to comply with the U.S. tax system (anonymous, Business Week, 1995). As was previously mentioned, there have been 9,371 alterations made to the code since 1981. Also, 100 forms have been added to the code since 1985
(McNamee, 1995). As can be see from Figure one, the rate, in this case the top individual rate, has also been adjusted regularly, adding to the complexity.

Figure 1;

![Graph of Fall and Rise of the Top Individual Rate](source)


Additionally, a recent poll by Anderson Consulting reports that 59% of the American public think that the tax form is too difficult to fill out (Gleckman, 1995). Finally, many people feel that the code just does not work. This view is supported by the $127 billion of uncollected taxes in 1992 (McNamee, 1995).
Also, the tax code can be viewed as unfair and intrusive. For example, due to the complexity of the tax system, there are several loopholes and exemptions which naturally favor the rich. Likewise, the tax system can be intrusive. After all, the IRS sends out about one billion form 1099's to track interest, dividends, and other business income (anonymous, *Business Week*, 1995). Similarly, as Mike McNamee proclaims in the July 13, 1995, issue of *Business Week*, 33 million penalty notices were sent to taxpayers in 1994. From 1980 to 1993, the number of penalties assessed has grown 68%. However, $5 billion in penalties were levied in error and refunded in 1993. The intrusiveness of the IRS will only get worse, according to McNamee. In 1995, the service established its Taxpayer Compliance Measurement Program audits. In this program, the IRS picks about 150,000 individual and business returns at random and examines them line by line. Also, IRS agents are being taught "to rely more on 'economic reality'--studying a taxpayer's home, vacation, entertainment, and even health spending--for evidence of unreported income" (p. 85). For example, McNamee explains, in a 1993 audit of the Green Glen Bed & Breakfast, agents insisted the Inn underpaid by $540. Although Edwin and Martha Collins, the owners, supported every answer they gave with detailed records, the IRS insisted they paid too much on their guests' laundry and cleaning services.

Another reason there is an emphasis on reforming the tax code is because it is an election year. Many candidates are offering some form of a consumption tax as their niche in the race. For example, Malcolm Steve Forbes, Jr., has long been a proponent of a flat tax. In September, 1995, Forbes decided to join the presidential race. Upon his initial announcement, he was given a very slim chance even to make a mark in the election. The
only thing people noticed about Forbes was his family's assets, estimated to be between $200 million and $1 billion (Marks, 1995). However, Forbes began to gain momentum in the election by making the tax code his number one target. In fact, a New Hampshire poll taken in mid-October had Forbes in third place in the Republican race. His 7% of the potential vote was still well behind Bob Dole's 35%, but was only a bit behind Pat Buchanan's 9% (Independent Record, 1996).

In just over one month, Forbes was able to establish himself as a legitimate contender in the Republican race. Forbes' push to eliminate the current tax code and replace it with a flat tax has been fueling his political fire. Forbes refers to the current tax code rather explicitly by saying, "Scrap it, kill it, burn it and hope it doesn't rise again on Halloween!" (Marks, 1995, p. 18). The fact that Forbes was able to gain so much ground on his competitors in such little time implies that the tax code issue could have a major impact on the presidential election.

Finally, the last major criticism of the tax code is that it does not induce people to save and invest. Consumption taxes, on the other hand, were basically designed to get people to save and invest more by only taxing consumption. The low savings rate in the United States is definitely a well founded concern. For example, Figure two shows how the personal savings rate in the United States has fallen over the years, and Figure three and four show how far behind the United States is in gross savings and investment compared to other G-7 countries.
Figure 2:

**U.S. Personal Savings Rate**

Savings as a percentage of disposable income


Figure 3:

**Gross Savings and Investment**

Savings and investment are important to the economy because they are key ingredients in promoting a higher standard of living. For example, the availability of capital is directly related to a nation's national savings rate (Pete Marwick, 1995). Therefore, when the national savings level is increased, more capital is available to businesses. Under the economic principles of supply and demand, a large supply of capital would push the price of such capital down. The lower price of capital would consequently increase its demand by investors and employers. Therefore, the rate of capital investment made by employers would increase. By making more capital investments, businesses...
would improve efficiency. Increased efficiency leads to greater productivity and higher employee wages, which improves the standard of living. Therefore, savings is a very important component pertaining to economic growth.

**How Tax Reform Could Become A Reality**

Completely replacing a tax code that has been around for over eighty years will not be easy. There are monumental obstacles that would definitely have to be overcome to accomplish such a feat. Also, if it is decided that the code should be replaced, it could take years to tackle all the roadblocks. The major obstacles that would have to be overcome to successfully establish a consumption tax are illustrated in Pete Marwick's 1995 *Tax Reform Update* and are described below.

The first roadblock listed in the *Update* is the economy itself. Trying to develop a simple tax code in such a complex economy is definitely a difficult task. The drafters of the tax code must find a balance between simplification and fairness. The simplest systems are not always fair and the fairest systems are not always simple.

In addition, even a simple system designed to be completely fair has the potential to be fouled up. The author of the thesis once had a law teacher who often proclaimed, "The laws are always clear; it's the facts in the matter that screw things up." This logic definitely applies to the drafting of a new tax code. For example, a simple tax code with clear-cut rules would definitely lead to situations in which the literal application of the laws would be unfair. These special cases would call for the design of new rules and regulations to deal with similar matters. After several new cases, the tax code that was
originally drafted to simplify affairs would become complex. The current income tax code is an excellent example of how a simple tax system becomes complex over time. Initially, the current tax code was short and simple. However, it has been purposely complicated over the years in an attempt to increase fairness. An economy such as ours, with such an assortment of different income levels and transactions, naturally lends itself to a complex tax. Therefore, the complex nature of our economy makes it difficult to simplify anything.

To draft a system maintaining the same level of fairness while simplifying everything would be a difficult task. However, drafting the plan would be simple compared to enacting the plan. In the past, developing plans calling for radical changes such as this has been easy to create but difficult to enact. President Clinton's health care reform plan is a good example of how difficult it is to enact such major changes.

Dealing with the economy and enacting a plan are not the only obstacles that must be overcome for the reform to take hold. Some type of system, or procedures, must be devised to deal with the radical changes and carryovers that may result. Likewise, the system must raise the same or nearly the same amount of revenue as the old system. If it does not, a plan must be developed to deal with the discrepancy. Finally, replacing the tax system would definitely change people's tax position. As Pete Marwick's Update describes:

There will be winners and losers. The shift in tax burden created by changing the tax system can be enough by itself to kill any reform effort unless the immediate "losers" believe the long-term gain is worth the short-term pain. (p. 2)
Developing a plan that meets all of the criteria above is only half the battle, though. There are several political issues listed in Pete Marwick's Update that also must be addressed. First, a tax reform proposal must be supported by a presidential candidate. In fact, the candidate must not only support the proposal, but must have it as one of his or her top priorities. Then, the proposal must receive enough support to pass Congress. In the past, not many candidates were willing to risk making tax reform such a high priority. However, this year may be different. As explained earlier, Malcolm Forbes has made great strides in his campaign by making a flat tax his top priority.

In addition, the Update explains that both a presidential candidate and Congress must have broad public support in their pursuit of tax reform to make it happen. Even if enough support is generated by the public, maintaining enough support to enact the plan may be difficult. For example, Clinton's Health Care Reform plan was heavily supported initially. However, in the light of some difficult choices, the support faded and the plan stalled. Therefore, tax reform must not only gain strong initial support, but it must maintain strong support throughout its establishment. To maintain such strong support, the public must feel that the change is absolutely necessary. As the Pete Marwick's Update describes:

Only if the man or woman in the street believes there is a real crisis—a system collapsing under the weight of complexity, and the American standard of living and his or her future jeopardized by the low savings rate—will the support for tax reform develop the muscle for the heavy lifting that lies ahead. (p. 3)
Finally, one of the new proposals must be seen as a significant improvement over the current tax code.

Really, it is impossible to tell if all of these roadblocks can be overcome. However, there are strong indications that this may be the year that the income tax will begin to be replaced. For example, there are several different consumption tax proposals on the table already. Each of these proposals has proponents claiming that they can successfully replace the current income tax system. Granted, there have been people in the past, like Jerry Brown, claiming that they have developed the perfect tax system, and they always end up being incorrect; but with all the attention reform is receiving, this year may actually be different.

Just as in the past, all the proposals claim that they can fit into the United States' complex society and work wonders. This claim really cannot be proven or disproven though; it can only be debated. Nevertheless, the proponents of tax reform do have some strong cases (which will be explained in chapter three). As mentioned earlier, there are presidential candidates making tax reform their top priority. In addition, Congress is much more favorable to tax reform than it has been in the past, mainly because of the Republicans' sweeping victory in the last election. There are now several key Congressional leaders calling for tax reform. For example, Bill Archer, chairman of the House Ways and Means Committee, says to "tear the income-tax system out by its roots" (Miller, 1995, p. 67). Senate Finance Committee Chairman Bob Packwood preaches that the tax code should be fundamentally reformed this year (Miller, 1995). Similarly, majority leader of the House Richard Armey is calling for reform as is minority leader
Richard Gephardt. The one notable leader absent from the reform party is President

Clinton. Without presidential support, reform is nearly impossible. However, those near
the President say he is paying close attention to the tax reform debate and that he is
concerned about increasing the savings level while maintaining fairness (Richman, 1995).

Nevertheless, even if President Clinton does not support a reform proposal, 1996 is an
election year and there are candidates pushing for reform.

Also, there is a strong indication that the public is fed up with the current tax

system. As mentioned before, a recent poll showed that 59% of the public believe it is too
difficult to fill out their taxes. Whether there is enough support in the public to change the
tax system radically remains to be seen. Although polls and the media depict people as
being unhappy with the current system, voters may not like the new proposals enough to
vote for a radical change. After all, a new tax system would definitely create winners and
losers. Voters may not be ready to take the chance that they will become a losers. Early
indications, however, show that there is at least a possibility that support for tax reform
will be present.

Although the focus of this thesis is on individuals, there are certain business groups
forming that may help tax reform come about. Therefore, it is worthwhile to mention a
few of these groups. A consumption tax is heavily favored by capital intensive businesses
and most manufacturers. In fact, several major associations in these industries are
campaigning strongly for a consumption tax. The Alliance USA coalition made the
unlimited savings allowance tax their main focus (Miller, 1995). Alliance USA is headed
by two industry giants, Alca CEO Paul O'Neill and Chrysler COO Robert Lutz. Currently,
the alliance is trying to "attract thousands of corporations and trade associations as members, as well as labor unions and academics" (Miller, 1995, p. 68). Additionally, the National Association of Manufacturers (NAM) is also pulling for a consumption tax. NAM’s senior Vice President Paul Huard "puts the prospects for overall restructuring at 1 in 3. They used to be 0" (Miller, 1995, pp. 65-67). Huard’s optimism is also shared by others in the industry. For example, American Council for Capital Formation (ACCF) President Mark Bloomfield believes the only question left about tax reform is "How soon?" (Miller, 1995, p. 65).

Although a consumption tax is heavily favored by capital intensive and most manufacturing businesses, it is adamantly opposed by those in retail and wholesale businesses, as well as the realty industry. If a consumption tax is passed, retailers and wholesalers believe that they will become the losers in the change. Their opposition is based on the fact that they depend on consumption—which would become taxed. In the realty industry, some predict that the value of houses could drop as much as much as 15%\(^1\) without the mortgage deduction (Middleton, 1995). This could severely hurt realtors, builders, and homeowners.

Just as there are powerful associations favoring a consumption tax, there are likewise associations opposing it. For example, The National Federation of Independent Business (NFIB) and the National Association of Wholesalers & Distributors are against a consumption tax (Miller, 1995). Still, members of the (NFIB) are scrutinizing the issue in an attempt to simplify matters. Their President, Jack Faris, believes the members "could be for a flat tax. But they'd want to know what's in it" (Miller, 1995, p. 70).

\(^1\) Estimate is by the economic consulting firm DRI/McGraw-Hill.
The business sector could have a major influence on whether tax reform passes or not. The big issue comes down to what side successfully sells its view to the voters and Congress. Currently, the proponents of tax reform are very optimistic that tax reform is coming and coming soon. In fact, the ABC President says "I used to be conservative and say that fundamental tax reform might happen someday. Now I tell people that it will happen, and that it'll happen within the next five years" (Miller, 1995, p. 70). This statement summarizes the general belief many proponents of reform hold. Still, there will be industries fighting a consumption tax vehemently until the end.
CHAPTER THREE- THE PROPOSALS

There are several different proposals to replace the current income tax system. All of the proposals would change the tax code from an income taxing system to a consumption taxing system. There are basically four major reform proposals and most contain a number of secondary proposals. This chapter will discuss each in detail by explaining the tax and its intended benefits. Then, the author will discuss the criticism of each proposal.

The Flat Tax

Originally, the flat tax was introduced to the public by Hoover Institution economists Robert E. Hall and Alvin Rabushka fifteen years ago. Currently, several congressmen have developed their own flat tax plans based on Hall and Rabushka's. The three most notable plans are by congressmen Richard Armey, Arlen Spector, and Richard Gephardt. All of their proposals are probably more popular than the Hall-Rabushka plan simply because they are able to get more press. However, all of the plans are based on the same principle: simplification. The flat tax is a very simple concept. In fact, it is basically explained in its name--flat. There is only one level of tax under such a system and all income is taxed at that single rate. Likewise, wages and pension distributions are taxed only once so various incomes like dividends are not taxed at the individual level. To maintain its simplicity, there are very few, if any, deductions allowed under this tax. Finally, all of the current flat tax proposals allow individuals to take some amount (the
amounts are different under various proposals) as standard and dependent deductions (doing so helps counteract its regressive nature).

Since Hall and Rabushka have been working on their plan the longest and it serves as the model upon which the others are based upon, it will be discussed first. Doing so will explain the foundation on which the current flat tax plans have been modeled. Therefore, when explaining the others, the author will focus primarily on the differences between them and the Hall-Rabushka plan.

The Hall-Rabushka Plan

Robert E. Hall and Alvin Rabushka are economists at the Hoover Institution, Stanford University. They developed a flat tax plan that they propose should replace the current income tax system. By doing so, they argue, the tax code would be much easier to comply with since people could fill out their taxes on a postcard. Individuals would no longer need to seek the advice of accountants and tax attorneys to sift through the countless pages of the current code. Rather, they could do their taxes at home in a matter of minutes. In addition, they believe that their plan would raise the same amount of revenue as the current system. The following explanation of the Hall-Rabushka plan is based on an article printed in the April, 1995, issue of Consumers' Research, pp. 23-28. The article was written by Hall and Rabushka themselves.

The key component of the Hall-Rabushka plan is, as in all flat tax plans, simplicity by taxing all income only once. By taxing all income once and at the same rate, Hall and Rabushka also argue that the system would become fairer. Currently, the tax system
double taxes some things and does not tax others at all. For example, dividends and capital gains are taxed at the corporate level and individual level while fringe benefits are not taxed (p. 23). Hall and Rabushka propose replacing the current system with a 19% flat tax rate. At this rate, all income would be taxed only once and as close as possible to its source. Since it is a consumption tax, families would be taxed only "on what they take out of the economy, not what they put into it" (p. 23). Their plan would also apply to both businesses and individuals as all income would be classified as either business income or wages. A different tax form would be used for each. However, both types of tax forms would be simple enough to fit on a postcard and would be taxed at the uniform rate of 19%.

The elimination of several rates, they argue, would increase equality in the tax code. Currently, by taxing different forms of income at different rates, the code allows people the opportunity to take advantage of the differences. In other words, the rich are able to find loopholes to protect themselves. Taxing all forms of income at the same rate would eliminate the loopholes, and everyone would be faced with the same tax level.

Currently, the main incentive for people to save is the exclusion of savings for retirement funds from the tax base (p. 23). Therefore, workers are able to contribute to pension funds without that income being taxed. Similarly, employees can deduct their contributions to the employees' funds. The incentive is also open to the self-employed as they can deduct contributions to Keogh, IRA, and Simplified Employee Pension (SEP) plans. However, there are not many other incentives to save. As the figures presented in chapter two indicate, the savings incentives are not working too well. The level of savings
and investment in the United States is very low. However, Hall and Rabushka think that their plan would spur savings and investment by not taxing earnings from savings. In other words, capital gains and dividends would not be taxed at the individual level under their plan.

The taxes on individuals would be one of two parts of this plan. The other is the taxes on businesses. However, since the thesis focuses on how the tax proposals affect individuals, only issues relating to individuals' taxes in the Hall-Rabushka plan will be discussed. As mentioned earlier, the Hall-Rabushka plan calls for a 19% flat rate. The rate would apply to a base consisting of wages, salaries, and pensions actually received. Contributions to pension funds would not be taxed. Instead, pension income would be taxed only "when the retired worker actually receives the pension, not when the employer sets aside the money to pay the future pension" (p. 24). As Hall and Rabushka profess, "This principle will apply even if the employer pays into a separate pension fund, if the worker makes a voluntary contribution to a 410(k) program, or if the worker contributes to a Keogh, IRA or SEP fund" (p. 24).

The plan also calls for a personal allowance deduction that adjusts depending on the taxpayer. The adjustment of this allowance is what Hall and Rabushka claim makes the tax progressive (p. 24). In addition, the allowance would be adjusted in accordance with the cost of living. For example, the personal allowance would be $16,500 for a married couple filing jointly; $9,500 for a single taxpayer; and $14,000 for a head of the household. The plan would also allow a deduction for dependents. A deduction of $4,500 would be allowed for each dependent. After adding all wages and salaries, then
deducting the personal and dependent deductions, all the taxpayer would have to do is multiply the remaining number by 19% to get his or her tax. After considering the taxes withheld by the employer, the taxpayer could determine the amount due or the refund due. The plan is that easy! Hall and Rabushka estimate that filling out the postcard would cover 80% of the population’s total tax responsibilities (p. 24).

<table>
<thead>
<tr>
<th>Form 1</th>
<th>Individual Wage Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your first name and initial (if joint return, also give spouse’s name and initial)</td>
<td>Last name</td>
</tr>
<tr>
<td>Home address (number and street including apartment or rural route)</td>
<td>Spouse’s social security number</td>
</tr>
<tr>
<td>City, town, or post office, state, and ZIP code</td>
<td>Your occupation</td>
</tr>
<tr>
<td></td>
<td>Spouse’s occupation</td>
</tr>
</tbody>
</table>

1. Wages and salary
2. Pension and retirement benefits
3. Total compensation (line 1 plus line 2)
4. Personal allowance
   (a) $16,500 for married filing jointly
   (b) $9,500 for single
   (c) $14,000 for single head of household
5. Number of dependents, not including spouse
6. Personal allowance (line 5 multiplied by $4,500)
7. Total personal allowances (line 4 plus line 6)
8. Taxable compensation (line 3 less line 7, if positive: otherwise zero)
9. Tax (19% of line 8)
10. Tax withheld by employer
11. Tax due (line 9 less line 10, if positive)
12. Refund due (line 10 less line 9, if positive)


Hall and Rabushka’s article then explains the major details of their flat tax plan. In particular, they explain how the flat tax will overcome some of the major obstacles mentioned above. Therefore, this thesis will continue to follow the format that they used and quote their article often. By reading excerpts from the makers of the plan, thesis readers will be able to understand the plan as Hall and Rabushka wrote it.

The first element of the current tax code that Hall and Rabushka believe they could improve is the treatment of fringe benefits. Currently, fringe benefits are not taxed at all at
the individual level but are deductible by employers. Therefore, they are a very attractive way employers can pay employees and disguise wages. According to Hall and Rabushka, fringes have been becoming very attractive as taxes have risen. For example, they state that in 1929, 1.2% of the total wages were for fringes. However, as tax rates have risen, so has the number of fringes. In 1993, almost 18% of total wages was in the form of fringe benefits (p. 25).

Hall and Rabushka believe that fringes are "an economically inefficient way to pay workers" (p. 25). They think the extra money fringes entail should be given to the workers in the form of cash wages. By doing so, they argue, employers would allow workers to "make their own decisions about health and life insurance, parking, exercise facilities, and all other things they now get from their employers without much choice" (p. 25). Hall and Rabushka believe that fringes should be taxed just like wages at the flat rate of 19%. Consequently, fringes would no longer be so attractive to workers. Therefore, Hall and Rabushka believe workers would rather receive their income in the form of cash. Finally, the two economists make the argument that since fringes are currently not taxed, other forms of tax must be higher to compensate for the lost tax revenue. By taxing fringes, the government could lower the overall tax rates.

The next issue Hall and Rabushka tackle is capital gains. Under their plan, all capital gains would be taxed at the business level, never at the individual level. This way, the gains would be taxed only once, eliminating double taxation. One exception Hall and Rabushka make in their plan pertaining to capital gains involves gains on owner-occupied houses. These capital gains would not be taxed at all. Hall and Rabushka believe that
very few capital gains on houses are taxed right now anyway because "gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death" (p. 25). Similarly, they suggest that property taxes already cover taxes on the home. By taxing capital gains on houses the government would be practicing double taxation; just as "adding a capital gains tax on top of an income tax is double taxation of business income" (p. 25).

Hall and Rabushka then discuss how they would handle transitional issues. Transitional issues are the general problems that would arise from switching tax systems. For example, Hall and Rabushka give the example of depreciation and interest deductions as major transitional issues. These are transitional issues because taxpayers may have made long term plans and commitments related to these in the future. Switching tax systems would definitely interfere with their plans.

Since this thesis concentrates on individuals, only Hall and Rabushka's plan for dealing with the loss of interest deductions will be discussed. In particular, the author will explain their plan to deal with the loss of the mortgage interest deduction.

In their article, Hall and Rabushka concede that there will definitely be winners and losers in the tax switch. A major class of losers would be those who depend on mortgage interest deductions to buy houses. Hall and Rabushka think that Congress may want some type of plan to help these particular people. Therefore, they developed a plan just for this situation. Their plan to deal with interest deductions follows:

Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses, the lender must treat the interest as taxable income. But the
borrower's deduction should be only 90% of the actual interest payment, while the
lender's taxable income should include 100% of the interest receipts. (p. 26)

This plan would still allow a 90% deduction for individuals who depend on a mortgage
interest deduction. The amount allowed, Hall and Rabushka say, would probably be
even to satisfy most people. However, they believe that their plan would induce people
to re-negotiate their interest payments. Hall and Rabushka give this specific example:

Suppose a family is paying $10,000 in annual mortgage interest. They could stick
with this payment and deduct $9,000 of it per year. Their net cost, after subtracting
the value of their deduction with the 19% tax rate, would be $8,290. The net income
to the bank, after subtracting the 19% tax it pays on the whole $10,000, would be
$8,100. Alternatively, the family could accept a deal proposed by the bank: The
interest payment would be lowered to $8,200 by rewriting the mortgage. The family
would agree to forego their right to deduct the interest, and the bank would no longer
have to pay tax on the interest. Now the couple's cost will be $8,200 and the bank's
income will be $8,200. The family will come out $90 ahead and the bank will come
out $100 ahead. The deal will be beneficial to both. (p. 26)

One of the good aspects of the plan, according to Hall and Rabushka, is that lenders
would always want borrowers to try to renegotiate. If they didn't, they would have a tax
bill that is 10% larger than the borrower's deduction. Similarly, the plan would work with
both old and new borrowings. Hall and Rabushka claim that it does not matter if the
borrowings took place before or after tax reform.
Hall and Rabushka believe that their plan would also affect interest rates. In particular, they think that a flat tax would pull interest rates down. The reasoning is based on their belief that interest rates are high partially because of "the income-tax deduction for interest paid and the tax on interest earned" (p. 26). Lenders must get high interest rates because of the taxes on interest income. As a result, Hall and Rabushka say lenders demand high interest rates and borrowers agree to them. However, the Hall-Rabushka flat tax does not tax interest. Therefore, lenders would not demand such high rates and borrowers would refuse to pay high rates. Lenders and borrowers would consequently decide on much lower interest rates, according to Hall and Rabushka.

In fact, Hall and Rabushka believe that the interest rate fall could be "spectacular" (p. 27). For example, they say that most borrowers and lenders are typically in the upper tax brackets. Under the assumption that all lenders and borrowers are in the top tax bracket of 40% (actually 39.6% but it is rounded up to 40%), tax reform would have a huge impact on interest rates. Hall and Rabushka propose that eliminating the deduction and taxation of interest would cause interest rates to fall by a factor of .4 if the above were true. However, they concede that not all borrowers and lenders are in the top brackets. Similarly, many in the top brackets find ways to get interest income at lower rates. Therefore, they believe the actual drop would be a little lower than a factor of .4. They estimate the factor to be closer to .2 (p. 27). Still, a .2 factor would drop a 10% interest rate to 8%, a considerable drop.

Finally, Hall and Rabushka discuss a major concern many people hold about the flat tax—effects on the housing market. Many people feel that eliminating the mortgage
deduction would cause house prices to tumble. However, Hall and Rabushka do not think the effects, if there are some effects, would be a concern. They go on to explain that house prices are set by the economic principles of supply and demand in all but the long run. Since supply changes slowly, any effects of tax reform would not be felt immediately in the housing market.

The two economists go on to explain that if their flat tax did not affect interest rates, then the effect of tax reform would definitely hurt the housing market. They also offered this example pertaining to the effects on the market without considering interest rates:

A $200,000 house with a $120,000 mortgage at 10% has interest costs of $12,000 per year before deductions and $8,640 after deductions (for someone in the 28% tax bracket). The monthly carrying cost is $720. Take away the deductions, and the carrying cost jumps to $12,000 per year or $1,000 per month. Inevitably, the prospective purchaser faced with this change would have to settle for a cheaper house. Collectively, the reluctance of purchasers would bring house prices down so that the buyers could afford the houses on the market. (pp. 27-28)

Although Hall and Rabushka concede that their plan probably would not stimulate the housing market, they do think lower interest rates will offset any decline. They use the example of the high interest rates of the 1980's. During this time, housing prices plummeted. Therefore, they argue that housing prices are inversely related to interest rates. If their flat tax is installed, interest rates would fall immediately, causing house prices to go up. However, the elimination of the mortgage deduction would cause house prices to ...
prices to go down. The two forces should offset each other and house prices would remain constant--affected only by a rather unstable market (pp. 27-28).

Hall and Rabushka also believe that after the initial drop in interest rates, a "rip-roaring investment boom" (p. 28) could take place. An investment boom would cause interest rates to go up. As a result, corporations would compete with home buyers for funds and house prices would drop. The situation, Hall and Rabushka believe, would be similar to the investment boom of the 1960's. In addition, the investment boom would strengthen the overall economy and create new jobs. The booming economy should compensate for "minor disappointments in housing values" (p. 28). Also, Hall and Rabushka say that "in the long run, higher incomes will bring a stronger housing market" (p. 28).

Still, homeowners who do not want to sell or buy would experience a major pinch which would not be offset with low interest rates. Rather, they would only feel the sting of losing their mortgage deduction. However, that is exactly why Hall and Rabushka developed the plan to allow these particular individuals to deduct 90% of their mortgage deductions.
The Dick Armey Plan

As explained before, the Armey plan is modeled after the Hall-Rabushka plan. However, Armey's plan is definitely the most radical and most popular. Armey insists that his plan will be "The great debate of 1996!" (Richman, 1995, p. 36). Similar to the Hall-Rabushka plan, Armey's main focus is simplicity. He claims that his plan will replace the 437 tax forms the IRS currently uses with two simple postcard forms: one for businesses and one for individuals (Richman, 1995). Similarly, Armey claims that thousands of accountants and tax attorneys would no longer be needed to sift through the countless pages of the current tax code. Finally, he believes that his system would eliminate the wasted billions of dollars used for tax compliance, the various loopholes, and the countless exemptions. In other words, his system would simplify everything immensely.

Since Armey's plan is considered to have the best political prospects and greatest amount of support, it deserves careful study. Just as the Hall-Rabushka plan was explained in basically their own words, so too will Armey's plan be explained. Thus, the plan is described as the original drafters intended it.

Texas Congressman Dick Armey first introduced his plan on June 16, 1994. Shortly after, on July 19, 1995, the plan was introduced to Congress by Armey and Senator Richard Shelby of Alabama. Officially, Armey's flat tax plan is called The Freedom and Fairness Restoration Act (FFRA). Initially, Armey calls for a 20% flat tax rate. However, after two years, the rate would be dropped to 17%. Armey believes the rate can be dropped after two years for two reasons. First, the 20% rate and beneficial
treatment of savings will cause economic growth and increase the Treasury's revenues. Second, the bill contains spending reforms that would decrease the government's expenditures. In addition, the plan calls for a $13,100 single personal allowance ($26,200 for a married couple) and a $5,300 deduction for each dependent. These amounts, Armey claims, would be indexed for inflation in the future (Gray, 1995). Also, Armey's flat tax eliminates all deductions. Unlike the Hall-Rabushka plan, Armey has not developed a contingency plan for the loss of the mortgage interest deduction. Armey says that allowing some deductions would be like "introducing a virus into a computer system, pretty soon it destroys everything" (Gray, 1995, p. 22). Likewise, the flat tax would completely replace the current income tax system but not affect Social Security and Medicare payroll taxes. Finally, Social Security benefits would be tax free.

Armey claims that the 17% rate is low enough to give almost all taxpayers a significant tax break while high enough to meet the government's revenue needs. However, Armey does concede the point that the government will have to make significant cuts. Armey claims that the 17% rate would raise about $40 billion less than the current tax system (Foster, 1995) (although this figure is widely disputed and will be discussed later). Likewise, Armey claims that his system has several benefits over the current income tax system.

First, Armey asserts that his plan is much simpler. Taxpayers would no longer have to spend hours and hours each year filing their returns. Rather, all the taxpayer would have to do is spend a few minutes completing a ten-step postcard. Second, the flat tax increases fairness, Army claims. Fairness would be restored by treating everyone the
same. However, it would also be progressive with its generous deduction amounts. For example, no income is paid on a family of four's first $36,800. Armey estimates that as many as 10 million poor people will not pay any taxes as a result of the deduction (Armey, 1996, Tax Reform News).

In addition to increasing simplicity and fairness, Armey claims that his plan will create economic growth. Since savings would no longer be taxed and tax rates would be decreased, Armey claims that productive investment and, consequently, economic growth, would occur. In addition, he estimates that the average annual income "of the typical American family" would increase by $4,300 by 2002 (Armey and Shelby, 1995, Freedom and Fairness Restoration Act Summary). Finally, to prevent congressmen from complicating the system in the future, the bill has guards against tampering. For example, 60% of the House and Senate need to agree to raise the rate, create multiple rates, lower allowances, and add loopholes (Armey and Shelby, 1995, FFRA Summary).

As mentioned earlier, Armey has proposed several spending restraints in his bill. These restraints, as explained in Armey and Shelby's FFRA Summary, would help ease the pain of the reduction in revenues that his flat tax proposal would create. In addition, the restraints would allow the tax rate of 20% to be lowered to 17% after two years. The first restraint Armey proposes is to cut most federal programs. As Armey says, "All discretionary and unearned entitlement programs are sunset, i.e., set to expire automatically, within two years of enactment of the bill, and again following each decennial census thereafter" (p. 4). However, Armey's bill would not "sunset" Social Security, Medicare, veteran's benefits, or federal retirement. Still, Armey believes the bill
will force Congress to examine every federal program and decide which ones are absolutely essential as all others would be cut.

In a similar matter, the bill caps entitlement spending. As Armey explains:

The bill provides that the total level of entitlement spending, excluding Social Security, may not exceed the increase in inflation as measured by the consumer price index, plus the growth in eligible population. If the increase in these programs exceeds this level, an automatic entitlement sequester to eliminate the excess spending will fall on all entitlements except Social Security. (p. 4)

Also, the bill would cap the total federal spending. These caps, Armey claims, would balance the federal budget by 2002 (p. 4). Finally, the bill establishes an 80-20 formula to deal with excess spending. On July 1 of every year, the President’s Office of Management and Budget would determine if spending caps have been exceeded. If they have, then an “across-the-board sequester would cut 80 percent from domestic discretionary spending and 20 percent from defense spending” (p. 4).

Armey concedes the fact that many citizens are worried about several aspects of his plan. In particular, the loss of the mortgage interest deduction concerns many people. However, Armey believes that their fears are groundless. Just as Hall and Rabushka predict that a flat tax would lower interest rates, so does Armey (Armey, 1995, Tax Reform News). The lower interest rates, Armey predicts, would lead to a higher demand for housing. The higher demand would cause house prices to go up, or at least stay the same. In addition, the lower interest rates would help create more jobs with better pay. Since there would no longer be any double taxation, business people would be more
inclined to invest in new jobs, Armey believes. Likewise, any inheritance parents leave for their children would no longer be taxed (p. 2). Again, this is another way to increase people's savings and investments. As Armey says, "Under a flat tax, we'll see economic growth that will raise American's wages and standards of living. The current code puts those who work hard into higher tax brackets, and punishes those who save and invest by taxing savings twice" (Middleton, 1995, p. 6).

Another area of concern about a flat tax is in the municipal bond market. Many municipal governments and municipal bond holders are concerned that a flat tax would hurt local governments' ability to raise revenues by issuing bonds. Since all interest would become tax deductible, tax-free munis could lose much of their appeal. Consequently, the market for tax free municipal bonds could be hurt severely. However, Armey does not believe that municipalities would have any difficulty financing their infrastructure needs. In fact, he believes that all interest rates would fall to the same level as tax-free municipal bonds. Therefore, the bonds would be just as attractive as any other bond. In addition, Armey says that "states will gain from a revenue windfall as the economy booms under a flat tax" (Middleton, 1995, p. 6).

Other Flat Tax Plans

There are also several other flat tax proposals currently on the table. All the others are very similar to the Hall-Rabushka and Armey proposals. However, the other tax proposals have not gained as much popularity as the Armey plan. Nevertheless, they are definitely worth mentioning.
Probably the most noticeable plan of late is that of Malcolm Forbes, Jr. Forbes is currently gaining notoriety through his presidential campaign. His plan calls for a 17% flat tax rate similar to Armey's (Marks, 1995). Another presidential hopeful with a flat tax proposal is Senator Arlen Spector (R-Penn.). His plan, explained on page 14 of Pete Marwick's 1995 Tax Reform Update, calls for a flat 20% rate. However, Spector's plan has some key differences from Armey's. For example, Spector would maintain a deduction for mortgage and charitable contributions. Deductions for interest would be allowed on home mortgages up to $100,000. Similarly, a deduction of $2,500 would be allowed for charitable contributions. In addition, Spector's exemption amounts differ. He proposes a $9,500 exemption for single taxpayers ($16,500 for married taxpayers) and a $4,500 deduction for each dependent. Plans similar to Spector's have been developed by other GOP candidates as well. For example, Pat Buchanan (15% rate) and Phil Gramm (16% rate) have developed plans that do not eliminate the mortgage interest and charitable deductions.

All of the flat tax proposals mentioned so far have been proposed by Republicans. However, a Democrat is also developing a flat tax proposal of his own. Richard A. Gephart is working on a plan that would be considerably "flatter" and more progressive than the Republican's plans. Gephart's plan is described by Sheldon Pollach in the September issue of The New Republic. His initial tax rate was set at about 10 or 11% on all but the wealthiest 20% of taxpayers. However, his plan has since been modified and now contains five tax brackets. The lowest bracket still starts at about 10% but the top bracket is set at about 34%.
In conclusion, all of the flat tax proposals are very similar. For most plans, the only differences reside in the rates and how deductions such as mortgage interest and charitable contributions are treated. Nevertheless, the structure of all the proposals are virtually the same and modeled after the Hall-Rabushka plan. Therefore, the next section of this thesis criticizes all of the flat tax proposals collectively. The only criticisms that may not apply to all of the proposals deal with how the different deductions are treated.

_Criticisms of the Flat Tax_

The flat tax proposition is a very heated debate. Just as in all debates, there are two sides to the issue. In the section above, the author discussed the flat tax proposals as the drafters intended them to be. Naturally, the creators of the proposals talked only about the positive aspects of their respective plans. However, this section will allow readers to examine the other side of the story.

_Revenue Neutrality_

One of the biggest criticisms of the flat tax concerns revenue neutrality. Critics argue that none of the flat tax proposals will generate as much revenue as the current income tax. For example, the Tax Foundation estimates that the tax level would have to be set at 21.1% (Foster, 1995) to raise the same amount of revenue; DRI/McGraw Hill estimates 22% (Richman, 1995); and the Treasury says it might have to be as high as 23% (Gleckman, 1995) or 25.8% (Pollack, 1995). Also, some experts estimate that the rate may have to be as high as 28% to be revenue neutral depending on if any deductions like
mortgage interest or charitable contributions are allowed (Middleton, 1995). The only plan that makes any real concessions about the revenue deficit is Dick Armey's. However, he claims that his plan will only come up $40 billion short while the Treasury estimates the figure to be about $186 billion (Kinsley, 1995, pp. 7-8). The discrepancy is $146 billion! In addition, Armey says the government should make do with less revenue. In other words, he thinks a flat tax is necessary to shrink government spending; it is why he developed the proposed budget cuts mentioned above. Although Armey believes the tax cuts need to be $146 billion less than the Treasury Department does, it would still be extremely difficult to cut anything. After all, last May a new budget passed the House Budget Committee to eliminate the deficit by enacting spending cuts of $459 billion over the next five years (Foster, 1995). Therefore, Armey would have to make his annual $40 billion to $186 billion in cuts on top of those already committed to balance the budget!

Fairness

Another criticism involves the fairness issue. Proponents of the flat tax claim that making everyone pay the same rate is inherently fair--everyone is placed on the same level. Similarly, they claim that the flat tax is progressive. However, the tax rate for the rich would be cut from 39.6% to around 20%, depending on the specific plan. In addition, the very poor would no longer pay any taxes. Therefore, a larger share of the total tax revenue would naturally have to come from the middle class. A recent study from the Treasury supports this position (McIntyre, 1995). At a revenue neutral rate of about 23%, the Treasury found that the average family's tax bill would go up $1,700. In

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2 Pollack lists the Treasury Department's number as $200 billion (Pollack, 1995, p. 18).
opposition, the very rich would benefit from an estimated $55,000 tax cut! These figures concur with a 1982 study by President Ronald Reagan's Treasury Department (McIntyre, 1995). This study found that tax liability would be shifted from the rich to the average taxpayer under a flat tax. In particular, taxes for families earning less than $20,000 would nearly double while those earning over $100,000 would see their taxes almost cut in half. Is it really fair to shift the majority of the tax liability from the very rich to the average taxpayer?

Similarly, taxpayers who are able to invest more (typically the rich) would benefit under a flat tax. Those who are not able to invest (typically the middle class and poor) though, could be hurt by a flat tax. In fact, a rich family with ample investment income might actually pay less tax than a middle income family earning strictly wages. For example, a middle class family of four earning $50,000 in wages would pay $2,640 in taxes under Armey's 20% rate. However, a rich family living off $2 million in investment and dividend income would pay nothing! Granted, the middle class family would be given the same treatment if they had investment income. Still, a family that earns more naturally has a greater opportunity to invest and save. Therefore, a flat tax definitely favors the rich in this regard.

Critics of the flat tax can also argue that many of the premises proponents say increase fairness actually do just the opposite. For example, proponents say that all income would be taxed under the flat tax. This point is true. However, critics such as Robert McIntyre contend that proponents are trying to make people believe that the rich are not paying their share of taxes. In other words, they want to convince people that the
rich are skipping out. According to McIntyre’s article in the *New Republic*, though, the compliance rate with taxes on wages is around 99% (p. 16). In addition, three-fifths of total income tax revenues is supplied by the wealthiest 10% of the population (p. 16).

Where the current income tax system fails, according to McIntyre, is in its collecting of investment income. There are too many loopholes which can hide this type of income. However, instead of trying to close the loopholes, McIntyre believes proponents are trying to create one huge loophole by not taxing any investment income (p. 16). The current income tax system does make the wealthiest people pay the most. However, McIntyre believes that switching to a flat tax would reverse this trend (p. 16).

Another big loser in the switch to a flat tax could be individuals unable to combat significant price increases. Robert Eisner, in his April, 1995, *Consumer Research* magazine article, said that prices will rise substantially with the installation of a flat tax (p. 26). Since businesses will pay more in taxes, he believes that they will pass their excess costs on to the consumers. In fact, Eisner estimates that the price increase could be as high 4.83% on consumer goods (p. 26). This price increase would be especially devastating for "low-wage earners without government support" (p. 27). The very poor, whose government assistance is indexed to inflation, would be afforded some protection. However, taxpayers with incomes so low that they pay very little in taxes already would feel a pinch. After all, they pay so little in taxes now that the large exemption amounts would not help much. In addition, any tax that they would have to pay would be taxed at the initial rate of 20%, notably higher than the current 15% rate they presently face (p.27).
Therefore, the large personal exemptions might not help these taxpayers enough to offset the increase in prices.

This fairness issue also relates to the progressivity of a flat tax. Proponents claim that by taxing everyone at the same rate, the flat tax is progressive. If taxpayers earn more, they pay a higher tax, and consequently, the tax is progressive. However, since investment income is not taxed, the rich can earn considerably more and still pay less tax. This scenario is actually regressive rather than progressive.

Robert McIntyre compares the flat tax to Reaganomics (McIntyre, 1995). During Reagan's Presidency, taxes on savings, investment, and capital income were slashed in an attempt to stimulate the economy. The rational behind these cuts was that they were supposed to make more people save and invest. Then, increased saving and investment by the rich would trickle down throughout the economy. However, the tax cuts led only to weak business investment and huge tax shelters (p. 15). McIntyre believes that the flat tax is very similar to Reaganomics in that savings, investment, and capital income would not be taxed at all in an attempt to stimulate savings and investment (p. 15). Again, he says that this would benefit the rich and hurt the middle class.

**Elimination of Deductions**

A third major criticism of the flat tax is the effect it would have on retirees. Eliminating the deduction allowed for contributions to employee pension plans would cause employers to stop contributing. Therefore, employees would lose right away. However, proponents (Hall and Rabushka) claim that employers would more than likely
offset the difference by increasing employees' wages. Therefore, the employees could invest in their own plans. Even if employers increased wages enough to completely offset the difference—and employees invest the entire amount—critics still argue that employees would end as losers (Johnston, 1995). The reason they would be losers is because the money already in the pension plan would be worth less if the plan stopped than if it were to continue. Therefore, workers with halted pension plans would not be able to save the same amount in a new plan at the same rate. Rather, these workers would have to save at a higher rate to retire with the same amount of money that they would have had under their old plan. Also, if an employer is putting 7% in an employee’s pension plan, then halts the plan and raises pay by 7%, the worker would still lose (Johnston, 1995). To attain the same amount of total savings upon retirement, that worker would have to save at a level above the 7% pay increase. Clearly, workers with a vested interest in a pension plan would be hurt with the adoption of a flat tax.

Still, proponents of a flat tax say workers without such an interest in a current plan would be at no disadvantage. For example, returning to the example above explained by Johnston, if the worker were given the option of having 7% of his pay put in a pension plan or being given a 7% raise, it would make no difference. As long as someone put 7% in the plan, the total would come out the same in the end. However, Gerald Cole, a special counsel for employee benefits and research at Milliman & Robertson, believes these workers would also be hurt. Cole provides this example in the July 9, 1995 issue of The New York Times written by David Cay Johnston;

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3 Milliman & Robertson is a consulting firm.
A hypothetical 40-year-old man who, after three years at his job, makes $60,000. He plans to retire at age 67 on his pension, which will pay 42 percent of his final salary based on a working-life contribution of 7 percent of pay (p. F5).

Johnston further explained Cole's example by citing Milliman & Robert's estimate that the particular employee, in his circumstances, would need $1,015 million to retire. An unhalted pension plan would furnish $701,000. Therefore, the employee would have to save only 4.1% of his or her salary to attain the other $314,000 (p. F5).

However, Johnson explains, if the plan were halted and the employee received and saved a raise of 7%, he would still be $106,000 short. The worker would have to save an additional $840 a year to make up the difference. Paying the proposed Arney rate of 17% (although the rate would initially be 20%), the employee's tax bill would shrink by only $484. Therefore, the employee would pay an additional $840 for a $484 tax break (p. F5).

In addition, many employers would not redirect money from halted pension plans to workers' salaries. And even if workers were given a raise in correspondence to their lost pension, most employees would not save the entire amount. A 1980 study of I.R.A.'s showed that only 20% of people earning $60,000 saved 7% (Johnston, 1995, p. F5). Therefore, these people might suffer upon retirement.

A similar issue to halting pension plans involves health care. Since health care costs would no longer be deductible to employers, they would be discouraged from offering employees health care benefits (Foster, 1995). Instead, employers might stop offering health care benefits and give workers a corresponding raise. Therefore, the
employees would have to pay for their own health care insurance. Since the employees
would have to pay individually, group rates would be eliminated. Group rates typically
offer insurance at cheaper prices. Consequently, individuals would possibly have to pay
higher initial premiums (Foster, 1995).

Another deduction that would be eliminated under a flat tax is the charitable
collection deduction. Opponents of the flat tax believe the elimination of this deduction
could severely hurt museums, colleges, churches, and other organizations dependent on
collections for survival. Bob Smucker, vice president of the Independent Sector, an
organization that represents groups using fund-raising, professes that his group would
"aggressively oppose" the elimination of this deduction (Gray, 1995, p. 22). Smucker
says that many of the groups his association represents depend on charitable contributions.
In addition, a majority of the contributions that they receive were given in relation to tax
incentives. In fact, his association estimates that 31% of the $100 billion given to
charitable contributions last year relate to tax driven incentives (p. 22).

A flat tax would severely hurt the amount given to these organizations. Even if the
charitable deduction were allowed, taxpayers would not have the same number of
incentives to give to charities. For example, at a tax rate of 17%, the tax incentive for
contributions would drop from 40 cents 4 in some cases to 17 cents (p. 22). Since most of
those who currently contribute to charities are in the upper tax brackets, there would
certainly be some loss in the tax incentive which charitable gifts provide.

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4 Under the current income tax system, a 40 cent deduction on the dollar results when those in the top tax bracket (39.6%) contribute.
As mentioned earlier, the housing industry could also be hurt by a flat tax. In particular, the elimination of the mortgage interest deduction and property tax deduction would be a detriment to homeowners. Currently, these deductions add to the value of homes by making ownership more attractive. There are 65 million housing units owner-occupied at a value of about $4 trillion (Gray, 1995). DRI/McGraw-Hill estimates that the elimination of these deductions would cause at least a 15% decrease in the value of homes (Richman, 1995). In fact, DRI estimates that a house valued at $150,000 could drop as much as 24%, to $113,571 (p. 39). In total, DRI estimates the value of all houses would drop $1.5 trillion (p. 39). Many owners who consider the home their security blanket would be outraged.

Tax plans that make no concession for the loss of these deduction are obviously criticized by homeowners, builders, and realtors. However, even the plans that do make concessions for these deductions are denounced by opponents. For example, the Hall-Rabushka plan would only maintain 90% of the mortgage deduction. Other proponents suggest capping the amount the mortgage deduction allowed at around $100,000.\(^5\)

These concessions might not appease critics for several reasons. For example, since rates would be falling, Hall and Rabushka believe most people would be willing to re-negotiate. In opposition, refinancing might not be practical for many homeowners who expect to sell their houses in the next year or two. In addition, when the mortgage interest deduction expired, a new mortgage would come with no tax advantages. Similarly, grandfathering current mortgages would cause the tax liability of mortgage lenders to be

\(^5\) Arlen Spector proposes capping the mortgage interest deduction at $100,000 in his flat tax plan.
raised. Finally, capping the amount of the deduction at some set amount would call for a higher flat tax rate to make up for the amount allowed in deductions.

Effect on Municipal Bonds

Many opponents of the flat tax believe the effect on the municipal bond market would also be problematic because the tax-free appeal of municipal bonds would be lost in a flat tax. Therefore, municipal bond interest would be treated the same as other investment income. Since municipal bonds generally pay a lower rate and depend on the tax-free appeal to attract investors, their popularity would be diminished. Jim Lebenthal, chairman of the New York-based municipal bond dealing Lebenthal & Co., projects a possible drop of 20% in the value of municipal bonds under a flat tax (Pare, 1995). The biggest reason for the drop is the loss of their tax free status. Municipal bonds have long been criticized as having several shortcomings. However, their tax-free nature allowed them to overcome these shortcomings and offer an attractive investment opportunity. Terence P. Pare explained two major problems with municipals that would cause the bonds to lose their appeal under a flat tax in his June 12, 1995, article in Fortune. One of the problems, Pare explained, is the high transaction costs caused by large gaps between bid and ask prices, an illiquid market, and "thousands of small issuers" (p. 50). Another problem Pare asserted about munis is that "getting good and timely financial information on many issuers is difficult" (p. 50). Therefore, with all their inherent difficulties, Pare insisted that investors would rather invest in Treasury bonds with similar yields under a flat tax.
Similarly, since Treasury bonds also exempt state and local taxes, municipals will have to offer higher yields to compete. Consequently, Pare explained, new issues of municipal bonds would have to pay higher rates. The higher rates would cause the cost of public works to go up, and some programs would probably be canceled (p. 51).

Under a flat tax, many investors would probably stay away from municipal bonds because of their shortcomings. However, municipal bonds are needed by communities to raise money to equip police and fire departments, build schools, upgrade drinking water facilities, and other public work programs. Without the large revenues municipals provide, communities would have to search for other ways to finance these public works programs. One way this could be done is by increasing property taxes on everyone (Pare, 1995). Increasing property taxes would act as a double hit to taxpayers as their property taxes would go up and they could no longer deduct them.

Simplicity

One of the biggest benefits declared by proponents of the flat tax is simplicity. Not only would tax forms be easy to fill out, they argue, but the tax code would be reduced to a few pages and the IRS's size would be decreased. However, Vern Hoven has contended that the size of the IRS may actually have to be increased to deal with the smaller tax code (Hoven, 1995). In particular, the elimination of most of the information on the tax forms used to track income and expenses would cause more underreporting of income. Therefore, the IRS audit division would have to be increased to look for unreported income (p. 15).
Tax Rates

Flat tax proponents suggest that the tax rate would be around 17% or 19%.

However, Robert Eisner, a professor at Northwestern, has warned that the tax rate would still be somewhat higher than that rate. After all, taxpayers would still have to pay state and local taxes, social security taxes, and all the other taxes that were imposed before (Eisner, 1995, p. 27). Therefore, the overall tax rate would come out considerably higher than proponents may want taxpayers to believe.

Similarly, proponents of the flat tax support the claim that taxes would be lowered for everyone. However, critics warn taxpayers that this would not be the case (Hoven, 1995). Granted, the rich would have significantly lower tax bills, but the middle and lower classes might actually have tax increases. In particular, taxpayers in the range of $30,000 to $60,000 would probably experience tax increases (p. 15). Additionally, taxpayers should be wary of soundbytes by flat tax proponents.

Miscellaneous

Additional criticisms of the flat tax, as described by Vern Hoven on pages 5 and 6 of his article titled "Flat Tax As Seen By A Tax Preparer," include taxing all workman’s compensation and other payments for injuries. Under the present law, these payments are not taxed. A new “kiddy tax” would be established. Under the new plan, all income earned by dependent children under the age of 13 must be included on the parent’s return. Similarly, the extra exemptions the blind and elderly receive would be eliminated.
Business expenses that are not reimbursed would no longer be deductible, and moving expenses would not be deductible anymore either. Finally, all credits would be eliminated. Therefore, there would no longer be credits such as child care credits, rehabilitation credits, and low-income housing credits.

<table>
<thead>
<tr>
<th>Present Law vs. Flat Tax: Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key Taxable Items</strong></td>
</tr>
<tr>
<td><strong>Present Law</strong></td>
</tr>
<tr>
<td>Salary and wages</td>
</tr>
<tr>
<td>Pension income</td>
</tr>
<tr>
<td>Capital gains</td>
</tr>
<tr>
<td>Dividend income</td>
</tr>
<tr>
<td>Interest income</td>
</tr>
<tr>
<td><strong>Key Deductible Items</strong></td>
</tr>
<tr>
<td>Standard deduction</td>
</tr>
<tr>
<td>Personal exemption</td>
</tr>
<tr>
<td>Other deductions</td>
</tr>
<tr>
<td>Home mortgage interest</td>
</tr>
<tr>
<td>Charitable Contributions</td>
</tr>
<tr>
<td>State and local taxes</td>
</tr>
<tr>
<td>Medical, dental expenses</td>
</tr>
<tr>
<td>Theft and casualty losses</td>
</tr>
<tr>
<td>Unreimbursed employee expenses</td>
</tr>
<tr>
<td>IRA contributions</td>
</tr>
<tr>
<td>Investment interest</td>
</tr>
<tr>
<td>Moving expenses</td>
</tr>
</tbody>
</table>

The National Sales Tax

Another tax reform plan is the national sales tax. This proposal is backed by those who favor radical changes in the tax system by way of eliminating the current tax code and the IRS. The most notable proponent of a national sales tax is Republican presidential candidate Richard Lugar. However, the sales tax is not nearly as popular as the flat tax and chances of it replacing the current tax code are small. Nevertheless, the sales tax is still an issue in the upcoming election and merits an in-depth discussion.

Most Americans are already quite familiar with the idea of a sales tax. After all, forty-five states currently levy a sales tax. A sales tax can be defined as a tax imposed on the final sale of retail goods; the tax comes in the form of a set percentage of the total transaction. Proposals for a national sales tax are very similar to state sales taxes with the major difference residing in the rates.6 The rates in a national sales tax would have to be set much higher.

The Richard Lugar Plan

The leading proponent of a national sales tax is Indiana Senator Richard Lugar. Although all the details of Lugar’s proposal have not yet been released, the main points have been. The main points are described on page 17 of Pete Marwick’s 1995 Tax Reform Update. For example, he is proposing a tax rate of about 17%. In addition, his plan calls for the abolishment of the current income tax code and, consequently, the IRS. Therefore, tax collection duties would be left up to the states. Also, his 17% tax rate

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6 Information for this definition was taken from page 11 of Pete Marwick’s 1995 Tax Reform Update.
would be levied on all retail transactions. Lugar believes that his proposal would generate
enough revenues to completely eliminate corporate and individual income taxes.

The Stephen Moore Plan

One of the most complete plans for a national sales tax comes from Stephen
Moore, an economist at the Libertarian Cato Institute. His plan is described in the
September 3, 1995 issue of the New York Times under an article written by Peter Passell
and titled "The Tax Code Heads Into Surgery." According to Passell, Moore has
proposed an 18% tax rate on all goods and services. In addition, Moore has suggested
exempting business purchases from the tax to avoid double taxation. Also, states would
be compensated by the Federal government for collecting the national sales tax under
Moore's plan. Finally, to combat the regressive nature of a sales tax, Moore says that
every American should get a $900 check. The $900 would be equivalent to a $5000
personal exemption in Moore's opinion.

Proponents of a sales tax believe the most appealing aspect of their tax is the
elimination of the IRS. Just as flat tax proponents feel that the IRS is too complicated,
burdensome, intrusive, and unfair, so, too, do sales tax supporters. Additionally,
proponents of a sales tax say that their system is much easier to comply with than the
current tax code. After all, taxpayers would no longer have to file any tax forms.
Supporters also claim a sales tax would stimulate the United States' lagging savings and
investment levels. The stimulation would be done by only taxing consumption and not
savings. Similarly, the tax base would be increased by taxing the illegal society.
Currently, crime families are able to make significant amounts of tax-free money. However, this money would be taxed when the criminals purchased goods or services under a sales tax. Finally, sales tax supporters refute the claim that their tax favors the rich since they save a larger portion of their incomes. In fact, Lawrence Kotlikoff, an economist at Boston University, says that a flat tax would initially be a big tax hit on saved wealth. For example, an 18% sales tax on all goods essentially increases prices by 18%. Therefore, saved income would lose 18% of its purchasing power (Passell, 1995).

Proponents of a sales tax also believe that the tax would boost the United States' national wealth. Harvard University economist Dale W. Jorgenson has predicted that the switching to a sales tax would increase the national wealth from 24 trillion to about 26.5 trillion (Banks, 1995). The increase would be due mainly to the shifting of taxes from savings to consumption.

**Criticisms of a National Sales Tax**

**Fairness**

The biggest criticism of a national sales tax is its regressive nature. Opponents say that the tax obviously favors the rich over the poor and middle classes. For example, the top tax rate is currently 39.6%. Under a sales tax, the rate would be cut down to about 17 or 18%. As a result, the very rich would be afforded a huge tax break. Additionally, the rich are able to save larger portions of their total incomes. Therefore, rich people would pay a much smaller percentage of total income in taxes than poor people. In fact, a study by the Congressional Budget Office has shown that the poor and middle class would be hit
hard by a sales tax while the rich would experience huge tax breaks (McIntyre, 1995). For example, the study found that middle income families would experience a $3,000 tax increase under the most regressive sales tax. Similarly, the poor would pay 30% of their total incomes in added taxes. The rich though, could experience tax cuts of more than $130,000.

Revenue Neutrality

Critics, such as Robert McIntyre, also claim that the tax rate would have to be much higher than the proposed 17 and 18% rates. In fact, McIntyre believes the tax level would have to be as high as 20 to 30% to raise as much revenue as the current tax system (McIntyre, 1995). The lowest possible base would tax everything from food and clothes to houses and medical services. A narrower base would not tax the essentials but would demand a much higher rate. Nevertheless, the lowest possible rate would still increase prices on all goods by at least one-fifth (p. 15). The price of a new car could increase by $6,600 (p. 15).

Other Issues

There are also some transitional issues regarding a sales tax that would have to be addressed further before a plan could be enacted. For example, a plan to help states collect the taxes would have to be developed. Also, it can be argued that the sales tax should have differential rates so taxes are lower on basic goods and higher on luxuries. The sales tax would also affect municipal bonds in a way similar to the flat tax.
Municipals would lose their appeal as all investment income would become tax free.

Finally, sales taxes are very ineffective at taxing all retail sales. In other words, it is very difficult to collect all the tax revenues under a flat tax. For example, it is easy for vendors to simply sell merchandise without imposing the tax rate (i.e., street vendors probably would not add the sales tax to their merchandise). As a result, a national sales tax calls for rigorous enforcements to collect all the revenues. Nevertheless, the tax would probably still fail to collect a good portion of total revenues. As a result of the lost revenues, many consumption tax proponents go one step further by supporting a value-added tax, which imposes and collects revenues at each stage in the production of a good or service.
The Value-Added Tax

Although a value-added tax (VAT) has not been formally proposed yet, it has been mentioned as a possible tax reform proposal. In addition, VAT systems are used in most industrialized nations already. The VAT has the potential to become a major issue in the tax reform debate. Therefore, the basics of the VAT will be discussed along with its major criticisms.

A VAT is considered a consumption tax because it is assumed that business would pass on their taxes in the form of higher prices to consumers. Hence, the VAT is based on consumption. In addition, the VAT is very similar to the sales tax. However, instead of collecting taxes only at the retail sale, the VAT collects taxes throughout the stages of production. The tax base for a VAT is, therefore, "the difference between the value of an enterprise's sales (outputs) and purchases (inputs)" (Willens and Phillips, 1995, p. 39).

Although there is no single notable proponent of a VAT, House Ways and Means Committee chairman Bill Archer (R-Tex.) is synonymous with the tax. In other words, when a VAT is mentioned, Bill Archer's name is usually mentioned. This happens because Archer often calls for the complete abolishment of the current income tax code. He often says to "tear the income-based tax system out by its roots" (Miller, 1995, p. 67) In its place, Archer wants to establish a broad-based consumption tax. In particular, he believes the new tax system should adhere to five basic principles, which were listed by William Miller in the April, 1995, issue of *Industry Week*:

1. Provide incentive for savings and investment.
2. Attack the underground economy, which currently costs the government $100 billion to $200 billion a year in lost revenue. Controlling this, he says, "would be enough to get us to a balanced budget".

3. Remove the IRS from people's lives as much as possible. Simplifying taxes, he argues, would save compliance and enforcement costs and reduce litigation.

4. Be waived on U.S. exports, as other industrialized countries currently are able to do through their VATs; GATT rules allow it.

5. Be imposed on imports, also allowed by GATT and practiced by the United States' international competitors. (Miller, 1995, p. 67)

Archer has not developed a specific plan to present at congressional hearings yet, but intends to develop a plan in the near future. In addition, based on his five principles and the fact that he says his plan would completely abolish the current tax system, many believe that Archer's plan will be a VAT.

Since no particular VAT tax plan has been created yet, this thesis will only discuss the different types of general VAT plans. The value-added tax can be collected in several different ways. The most popular collection methods are the credit-invoice method, the subtraction method, and the addition method. The most popular approach in other countries (especially Europe) is the credit-invoice method. Also, Representative Sam Gibbons (D-Fla.) and Senator Ernest Hollings (D-S.C.) are partial to a European-style VAT. Therefore, the credit-invoice method will be discussed first.
The Credit-Invoice Method

As mentioned earlier, the credit-invoice method is the most popular type of VAT. It is used by all the countries in the European Community and is often referred to as the European-style VAT. Under a credit-invoice method, each taxpayer multiplies the VAT percentage by each sales invoice. Then, the VAT on all sales invoices is totaled and the total amount of taxes paid earlier is subtracted out. The remainder is the VAT due at that particular stage. Basically, the tax is based on the value the taxpayer adds at a particular stage. To get credit for taxes already paid, the company must report the taxes owed by the other companies in the production stage. Therefore, tax avoidance is extremely difficult. Exhibit #1 provides a good example.

Exhibit #1: Credit-Invoice Method VAT

Assume Bob the miner discovers a deposit of copper on his land. He mines and then sells the copper to a mill for $1,000. The mill processes the copper into wire and sells the wire to a distributor for $1,500. The distributor packages the copper wire and sells it to a retailer for $2,000. The retailer then sells the wire to a customer for $2,400. Assume that a 10% VAT is imposed throughout all the transactions.

<table>
<thead>
<tr>
<th>Stage of Production</th>
<th>Sales</th>
<th>VAT on sales</th>
<th>VAT on purchases</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner of land</td>
<td>$1000*.10=</td>
<td>$100-</td>
<td>$0 =</td>
<td>$100</td>
</tr>
<tr>
<td>Mill</td>
<td>$1500*.10=</td>
<td>$150-</td>
<td>$100 =</td>
<td>$50</td>
</tr>
<tr>
<td>Distributor</td>
<td>$2000*.10=</td>
<td>$200-</td>
<td>$150 =</td>
<td>$50</td>
</tr>
<tr>
<td>Retailer</td>
<td>$2400*.10=</td>
<td>$240-</td>
<td>$200 =</td>
<td>$40</td>
</tr>
<tr>
<td>Total</td>
<td>$690-</td>
<td>$450 =</td>
<td></td>
<td>$240</td>
</tr>
</tbody>
</table>

The tax would collect a total of $240. This amount would be collected at the end of production after the retailer sells the goods to the customer. The retailer would be responsible for collecting the tax.
The Subtraction Method

This method is very similar to the credit-invoice method. However, the principle difference lies in that the tax rate is applied to a net amount of value added rather than a gross sales less credits. To calculate the total VAT under the subtraction method, businesses first add up all of their sales to purchasers. Then, businesses add up all purchases from other businesses. Finally, the total purchases are subtracted from sales and the remainder is multiplied by the VAT rate. Exhibit #2 provides a good example of this type of tax.

Exhibit #2: Subtraction-Method VAT

Assume the same facts in exhibit #1 about miner Bob.

<table>
<thead>
<tr>
<th>Stage of Production</th>
<th>Sales</th>
<th>Purchases</th>
<th>Value added * rate</th>
<th>VAT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner of land</td>
<td>$1000</td>
<td>$0</td>
<td>$1000*.10</td>
<td>$100</td>
</tr>
<tr>
<td>Mill</td>
<td>$1500</td>
<td>$1000</td>
<td>$500*.10</td>
<td>$50</td>
</tr>
<tr>
<td>Distributor</td>
<td>$2000</td>
<td>$1500</td>
<td>$500*.10</td>
<td>$50</td>
</tr>
<tr>
<td>Retailer</td>
<td>$2400</td>
<td>$2000</td>
<td>$400*.10</td>
<td>$40</td>
</tr>
<tr>
<td>Total</td>
<td>$2400</td>
<td>$2000</td>
<td>$240*.10</td>
<td>$240</td>
</tr>
</tbody>
</table>

The Addition Method

The addition method is essentially the exact opposite of the subtraction method VAT. However, both produce virtually the same results. The addition method uses inputs not purchased in determining the total tax. For example, wages, interests, profits, etc. are added together and then multiplied by the VAT rate. The sum is the VAT due.

Proponents of a value-added tax suggest that their tax will spur savings and investment because they no longer would be taxed. Similarly, supporters say the VAT will
completely eliminate the IRS and make filing taxes simple. The underground economy would be exposed under a VAT. As mentioned earlier, Bill Archer had estimated that the underground economy costs the government $100 to $200 billion in revenues each year. Because it is so difficult to escape paying taxes under a VAT, criminals would no longer be able to go through life tax free. Finally, Archer and other proponents believe a VAT would help aid U.S. competitiveness in world trade (Gray, 1995). For example, goods shipped out would not be taxed but imports would be. Archer also says that taxing imports and not exports is "GATT-legal" (p. 22).

**Criticisms of the VAT**

The major criticism of the VAT—as listed in Willens and Phillips November, 1995, *Journal of Accountancy* article—is the same as the sales tax: fairness. Under a VAT, lower and middle income families would pay a larger share of their total income than the rich. This is because the greatest portion of their income is directed towards consumption. Similar to the sales tax, those who are able to save more under a VAT would pay a smaller percentage of income in taxes.

In addition, critics argue that the VAT is too easy to increase (Gray, 1995). Congress could simply increase the rate if they feel they need more money. Also, many opponents fear that a VAT, if adopted, would simply be placed on top of the current income tax system and not used as a replacement. This fear is based on the Congressional Budget Office statement saying, "a VAT may be preferable to an income-tax increase."

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7 GATT stands for General Agreement on Tariffs and Trade and it sets the rules on international trade.
(Gray, 1995, p. 23). Many critics feel that this remark suggests that the VAT is being considered as an additional tax instead of a replacement.

A VAT would also receive heavy criticism from retailers. The National Retail Federation says that a VAT would hurt their industry, their 20 million employees, and their customers (Gray, 1995). John C. Dill, senior vice president for governmental affairs, believes a VAT, or any consumption tax, "would produce a serious upheaval in our economy, drastically shift the tax burden among various economic sectors and taxpayers, thereby producing winners and losers, and would undoubtedly spawn numerous unintended consequences" (Gray, 1995, p. 23).

Finally, it can be argued that a VAT would not be as simple as supporters would like people to believe. Although on the surface the VAT appears easy to calculate, it can become infested with exceptions and complications. For example, the tax could be adjusted to exclude certain items like food, housing, and medical care. When exclusions and exceptions are installed, the tax system becomes complex. The European-style VAT, which has become quite complicated, is an example of how a value added tax can become problematic.
The Unlimited Savings Allowance Tax

Although not as popular in the public's view as the flat tax proposals, the Unlimited Savings Allowance (USA) tax is receiving its fair share of attention. In fact, many experts believe that the USA tax is actually the most popular plan in Congress and "is given the greatest chance of enactment" (Willens and Phillips, 1995, p. 41). The tax plan was developed by Senator Sam Nunn (Democrat-Ga.) and Senate Budget Committee Chairman Pete Domenici (Republican-N.M.). The two presented their plan to legislation on April 25, 1995. The main purpose of the USA tax is to shift taxes away from savings and onto consumption in an effort to stimulate savings and investment in the United States.

Just as in the flat tax, the USA tax has two components: one for individuals and one for businesses. However, unlike the flat tax, the USA tax was developed mainly for the purpose of stimulating savings and investment. In other words, the tax is not as easy to compute as the flat tax. Also, the USA tax does not call for nearly as radical changes as the other consumption tax proposals do. In fact, the USA tax's lack of extremism could hurt its position in the public's view. The general public seems to hold a consensus that they are the victims of an unfair tax system; the poll by Anderson Consulting supports this position. Therefore, anything but a complete overhaul in the tax code may be unacceptable to many people. The only major change the USA tax brings to individuals, though, is the deduction of increased savings and the taxing of decreased savings. In addition, the tax maintains progressive rates and several deductions preserving some
degree of complexity. Still, the USA tax is much easier to comply with than the current tax code.

There are several steps involved in calculating taxes due under the USA tax. These steps are described on page 13 of Peat Marwick's *Tax Reform Update*. The first step in calculating tax liability under the USA tax is to determine gross income. Gross income would include all wages, salaries, dividends, interest, rents, fringe benefits, capital gains, insurance proceeds and pensions. Next, taxpayers would subtract their exemptions from gross income. The plan allows for a family living allowance of $7,400 for joint filers and $4,400 for individuals. Additionally, a $2,225 deduction is allowed for the taxpayer, spouse, and each dependent. Third, taxpayers would subtract out their allowable deductions from the remainder to arrive at their tax base. So far, the tax probably sounds very similar to the current income tax system. However, the major difference in the Domenici-Nunn plan lies within the third step dealing with deductions.

Domenici and Nunn would maintain the popular deductions for home mortgage interest, charitable contributions, and alimony. In addition, they would add deductions for education expenses and savings. However, all other deductions (state taxes, medical expenses, gambling losses, etc.) would be eliminated. Allowing more deductions would call for higher tax rates.

The education expense allows for a $2,000 deduction (limited to $8,000) for each college student in the family. Domenici and Nunn believe education should be deductible because it is an investment in human capital (Pete Marwick, 1995). The most distinguishing factor of the plan, though, is the savings deduction. It is this deduction that
qualifies the plan as a consumption tax. For example, all net increases in qualified savings would be tax deferred. The qualified savings institutions can be described as follows:

Qualified savings assets would include stocks; bonds; securities; certificates of deposit; interests in proprietorships and partnerships; mutual fund shares; life insurance policies; annuities; retirement accounts; and bank, money market, brokerage and similar money accounts. Excluded assets would be investments in land, collectibles and cash on hand. (Willens and Phillips, 1995, p. 42)

To receive a deduction, though, there would have to be a net increase in savings; simply shifting savings from one form to another would not qualify as tax deferred. Likewise, all withdrawals from savings would be taxable. Since withdrawals from savings would likely be used for consumption, the USA tax is a consumption tax. In addition, interest and other such earnings on savings would be taxable, unless they were reinvested in savings.

Additional consumption might occur when taxpayers borrow money and use the proceeds for consumption. However, the proceeds would not be considered withdrawals of savings and would not be taxed. This way, a taxpayer will never pay tax on an amount greater than total income for a respective year. However, since the loan repayment and interest payments would not be deductible, the additional consumption would essentially be taxed as the loan is repaid.

To illustrate the savings deduction inherent in the USA tax, assume that someone invests $500 of wages in a savings account. Later that same year, the individual withdraws $100, spends $40, and reinvests $60 in stocks. The total amount invested in
savings equals $560 (500+60) and the total amount withdrawn equals $100. Therefore, the individual would be allowed a $460 net savings deduction.

By subtracting all of the allowed deductions, taxpayers would be left with a tax base. Domenici and Nunn have developed three rates at which to tax the base for both joint filers and individual filers (Price Waterhouse, 1995). For joint filers, a 19% rate would apply to taxable income of $5,400 or less. A 27% would apply to taxable income between $5,410 and $24,400. And finally, a 40% rate would apply to all taxable income over $24,401. For single filers, the rates would be 19% for taxable income of $3,200 and less; 27% for taxable income between $3,201 and $14,400; and 40% for taxable income over $14,401. In addition, Domenici and Nunn plan on phasing the 19 and 27% rates down to 8 and 19% after four years (p. 24). Finally, the tax brackets would be indexed for inflation (p. 24).

The final step in calculating the amount of taxes due under the USA tax is to deduct the allowed tax credits. Domenici and Nunn would allow two tax credits: the earned income credit and the payroll tax credit (Peat Marwick, 1995). The earned income credit would be provided to lower-income taxpayers, similar to the current law. The payroll tax credit would be a 7.65% credit used to offset Social Security and Medicare taxes withheld from wages.

A major criticism of the USA tax is the fact that some transitional transactions might be subject to double taxation (Price Waterhouse, 1995). For example, suppose an individual earns $200,000 in wages, pays $80,000 in taxes, and invests the other $120,000 in savings. All of these transactions fall under the current tax system. A short time later,
assume the USA tax is established. Now the individual decides to take the money out of savings and spend it. The $120,000 would be subject to tax again under the USA tax. However, Domenici and Nunn have developed specific propositions to deal with this type of transaction. For example, taxpayers with less than $50,000 invested before the adoption of the USA tax would be allowed to amortize and deduct the amount over three years (Price Waterhouse, 1995). Taxpayers with more than $50,000 invested before the tax change would receive a credit applicable to the tax basis used in figuring their savings deduction (Price Waterhouse, 1995). In other words, their net savings would be increased by the amount saved before the tax change.

Proponents of the USA tax believe that it would increase savings and investment, simplify the tax code, and maintain fairness by the use of progressive rates. In addition, because the USA tax is very similar to the current income tax system, it would be relatively easy to establish (in comparison with the other tax proposals). In other words, there would not be as drastic a change or as many transitional issues.

The author has already discussed how low the United States' levels of savings and investment are. Adopting the USA tax would allow additional savings to be used as a tax deduction. Therefore, taxpayers would have a huge incentive to save and invest as much as possible. After all, more money saved and invested would translate into larger deductions.

Similarly, proponents of the USA tax claim that the elimination of most of the deductions and several tax rates would simplify the tax code. Essentially, the USA tax is very similar to the current tax code. However, a major difference is that most of the
deductions are eliminated. Therefore, the USA tax, although it is more complex than the other tax proposals, is still much simpler than the current tax code.

Finally, supporters of the USA tax claim that their tax maintains a progressive nature which the other proposals do not. Because the USA tax would establish three tax rates, those who can pay more would pay a higher percentage of taxable income. This, proponents argue, would make the USA tax fair.

**Criticisms of the USA tax**

A problem with the USA tax is that it is still complex. Although many of the deductions would be eliminated, the overall structure of the tax code would remain the same. Therefore, many of the loopholes and trappings in the current code would still remain. In addition, a new set of schedules would be needed to track changes in savings. These new schedules would actually add to the complexity of the tax.

Critics, such as Robert Kuttner, also claim that the USA tax is regressive, despite its progressive rates (Kuttner, 1995). For example, assume a taxpayer makes $10,000,000 in a year. Also, $1,000,000 is used for consumption and is taxable; the remainder is saved. Under the top rate of the USA tax of 40%, this individual would owe $400,000 in taxes. The resulting effective rate would be only 4%. Since this extremely rich taxpayer would experience a significant tax decrease; the lost revenue must be made up by tax increases on others. As a result, Kuttner claims the USA tax would be regressive, as well as unfair.
Finally, the USA tax would face major technical problems (McIntyre, 1995). In particular, these problems would arise in connection with existing savings. Establishing a USA tax would allow anyone with saved wealth to withdraw all savings before the actual implementation of the tax. Then, the cash could be stored in a place where records were not kept. After the USA tax was officially established, the cash could be re-invested for a significant savings deduction in the current year. This type of practice could be outlawed, but enforcement of such a law would be very difficult.
CHAPTER FOUR - EFFECTS OF THE PROPOSALS

The purpose of this chapter is to illustrate the effects each tax proposal would have on various taxpayers. The chapter will concentrate on the current income tax, the flat tax, the sales tax, and the USA tax by comparing different taxpayers' tax liabilities under each.

Since the VAT has not been officially proposed, it will not be included in this discussion.

All of the following calculations were done by Shvetank Shah of Price Waterhouse and are printed in the Sept. 3, 1995, issue of The New York Times. All of Shah's examples describe a family with two children, one being in college.

CURRENT INCOME TAX

<table>
<thead>
<tr>
<th>Family</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages and salaries</td>
<td>20,000</td>
<td>46,623</td>
<td>90,000</td>
<td>189,267</td>
</tr>
<tr>
<td>Income from capital</td>
<td>-</td>
<td>3,017</td>
<td>10,000</td>
<td>115,505</td>
</tr>
<tr>
<td>Miscellaneous adjustments</td>
<td>-</td>
<td>360</td>
<td>4,772</td>
<td></td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>20,000</td>
<td>50,000</td>
<td>100,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>9,800</td>
<td>9,800</td>
<td>9,800</td>
<td>-</td>
</tr>
<tr>
<td>Standard or itemized deductions</td>
<td>6,350</td>
<td>9,823</td>
<td>43,000</td>
<td>47,839</td>
</tr>
<tr>
<td>Mortgage interest deduction</td>
<td>-</td>
<td>4,429</td>
<td>30,000</td>
<td>21,582</td>
</tr>
<tr>
<td>Charitable contributions deduction</td>
<td>250</td>
<td>746</td>
<td>1,000</td>
<td>6,532</td>
</tr>
<tr>
<td>Taxable income</td>
<td>3,850</td>
<td>30,377</td>
<td>47,200</td>
<td>252,164</td>
</tr>
<tr>
<td>Income tax before earned income credit</td>
<td>578</td>
<td>4,557</td>
<td>8,276</td>
<td>76,162</td>
</tr>
<tr>
<td>Earned income credit</td>
<td>932</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tax after earned income credit</td>
<td>(355)</td>
<td>4,557</td>
<td>8,276</td>
<td>76,162</td>
</tr>
</tbody>
</table>

FLAT TAX

<table>
<thead>
<tr>
<th>Family</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages and salaries</td>
<td>20,000</td>
<td>46,623</td>
<td>90,000</td>
<td>189,267</td>
</tr>
<tr>
<td>Pension and retirement benefits</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total compensation</td>
<td>20,000</td>
<td>46,623</td>
<td>90,000</td>
<td>189,267</td>
</tr>
<tr>
<td>Less personal exemption and allowances</td>
<td>29,650</td>
<td>29,650</td>
<td>29,650</td>
<td>29,650</td>
</tr>
<tr>
<td>Taxable income</td>
<td>-</td>
<td>16,973</td>
<td>60,350</td>
<td>252,164</td>
</tr>
<tr>
<td>Tax (at 20%)</td>
<td>-</td>
<td>2,885</td>
<td>12,076</td>
<td>76,162</td>
</tr>
</tbody>
</table>

### NATIONAL SALES TAX

<table>
<thead>
<tr>
<th>Payroll tax</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,530</td>
<td>3,567</td>
<td>4,636</td>
<td>4,636</td>
<td></td>
</tr>
<tr>
<td>Charity</td>
<td>250</td>
<td>746</td>
<td>1,000</td>
<td>6,532</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>-</td>
<td>4,429</td>
<td>30,000</td>
<td>21,582</td>
</tr>
<tr>
<td>State and local tax</td>
<td>-</td>
<td>4,648</td>
<td>6,000</td>
<td>19,722</td>
</tr>
<tr>
<td>Savings</td>
<td>-</td>
<td>1,979</td>
<td>10,000</td>
<td>35,407</td>
</tr>
<tr>
<td><strong>Taxable spending</strong></td>
<td><strong>18,220</strong></td>
<td><strong>34,631</strong></td>
<td><strong>48,364</strong></td>
<td><strong>212,121</strong></td>
</tr>
<tr>
<td>Federal tax at 18 percent</td>
<td>3,280</td>
<td>6,234</td>
<td>8,706</td>
<td>38,182</td>
</tr>
<tr>
<td>Credit</td>
<td>900</td>
<td>900</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td><strong>Tax after earned income credit</strong></td>
<td><strong>2,380</strong></td>
<td><strong>5,334</strong></td>
<td><strong>7,806</strong></td>
<td><strong>37,282</strong></td>
</tr>
</tbody>
</table>

### UNLIMITED SAVINGS

<table>
<thead>
<tr>
<th>Wages and salaries</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>20,000</td>
<td>46,623</td>
<td>90,000</td>
<td>189,267</td>
<td></td>
</tr>
<tr>
<td>Income from capital</td>
<td>-</td>
<td>2,843</td>
<td>10,000</td>
<td>105,794</td>
</tr>
<tr>
<td>Miscellaneous adjustments</td>
<td>-</td>
<td>(2)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Adjusted gross income</strong></td>
<td><strong>20,000</strong></td>
<td><strong>49,463</strong></td>
<td><strong>100,000</strong></td>
<td><strong>295,061</strong></td>
</tr>
</tbody>
</table>

Less:
- Personal exemptions: 9,600
- Family allowance: 6,950
- Home mortgage deduction: -
- Charitable contribution deduction: 250
- Higher education deduction: 2,000
- Net deductible savings: -

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,200</td>
<td>23,759</td>
<td>42,450</td>
<td>212,990</td>
<td></td>
</tr>
<tr>
<td>Tax before credits</td>
<td>228</td>
<td>6,151</td>
<td>13,628</td>
<td>81,843</td>
</tr>
<tr>
<td>Earned income credit</td>
<td>932</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Payroll tax credit</td>
<td>1,530</td>
<td>3,567</td>
<td>4,636</td>
<td>4,636</td>
</tr>
<tr>
<td><strong>Tax after credits</strong></td>
<td><strong>(2,234)</strong></td>
<td><strong>2,584</strong></td>
<td><strong>8,992</strong></td>
<td><strong>77,208</strong></td>
</tr>
</tbody>
</table>

In conclusion, the author suggests that tax reform is needed. The current tax code is complicated, burdensome, and intrusive. Because of its perceived flaws and inequities, the tax system does need to be reformed in some way. Therefore, it appears that attention to the tax code is a good idea; it shows that Americans are addressing a real problem. However, though the new proposals do address some of the current tax system's problems (increasing savings and simplification of the tax code), the author does not believe that they should be enacted. The proposals just have too many inherent problems right now. Only when these problems are worked out, or at least a plan to deal with the problems is devised, should the new tax proposals be considered as replacements to the current tax code. The author believes the proposals closest to being enacted are the flat tax and USA tax plans.

As mentioned earlier, the flat tax is probably the most popular plan in the public's view at the present time. In particular, voters who want radical tax reform are big supporters of this proposal. In addition, the flat tax would address the lagging levels of saving and investment, simplify the tax code, and eradicate the IRS from most people's lives. However, the flat tax just has too many problems and question marks right now. For example, the tax would definitely provide tax cuts for the rich, and as a result, more of the tax burden would fall on the middle and lower class taxpayers. Similarly, a better system to deal with the elimination of certain deductions must be devised (i.e., mortgage interest and charitable deductions). Finally, some plan must be created to help the local governments that would be hurt by the decrease in the municipal bond market.
Like the flat tax, the USA tax has several good points. The best aspect of the USA tax is that it would stimulate savings and investment in the U.S. Also, the USA tax is very similar to the current tax code and adopting it would not be a major change. For example, many of the current deductions would be retained under a USA tax. However, the USA tax also has some major problems that would have to be addressed before it could successfully replace the current income tax system. For example, the USA tax still favors the wealthy in that they are able to save more and, consequently, take larger savings deductions. Therefore, some type of plan should be devised to limit the amount of the savings deduction, making the rich pay their fair share of taxes.

Finally, tax reform is overdue. The current proposals definitely address serious problems in the tax code. However, the current proposals are laced with too many problems to replace the income tax system successfully. Therefore, the type of reform that is needed this year should resemble the tax reform of 1986, when the code was simplified and loopholes closed. In particular, the current tax code should be modified to address its major problems, such as the lagging savings and investment rates. In the future, if the tax proposals are adjusted to correct their shortcomings, then perhaps they will deserve a second look. However, for the time being, the best tax system for the U.S. is probably the one already in place.
BIBLIOGRAPHY


"What's This Flat Tax?" Independent Record 26 Jan. 1996: 7A.