

How Much Tax Would You Like to Pay?

The following article was written by Mr. Stephen Moore who is president of the Free Enterprise Fund and a senior fellow in economics at the Cato Institute.

Former Senators Connie Mack of Florida and John Breaux of Louisiana and the chairmen of President Bush's new tax reform panel, have been granted a historic opportunity to dramatically overhaul our economically debilitating federal tax system. The surest way for the tax panel to crack through the political gridlock that has paralyzed this issue for decades would be to endorse the Freedom to Choose Flat Tax. This is an idea that I first introduced exactly eight years ago—to an extraordinarily enthusiastic reception.

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Financial Windfall

The potential economic gains for American workers and firms if the tax panel can get the job done are gigantic. For example, if the \$225 billion a year compliance costs attributable to the tax code could be cut in half, the financial windfall to the nation would be larger than the value of all goods and services produced by every worker and business in the states of Maine, Vermont and New Hampshire combined.

On top of that, economist Dale Jorgenson of Harvard University estimated several years ago that if the U.S. tax code were replaced with some kind of flat and simple consumption tax, the economy would grow about 10% faster. This would mean that instead of the economy growing at 4% per year, it could grow at almost 4.5% per year, and in that case the nation could expand its way out of many of its thorniest problems, such as low wage-rate growth, stubbornly high poverty rates, the \$413 billion budget deficit, and the decline in jobs in the manufacturing sector.

So the stakes are pretty darn high here, but almost no one believes that Senators Mack and Breaux have much chance of succeeding. Most Washington insiders predict that the best that can be hoped for is a series of incremental reforms that would amount to tinkering. To me, this is like sending boxes of band-aids to the devastated Tsunami victims in Asia. There have been more than a dozen "tax reform" attempts in Washington over the last 30 years; yet after all of this "reforming," the tax code is as monstrously complex as ever. The tax code is now 3.5 million words long and IRS regulations are another eight million words—together that's about 12 times the length of William Shakespeare's complete works, and 15 times the length of the King James Bible.

The central idea behind the Freedom to Choose Flat Tax is to create an optional post card flat tax, which would be offered to tax filers as an alternative to—rather than a replacement of—the current tax code. There would be no deductions whatsoever, except for a generous personal deduction and child deduction.

If this idea seems gimmicky or unworkable, consider that we already have two tax systems. We have the standard internal revenue code with 1040 forms, etc., and we have an alternative minimum tax (AMT). Under current law, millions of filers must fill out both forms and pay the greater of the two. What I am proposing is an Alternative Maximum Tax of 20%. Under this plan the tax filer would be allowed to pay the lesser of the two tax liabilities. In fact, this idea eliminates the hated AMT by simply lowering the tax rate to 20% on all income, and then letting Americans opt into that system if they so wish.

The plan would be a boon to American competitiveness and job creation because wage and business income would be taxed at a maximum rate of 20%. The corporate tax rate, which is now 35% and well above the world average, would fall to 20%, but all tax credits would be ended. Business capital purchases would be expensed, thus eliminating complicated depreciation schedules. Capital income—from capital gains, dividends, and estates—would also be taxed at 20%.

This plan would accomplish each of the major goals of tax reform. It would be; (1) sweeping in magnitude, (2) fair, because everyone would pay the same tax rate, (3) dramatically simpler

than the current tax code, (4) an enormous boost to U.S. economic growth: and (5) politically feasible to adopt.

The last point is the most significant: This plan would allow tax reformers to avoid the grueling task of dredging the IRS tax code swamp. The plan would also steer clear of the kind of ferocious opposition from deep-pocketed special interest groups that inevitably leads to a political head-on collision where reform advocates suffer most of the casualties.

The advantages to this approach are manifold. First, there are no winners and losers as there are under conventional tax reform plans. Under this optional flat tax, no one is forced into a losing hand because every filer has the option of sticking with the current tax system. So the conventional complaint about a flat tax, that it would raise taxes on the middle class, is rendered null and void.

Second, the plan does not force people to give up “sacred cow deductions” for homeowners, or charitable givers, or owners of municipal bonds. If tax filers want the homeowners’ deduction, they can take advantage of it by staying in the current tax system. Hence, the major opponents to the conventional flat tax—corporate lobbyists, realtors, home builders, mortgage bankers, and charitable foundations—would have little to complain about.

Third, the plan does not require the writing of horrendously complicated transition rules to get from one system to the other. When I worked with Dick Armey on his flat tax proposal in 1994, we were aghast to learn that to implement a flat tax would have required writing tax transition rules that were nearly as lengthy and Byzantine as the rules we were trying to replace. The optional flat tax has no transition rules: Workers and businesses migrate into the flat tax when it is advantageous for them to do so—which, for most of us, is right away.

A broad tax base is also consistent with most Americans’ notion of fairness. Two people with roughly the same income should pay roughly the same income tax.

In the eight years since this plan was first proposed, I’ve heard one persistent objection: that it would dramatically reduce tax collections because people would game the system by filling out both tax forms and paying the lesser of the two.

I believe that most people would simply opt to be done with the complicated tax code immediately, even if it meant a slightly higher tax liability, just so they could avoid the migraine headaches and the enormous compliance costs of the current system. Last year the average tax filer at H&R Block, one of the least expensive tax preparers, paid \$130 in tax preparation costs. Rationally, they would be willing to pay at least up to \$130 more in taxes to have a postcard return. On the corporate side of the tax code, it is currently estimated that tax compliance costs for firms amount to as much as two-thirds of all money collected from the corporate income tax. Hence, many companies, to avoid the nightmare of accounting and legal tax preparation costs, would also opt in to a flat tax even if their tax liability were somewhat higher.

Moreover, since polls consistently show that Americans do not believe that any taxpayer—even the super-wealthy Bill Gates, Warren Buffet, or Britney Spears, should be forced to pay more than 25% of their income in federal, state, and local taxes—this would cap the federal component at 20%. A broad tax base is also consistent with most Americans’ notion of fairness. Two people with roughly the same income should pay roughly the same income tax. One neighbor should not pay less than the other because he invested in bull sperm, windmills, or tobacco farming—or because he has a crafty tax accountant.

Under the optional flat tax, every tax filer would be grandfathered into the old tax code as long as they wished; but once they migrated into the flat tax, they’d be in the flat tax system for good. All new workers would go immediately into the flat tax. Hence, over time, the old tax code would be essentially phased out and would soon become as obsolete as the rotary phone. The plan would require a two-thirds vote of both houses of Congress to raise the flat tax rate.

Hong Kong

For those who believe that such a system is completely unworkable. I would note that the famous and spectacularly successful Hong Kong flat tax of 15% is an optional income tax. Hong Kong has a convoluted "long form" tax system, but not many know about it because nearly all the workers favor the flat tax. And Hong Kong proves that flat taxes do not have to lead to budget deficits. In fact, Hong Kong has run a budget surplus in most years. Similarly, Russia real income tax receipts have soared by more than 80% in just three years since it shelved its three brackets and 30% top rate and adopted its 13% flat rate income tax instead.

Senators Mack and Breau need to understand that a fundamental overhaul of the tax system doesn't require a single change in a paragraph, word or comma of the internal revenue code. All that is needed is a one page supplement to the current tax laws, which says that workers and businesses may have the option of bypassing the first 10,000 pages of legal gobbledygook and instead comply with a post card return with one flat rate for all. If Senators Mack and Breau were to recommend this policy and Congress was to adopt it, this would be the most pro-growth policy change in America since the Reagan tax cuts in 1981. And the Mack-Breau panel would arguably be the most successful presidential commission in American history.