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Treating Flat-Tax Fever

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by

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TREATING FLAT TAX FEVER

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It's a common concern of taxpayers from time to time: “What is my tax bracket (and yours for that matter)?” I look up the word “bracket” in the dictionary and learn that it is “... a thing that nails objects to the wall!” I dare to want to know more and want to be able to confidently trust what I learn. Over time, I have believed in Santa Claus, the Easter Bunny, and more recently the Flat Rate Tax -- with equal sincerity and for good reason.

What little I know about them, they sound almost too good to be true. The idea of a flat rate tax is very seductive. And there are two schools of thought on this issue; some people were absent both days. I have sincerely gone into a study of the flat tax with an open mind; as of yet, it just does not seem to compute, although it sounds good on the surface.

The flat rate tax idea does seem so clean, neat and right--like apple pie, motherhood and solar energy. The flat rate tax is, and has been, oversold. It is a two-edged sword--neither all good nor all bad. It could mean the end of a maze of deductions that seem to let us escape some taxes. However, it could also cut in half the rates paid by the wealthy, compelling the rest of middle Americans to pick up the slack by paying more taxes in dollar terms.
TREATING FLAT TAX FEVER

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Taxes can be complicated and fair, treating every situation differently as needed. Or taxes can be simple and unfair, treating everyone the same when they are not, therefore being discriminatory. Our original income tax in 1913 was a flat tax: one percent of the income above the first $3,000; only the wealthy professionals were in that bracket.

I. Nothing Heals Like A Tax Cut

Observing what has happened since then with taxflation--average Americans being bumped into higher tax brackets (until it was indexed in 1986) -- of greater concern than the actual bracket initially selected would be this: how easy would it be to raise the bracket? To keep the proposed flat rate tax flat, House Majority Leader Dick Armey (author of the 1996, election year Forbes plan), is pressing for a three-fifths majority vote to be required on all tax votes in both chambers.

Why is the flat tax so popular? Is it really practical? Could it be implemented? Surveys show that Americans want such a tax because they're convinced that their neighbor is paying less than he should. So, if my neighbor had to use the same form as I, he'd have to pay his fair share. It just seems to me that there are bigger issues: What is the legitimate role for government in the late 20th century, and how can we get a good government at a reasonable cost without diminishing personal freedoms and property rights?

Some proponents of a flat rate tax claim that economic growth could double, say, from 2.5 percent to 5.0 percent annually, as measured by the Gross Domestic Product. That would be very unlikely, as we have averaged 3.3 percent a year since the Civil War 125 years ago. In reality, other things affect growth: private sector performance, applied science breakthroughs, business leadership, employee performance, and price movements, etc.

According to Norman Ture, former Under Secretary of the Treasury for Tax and Economic Affairs, the outbreak of "born-again" enthusiasm for the flat tax among Washington politicians may simply reflect Congress's "urgent desire to find some way of increasing Federal revenues in a manner that will convince taxpayers good things are being done to them even while additional taxes are being extracted." The popular flat rate tax proposals do fit well with the current anti-big government mood of the taxpaying electorate.

II. Something For Everyone?

A less publicized but equally critical problem with the flat-tax proposal concerns the proposed blanket elimination of deductions. If a flat-tax proposal results in the elimination of such deductions, it could stifle private sector alternatives to
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II. Something For Everyone?

A less publicized but equally critical problem with the flat-tax proposal concerns the proposed blanket elimination of deductions. If a flat-tax proposal results in the elimination of such deductions, it could stifle private sector alternatives to
government programs. Further, a truly flat rate might benefit the wealthy. And the poor would probably then receive a tax credit to keep from being hurt. Alas, that leaves the middle class to carry the burden.

Don't be surprised that if, with the flat tax plan's favorable capital gains provision for individuals (i.e., the elimination of taxation of unearned income -- interest, dividends, rent, and capital gains), combined with possible exclusion of mortgage interest and itemized deductions, the middle class might pay more money. It would also be possible, therefore, for wealthy investors to pay little, if any, income tax by moving all forms of compensation into the realm of unearned income.

Example: Suppose my business partners owe me $200,000 in compensation for 1995. Instead of paying me that amount as a taxable salary, we could arrange for them to buy me a $200,000 condominium at a nearby resort of my choice. No income tax would be paid by me under the popular Forbes proposal.

The 1994 Tax Reform Act did accomplish much to achieve a measure of fairness. It lowered the top rate to 28 percent and broadened the tax base. Later in 1993, Congress increased the top rate to 39.6 percent. Currently, there are five federal income tax rates starting at 15 percent and running through five brackets to that top rate of 39.6 percent.

Specifically, the 15 percent rate is for the income range from zero income to $39,000. The 28 percent bracket weighs in on incomes of $39,001 to $94,250. The 31 percent bracket is for incomes of $94,251 to $143,600. The 36 percent bracket encompasses incomes of $143,601 to $256,500. The 39.6 percent bracket is applied to incomes of $256,501 and up.

III. Domestic Taxation Wedge

One-third of all American taxpayers now file short forms. Two-thirds of us will continue to file long forms, schedules, use tax accountants and attorneys and buy safes, fences, and burglar alarms because we really don't know up front if, or how much, money we made. And by the way, the progressive tax code is alive and well. This year, the wealthiest 20 percent will pay over 60 percent of all federal tax dollars.

I'm concerned that a premature embracing of a flat rate tax would amount to traumatic, open heart surgery on the current progressive tax code with all of its exemptions, deductions, and credits. Presently, there are 28 million taxpayers who have home mortgages for which they have the incentive to deduct significant amounts of interest payments.

There are 31 million Americans who gave charitable gifts last year. Under proposed new flat tax programs, all such contributions would be made with more
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expensive “after tax” dollars. Two-thirds of under-65 population in America now have company health insurance excluded from their taxes. That would change under the flat rate plan.

The flat rate tax plan by Mr. Forbes, and patterned after Representative Dick Armey’s proposal, would keep Medicare and Social Security taxes intact -- the largest single tax on low income workers, as a matter of fact. The Forbes flat tax plan would place a levy on previously untaxed health insurance for both the employer half and the employee half at 17 percent flat tax rate on both business income and on personal income, respectively. Under the Forbes flat tax proposal, state and local income taxes are no longer deductible, nor would there be credits for the care of children, the elderly, the disabled, etc.

IV. Sustaining A Balance

The proposed Forbes flat tax plan would exclude from personal income tax the following: interest, dividends, rental income, and capital gains. The inheritance tax would also be eliminated. Simultaneously, the income tax rate on the wealthy would be cut in half from 39.6 percent to 17 percent. One would only have to wonder if later on we might have to entertain the possibility of a tax surcharge on the wealthy to regain some progressivity. Keep in mind, as well, that the rate on the poor goes up to 17 percent. We could also envision a tax credit down the road, to try to absolve some of the poor from what could be a greater tax burden than under the old tax code. The Forbes flat rate plan is indeed a tax proposal that essentially would allow wealthy investors to not pay taxes while the working poor’s tax could go up to 17 percent (albeit there are generous personal exemptions for each family member).

The Forbes plan does exempt the first $36,000 earned by a family of four. Herein lies a hint that those in the great American middle class could be paying more tax dollars at lower rates. Remember, at the other end of the spectrum, the Forbes plan reduces the rate on the wealthy from 39.6 percent to 17 percent, exempting any form of non-labor income. How can a flat tax based solely on labor be viewed as fair?

V. No Free Lunch Served

The Gramm plan (Sen. Phil Gramm, R-TX) includes deductions for mortgage interest and charitable deductions and yet touts a lower flat rate (16 percent) than Forbes’ 17 percent. That does not compute. To generate the same amount of tax revenue, the Gramm proposal described herein as embracing major deductions would have to require a higher flat rate than the Forbes plan.
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Actually there are two effective rates in the Forbes’ plan: Zero (for the working poor) and 17 percent. I would worry about attitudes which could develop in those citizens who do not pay even a nominal amount to support the body politic. There is an old adage, “He who is carried on the back of another does not care nor appreciate how far off it is to the town.” Thus, we could be encouraging an ever expanding constituency, wards for the state, who press for more government largess.

The U.S. Treasury Department estimates that the flat rate would have to be pegged at 21 percent to avert enlarging the current federal budget deficits through a shortfall in tax revenue. Further, the Treasury estimates that most middle Americans would end up paying 10 percent more than presently, due to exclusions of both mortgage interest and charity deductions, along with the inclusion of newly taxable fringe benefits.

VI. Business Performance Dynamics

Under the Forbes flat rate proposal for businesses, all enterprises would be treated the same with one rate: proprietorships, partnerships, and corporations alike. Businesses would be taxed on their net cash flow, not net income. This would eliminate, says J.D. Foster of the Tax Foundation, all the complications of attempting to match the timing of income and expenses. Some fringe benefits, health insurance, and payroll taxes, now tax sheltered, would also be subject to a 17 percent flat rate on business income.

According to the Tax Foundation, the business sector which now bears 31 percent of the total federal tax burden would, under the Forbes (Armey) plan, bear about 50 percent of the federal tax burden -- an increase of about two-thirds as the burden is shifted from individuals to businesses. That is, the loss of deductions for state and local income taxes and for the payment of employee fringe benefits (such as health insurance coverage) would cost businesses significantly more tax dollars. I don’t think the word is out on that yet, as many in the business community have currently jumped on the flat tax bandwagon.

Would employers react by cutting back on future employee fringe benefits? And would families be left to buy their own coverage with fewer post-tax dollars? Would this not also bring new pressures on the finances of state and local governments? Inquiring minds want to know. The estimates from the Arkansas Department of Finance and Administration is that such a flat tax could cause an annual shortfall in revenue $40 million.

VII. Tough Questions To be Asked

I believe that, although the flat tax currently is experiencing a great populist ground swell in this election year; it is a form of bumper sticker economics or “pop
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economics," if you will. Most of us have mere superficial understanding. Many questions remain to be answered. This writer is reminded of the story that surfaced a few years back about a troubled man, who, during income tax season, stood up in a darkened theater and shouted, "Is there an accountant in the house?"

The jury is still out on this issue. It will need further study, for there is a sizable built-in lobby in favor of the status quo: accountants and tax lawyers for whom the current, complex tax code is a full employment policy. Alas, we go through three stages in our relation with Santa Claus: first we believe in him; second, we don't believe in him; and finally, we are him. The last stage is the most expensive.

Let the dialogue continue.

References for Further Information

"A Tale of Two Jobs: One Lost, One Gained," by James Carney and Adam Arkley


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Bipartisan Committee on Entitlement and Tax Reform, J. Robert Kerry, Chairman, Washington, D.C.

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In 1995, he received the "Champion of Enterprise" award and became the first inductee into the National Students In Free Enterprise Hall of Fame in Kansas City. The First Annual Distinguished Scholar Award was also presented in 1988 to Dr. Diffine in Cleveland, Ohio, by the Association of Private Enterprise Education. The Wal-Mart Foundation has designated him as a Samuel Moore Walton Free Enterprise Fellow.

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