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FLAT TAX PROPOSALS

HEARINGS

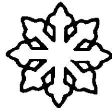
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

APRIL 5 AND MAY 18, 1995



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FLAT TAX PROPOSALS

WEDNESDAY, APRIL 5, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood, (chairman of the committee) presiding.*

Also present: Senators Grassley, Murkowski, Moynihan, Bradley, Breaux, Conrad, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order, please. Today is the first of our hearings on the proposals called flat taxes. We will have some hearings on the Nunn-Domenici bill. There are a variety of alternatives, consumption taxes, as they are called, the flat one being the simplest, and, in my judgment, perhaps the best.

I was just talking to Senators Shelby and Mack. Every now and then there is an idea whose time may have come, and when it does it comes faster than people realize. I do not dismiss the possibility that some form of this tax, something very close to what the witnesses today and I am thinking about, could pass in this Congress.

Any of us who go home are asked this question: "why can we not have a flat tax? why can we not have a flat tax?" why can we not have a flat tax? It is not something we have to bring up. The mood is there, the momentum is there. I think the public is waiting for this.

Are there some differences? Yes. Are there some flat taxes that are not really flat because they have lots of exemptions? Yes. Are there some that have different rates so that they are not really flat, they have progressive rates? Yes.

But, basically, there are really two or three essentials. One, almost everything is counted as income. Two, most deductions are eliminated. By doing that you can get the rates low enough—and this is the encouraging thing about it—that almost any economist will say, this will encourage savings and productivity.

You get the rates far enough down and many taxpayers will say, all right, I will give up my special exemptions, and deductions, and doodads, and gewgaws that would encourage me to invest in—and pick whatever it is you want to pick—a particular thing if you get

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*The Joint Committee on Taxation prepared a pamphlet entitled "Discussion of Issues Relating to Flat Tax Rate Proposals," (JCS-7-95), April 3, 1995.

the rates low enough that I can pay it, simply, and I have got enough left over to invest.

So, I welcome both Senator Shelby and Senator Mack, and I expect Senator Craig will be here soon. Congressman Armey was scheduled to testify but I think he has a conflict with the tax bill they are trying to work on with the House right now and will not get here today. But I am delighted to start with both Senators Shelby and Mack, and I would call on Senator Moynihan for any comments he may have.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Just to welcome our colleagues and say we look forward to the Majority Leader, when he can come. If I can, just once more, Mr. Chairman, put in the record the letter I received a year ago from that most revered of Solicitor Generals, Erwin Griswold, who, from the time he entered the Solicitor General's Office in the Hoover years and became the Nation's leading law school authority on taxes, made it a point of principle to make out his own tax returns and to record just what he did.

Last year he had just finished them and, in great detail, he reports that it took him 100 hours. This is the man who wrote most of the tax laws of our age. He suggests—it is a nice image—getting other people to make out your tax returns is like buying a volunteer to get out of the Civil War draft. I would like to insert that into the record.

The CHAIRMAN. Without objection.

[The letter appears in the appendix.]

The CHAIRMAN. Senator Conrad?

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. Welcome, Senator Mack and Senator Shelby. It is good to have you with us. I look forward to your testimony. I am a former tax administrator, as many of my colleagues know, so I have a special interest in this subject.

One of the reasons I am probably in the U.S. Senate is I convinced our State to go to a very simple State income tax. We took a percentage of the Federal return, all done on a postcard-sized return, and it was very popular in the State of North Dakota. I think we saved, literally, hundreds of thousands of hours of tax preparation time.

It is always interesting to serve on this committee and see the extraordinary complexity of the Federal system. There is no reason that system cannot be dramatically simplified.

I think the taxpayers would appreciate that and I think we would save, not only hundreds of thousands of hours of tax preparation time, but I think we would save an awful lot of time of people figuring out how to reduce taxes instead of figuring out a way to make productive investments.

With that said, Mr. Chairman, I think there is an important caveat to all of this. First of all, many of the flat tax proposals that have been made do not raise the same amount of money. They fall

very short of raising the same amount of money as the current system.

When you adjust for that, you then often have a percentage that means that everybody under $70,000 a year of income pays more under a flat tax arrangement, and those over $70,000 a year of income, pay less. I do not think that is the intention of at least many of the advocates of a flat tax. I think we would want to have roughly the same distributional burden as we have now. But those are things I think we have to watch very carefully.

Is it going to raise the same amount of revenue? If it does, does it then have this perverse effect of raising taxes on those below $70,000 and reducing taxes on those over $70,000? So, those would be tests that I would apply as we evaluate these various proposals.

I thank the Chair.

The CHAIRMAN. Senator Murkowski.

STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Thank you, Mr. Chairman. I guess we would all agree, over the next 12 days or so, we would all be happy to settle for a flat tax. It sounds simple, it is easy to spell, and, therefore, it ought to be a great relief.

I am told that for the IRS instructions for last year's return, the average amount of time for recordkeeping—or I think the term was learning the law, or the form—in preparing a 1040, was nine hours and 39 minutes.

And, if a taxpayer itemizes deductions, the taxpayer is going to have to spend another four hours and 5 minutes to complete Schedule A, and another 58 minutes would be needed to complete Schedule B. I am told that is a total of 14 hours and 42 minutes. If you believe that, I have some wetlands in Alaska I would like to sell to you, because it is much more than that.

The fact is, the tax forms are becoming so confusing and complex that the only gratification I have is that I see a couple of my colleagues here prepared to testify about how to do something positive, because it is the fault of the Congress that we got into this dilemma and we are looking to the Congress for relief. That means, as Pogo said 1 year, "The enemy is us."

I think there is a great deal of appeal, Mr. Chairman, for an easily understood tax system, not just for individuals, but for businesses. But, as you know better than anyone in this room, getting from here to there is not an easy task.

We did a little research, Mr. Chairman, and I am told back in April of 1986 there was a tax reform effort that almost came to a halt in this committee, and you had your famous beer—I trust the Chairman is paying attention—with Bill Diefenderfer at the Irish Times and tried to figure out how to get tax reform back on track.

I am told that you looked at how low you could get the rates and you came to a top near 20 percent initially, but that meant ending the mortgage interest deduction, deductibility of State and local taxes, and a host of all kinds of tax preferences.

I am also told, you restarted the process with a compromise with a 15 and 27 percent rate structure, but to get there you had to re-

store State and local income, property tax deductibility, and you had to keep the mortgage interest deduction.

So, nearly 10 years later here we are looking at the flat tax. We will have to ask the American people, what trade-offs do they want to make for a lower rate? Do they want to keep full deductibility of State and local taxes, do they want to keep a mortgage interest deduction, and what about charitable deductions?

How should the base of income be defined? Should employer provided health care benefits to be included in income? What about pension contributions? What about the exclusion of employee educational expenses? What about the deduction for health care? These are some of the trade-offs that we are going to have to reflect on and weigh in considering a complete revision of the income tax.

I want to assure you 10 years later, as a new member of the committee, Mr. Chairman, I look forward to working with you. Based on your experience in that, with your colleague, Senator Moynihan, hopefully we will have learned something in the last 10 years and we will not have to start where we did 10 years ago. But hope springs eternal.

The CHAIRMAN. Senator Grassley has indicated that he did not want to make an opening statement. I want to quote just one thing from Congressman Armey's statement, in answer to what Senator Conrad said.

This is on page four of his statement. "Let me be clear about one thing. I would like my bill to be debated on the merits, not on the issue of revenue loss. If the Joint Committee on Taxation predicts a greater revenue loss than my figures indicate, the legislation can be simply adjusted by raising the rate, trimming back the family allowance, adding further spending reforms as offsets, or some combination of these, the revenue loss argument is a red herring."

That is the first time I have heard him say he is willing to do that, but I think that is a great step in the right direction of saying, all right, we are not going to lose revenue on this.

Second, I will comment, and then we will take Richard. There is no question, if we go this route, of the flack we are going to get. The headline in the publication of the National Association of Realtors a week or two ago, their little flysheet, big headlines, "It's War!". It was like VE Day or Pearl Harbor. It is war!

They were going after anybody who supports a flat tax. It was not just me, it was anybody that is going for a flat tax that in any way limits the mortgage interest deduction.

Senator MOYNIHAN. And just think, every one of them a contributing member of the Republican Party. [Laughter.]

The CHAIRMAN. Senator Shelby.

STATEMENT OF HON. RICHARD SHELBY, A U.S. SENATOR FROM ALABAMA

Senator SHELBY. Thank you, Mr. Chairman. I am sorry that the Majority Leader over in the House, Congressman Armey, could not be here today because, as you well know, he is the principal sponsor of this bill in the House, and has been a proponent of the flat rate tax a long time. I am handling the Armey version of the bill in the Senate.

Mr. Chairman, I want to thank you for presenting a forum to discuss the advantages and the disadvantages of a flat tax. I will say from the start, Mr. Chairman, I believe the disadvantages of a flat tax are little to none.

I would like to begin the discussion by answering the question, why is Congress even considering tax reform? The current system, as you well know, Mr. Chairman, and as the Senator from New York knows, the former Chairman of the committee, while serving its purpose of revenue collection, has been criticized for not being fair, for punishing individuals who save, and for being too complicated, as the Senator from New York just alluded to.

Keeping in mind those criticisms, I believe any reform we implement must address these problems. Over the years the income tax has had many graduated rates, each adjusted during different years of history.

During the Hoover Administration, rates ranged from 25 percent to 63 percent. During the Kennedy years, rates ranged from 14-70. Now the top rate is 39.6 percent. Which of these rates are fair? Is a rate of 39.6 on the wealthy more fair than 70 percent, or is it fair, period? Clearly, these so-called "fair rates" are arbitrary.

In addition, Mr. Chairman, the current Tax Code punishes thrifty individuals who save and invest, individuals who work hard to pay the taxes on his or her wage income, to put food on the table, a roof overhead, and clothes on the children.

If the individual is thrifty and saves money, this person is currently taxed on investment income. This double taxation hinders capital formation. Indeed, individuals now hold onto capital gains simply to avoid paying taxes. Instead of putting the capital to the highest valued use, the individuals feel their money is trapped by the current high marginal rates of investment income.

As for simplicity, the current Tax Code is anything but simple. With approximately 480 tax forms, the Tax Code makes the average individual's head spin. The time and resources wasted just to comply with the current Tax Code is estimated at 5.4 billion hours, or a cost of over $150 billion, Mr. Chairman. Clearly, the U.S. could be more productive with a less burdensome tax system. The flat tax addresses each of these problems.

The definition of fair, as defined by Webster's Dictionary, states "marked by impartiality and honesty, free from self-interest, prejudice, or favoritism."

The Armey-Shelby flat tax has one integrated rate of 17 percent. Everyone is treated the same and there is no favoritism. The beauty of the Armey-Shelby flat tax is the general individual allowances which, in effect, make the system progressive. As a result, the flat tax meets the criteria of fairness as historically defined, and as the current political rhetoric would have it.

The savings rate in America, Mr. Chairman, as you well know, is anemic. A great deal of this can be attributed to the current Tax Code. The flat tax repeals the double taxation of investment income by taxing it once, Mr. Chairman, and only once, at the source. As a result, individuals will not feel their capital is locked in and will be able to move capital into the highest valued use.

In addition, the flat tax is expected to pull down interest rates because today's interest rates are sustained partly by the income

tax deduction by interest paid and the tax on interest earned. By repealing this treatment of interest in the Tax Code, interest rates are expected to fall to about the same level as that of municipal bonds. This will reduce the cost of capital and also aid in capital formation.

Mr. Chairman, on the issue of simplicity, no other plan meets this criteria better than the flat tax. Although the Nunn-Domenici tax reform achieves some of the same goals of a flat tax, like ending double taxation, it does not simplify the Code that most of us would like to do. Indeed, some may argue Nunn-Domenici complicates the Code further.

Instead of countless hours and expensive accountants, the individual can fill out the income taxes on two simple tax forms the size of a postcard under Armey-Shelby.

Lastly, Mr. Chairman, I would like to say that any tax reform Congress may adopt must reduce the marginal tax rate. Economists on both sides of the aisle agree that a lower marginal tax rate will stimulate growth in our economy.

In the face of the current fiscal crisis I am convinced, Mr. Chairman, the most effective, but least painful, way to address the issue is with strong, sustained economic growth. The Armey-Shelby flat tax would provide that growth.

Mr. Chairman, you have probably seen this, but this is a proposal of the tax form that American people would use under the Armey-Shelby flat tax reform.

Senator MURKOWSKI. That is just the first page.

Senator SHELBY. That is right. That is what we want Senator Murkowski to use. Thank you.

Mr. Chairman, as I said earlier, I appreciate the opportunity to be here. I am probably not wanted, but overdue, at the Appropriations Committee, where I have the head of NASA there, if you would excuse me.

The CHAIRMAN. I am sure you are both wanted and overdue.

Senator SHELBY. Thank you, Senator.

The CHAIRMAN. Senator Mack.

[The prepared statement of Senator Shelby appears in the appendix.]

STATEMENT OF HON. CONNIE MACK, A U.S. SENATOR FROM FLORIDA

Senator MACK. Thank you, Mr. Chairman, and members of the committee. Today the committee will hear from many distinguished thinkers about the need for a flat tax. They will make arguments about fairness, simplicity, cost, and class warfare. They are all right. Flat tax will improve today's tax system in too many ways to count, but the most important benefit the flat tax has to offer is unparalleled economic growth.

In the last 30 years, our economy has slowed to well below its historic growth rate of four percent, and that has hurt the standard of living for every American. This chart illustrates the gap between the historic four percent growth rate and where we are today. That gap amounts to almost $2.7 trillion.

Now, I am not trying to imply that a change in the Tax Code alone would allow us to return to that historic growth rate, but I

would make the argument that, along with getting control of Federal spending and giving a specific target to the Federal Reserve with respect to stable prices as its primary objective, a change in the Tax Code can get us back to that historic four percent growth rate.

The flat tax is such a fundamental change from the way government does business today that there are no economic models which accurately calculate its impact on economic growth. Nobody—not CBO, not OMB, not Treasury, and not the Joint Committee on Taxation—has predicted the dynamic potential of a flat tax.

I am absolutely convinced that the facts are allies in this struggle, and we will need all the information we can muster in our battle with the guardians of the status quo.

As chairman of the Joint Economic Committee, I commit to the members of this committee that I will use the resources at my disposal to give us better information on the effects of the flat tax on individual behavior, corporate behavior, and the economy in general; in short, the information we need to make an informed decision.

I applaud you, Mr. Chairman, for holding this important hearing. Under your guidance in 1986, we began to reform the tax system by lowering marginal tax rates and broadening the tax base. Unfortunately, the marginal income tax rates that were limited to 15 and 28 percent only a few years ago now reach as high as 45 percent.

Tax rates affect people's incentive to work and invest. The amount of after-tax income they get to keep determines whether they work, whether they work overtime, whether they seek out tax shelters, or simply stay at home.

As Americans struggle to complete their tax returns by April 17th, it is appropriate to consider the failings of today's tax system. It punishes work, savings, and investment through high marginal tax rates and double taxation.

It hinders the full productive potential of our economy in every American's effort to achieve a higher standard of living. It is too complex, it is inefficient, inequitable, and costly for both individuals and government. I believe we need a single, low-rate flat tax.

The flat tax would spur unprecedented economic growth by eliminating destructively high marginal tax rates and boosting investment, productivity, wage growth, and standard of living. This is not idle speculation; when Presidents Kennedy and Reagan lowered marginal tax rates the economy boomed.

The flat tax would radically reduce the cost of complying with the Tax Code, costs currently imposed on every individual and business. People would finally be able to easily calculate what they owe in taxes, the IRS would no longer publish 480 different tax forms, taxpayers would not have to wade through 1,378 pages of Tax Code, and 6,439 additional pages of Federal tax regulation.

The flat tax would end the economic damage caused by the current system. Today the graduated income tax demands an increasing share of people's hard work and success. It is no wonder Americans feel that they are working longer and harder with nothing to show for it, because they are. Under a flat tax, class warfare would

end. People would be treated equally under the law, and all taxpayers would be treated fairly.

No doubt, some will try to kill the flat tax to preserve the status quo. For 80 years, the Tax Code has grown to accommodate the demands of special interest groups. Over time, taxpayers have come to feel dependent on these tax credits and deductions for their economic survival. However, once marginal tax rates are drastically reduced, today's deductions will be unnecessary for everyday taxpayers.

A low flat-rate tax would allow people to keep more of their own, hard-earned money, decide for themselves how to use it, and not grovel for lower taxes by conforming to a list of approved uses dictated in Washington. Under the flat tax, government would finally stop tinkering with people's lives through the Tax Code.

Americans are working longer and harder to improve their lives, but their efforts are being eroded by our outdated and punitive Tax Code. With the flat tax, we have the chance to free our economy and secure for our children and grandchildren a better standard of living. I embrace that goal, and will work to make that dream a reality.

Mr. Chairman, if I may add just one additional comment with respect to the discussion we had a few moments ago, I hope you are right. I hope that there is a momentum that is building in the country. I certainly hear it throughout my State with respect to, why do we not have a flat tax, why are you not pursuing a flat tax?

My own instincts indicate, however, that this is a debate that is going to have to go on for some time, and probably will be a central point in the elections in 1996. Hopefully, at the end of that election we could come back and, in 1997, be prepared to move a flat tax forward. If it can be done faster, I am all for it.

The CHAIRMAN. My experience on this has been threefold. Either you move deliberately, in which case you lay the groundwork and you do lots of David Brinkley, and Meet the Press, and Face the Nation appearances, and editorial symposiums, and you lay broad groundwork, or you do it quick, before there is much organized opposition. If you try to do it the middle way, what you end up doing is losing, and then you set the cause back 10 years because people do not want to try that again.

I want to congratulate you. I think I have got this figured right. This Joint Economic Committee letterhead is new, is it not?

Senator MACK. That is correct.

The CHAIRMAN. For those who cannot see this, it is a very well-done letterhead. There is a picture up in the corner, and the picture is of Adam Smith, which I thought was very interesting, from the Joint Economic Committee standpoint. I assume that may reflect the philosophy of the chairman, somewhat.

Senator MACK. I think that is a fair assumption.

The CHAIRMAN. Who happens to be Senator Mack.

Let me ask you a question, Connie, and I am quoting from your statement. "There are no economic models which accurately calculate its impact on economic growth. Nobody—not the Congressional Budget Office, not OMB, not the Treasury Department, not the Joint Committee on Taxation—has predicted the dynamic potential of the flat tax."

I think you are right. How can you model it? How can it be done so that with some degree of confidence we can have a feeling that an estimate is right?

Senator MACK. Well, that is a very difficult question and it is a debate that we have had around here for years. In dealing with the Tax Code, as we presently do, the issue on the capital gains, we have had several meetings to try to make determinations about whether it accurately reflects what will happen in the future.

I am told that there are a number of academics that have been pursuing how changes in marginal tax rates affect the amount of time an individual is willing to work. There are many who state that, for example, for women with a husband working, that when you add their income to the husband's, that they, in effect, are being taxed at the marginal rate of the husband and, therefore, discourages women in the work force.

There is indication that those between 55 and 65 have retired early, that a lower marginal tax rate would encourage those folks to come back into the work force. So, there are people out there who are working on different aspects of how the lower marginal tax rate would affect the work force. That is only one aspect of it.

Then what about investment? Under the present Tax Code you can make arguments that it really discourages entrepreneurial activity, that it focuses more investment into the safer interest-related investments because of the deduction of interest. There are those who are looking at that aspect of it.

So, I do not know at this point whether there is one individual or one organization that you can go to, as I have indicated in my statement, but I believe there is more and more work that is being done in these different areas. Hopefully, again, with the Joint Economic Committee, we can find those folks, bring them together, and see if we cannot develop a way to make a reasonable estimate of what the effect of a lower marginal tax rate would be.

The CHAIRMAN. Let me ask you this. We can bring them together. I think I have seen every economic study done known to man as to what tax rates will produce and what they will not produce, from pure static, double the rate, double the revenue, have the rate, have the revenue. They are the most wildly optimistic, beyond behavioral, beyond dynamic. It is a word not known to the English language in terms of, cut the rate to 5 percent and we will quadruple our revenues.

Would you be willing, as Congressman Armey now apparently is, to say, all right, for better or for worse, I will live or die with the Joint Tax Committee estimates? I realize that is what we rely upon. We can work with them, we can meet with them, we can say, how did you get there, we can question their estimates, but, at the end, could you agree to live with them?

Senator MACK. Well, let me respond to that question this way. I certainly want to work with the folks on the Joint Tax Committee and work through the process. We have had several opportunities to talk about the analysis of capital gains tax rate reductions and what effect they are projecting. I have some additional suggestions that I would like to make to them before we conclude exactly how I will come down on the issue.

I guess I do not want to say going in that I am just going to accept anything that the committee puts forward, I want to see and understand the process that they go through. If I am satisfied with that, then obviously I am going to be supportive. If I have a difference of opinion, I will state that, and clearly we can all decide which we are more comfortable with.

The CHAIRMAN. All right. A couple of more questions. This is a figure I ran, it is seven or 8 years ago, now. It is the difference in revenue collections to the Federal Government between an economy growing at three percent and four percent, not unlike what your chart showed. These figures are, I think, 8 years old.

Then over 5 years we collected someplace between $250–300 billion more in revenue with just the 1 percent growth. My guess today is, that would be closer to $400 billion. That is just my hunch, based upon inflation a bit in the last years.

So, there is no question but what growth can be a tremendous engine. There is no question, four percent versus 3 percent is a tremendous difference. There is no question with that growth, everybody benefits, the poor, the middle income, the rich.

There is also no question that you can exempt in almost all of the flat taxes, not the poor, but I would say the lower, middle-income group, and you just exempt them. As a matter of fact, if you were to do a 19 percent rate with about a 16 and 32 married and single deduction, you would drop an additional 13 million people off the tax rolls, beyond what we now do.

There is also no question that if you have a fixed percentage, 17, 18, 19, 20 percent, whatever percent you have, the very rich will pay less taxes than they pay now. I do not mean in the aggregate. The growth may be so great that they produce more taxes. But, if somebody is making $1 million at 20 percent they will pay $200,000, less whatever exemption they have, if everybody gets the exemption. You are making $100,000, you pay $20,000.

Do you think that presents a political hurdle, and how do you defend against the charge that that is favoring the rich?

Senator MACK. Well, I think there are two responses that I have. One, is that we have to understand that if we end up with a tax proposal in which middle-income America is picking up a greater burden of government than they are presently paying, I think it is almost written in law that that ends up being defeated. So, I think it has to be done in such a way that we do not ask middle-income America to pick up that burden.

I am a little bit surprised at this because most of us were trained—at least I was trained—in economics in the late 1950's and 1960's, and Keynesian economics was kind of the driving force.

And I can remember in our discussions on tax policy and progressivity what appeared to be the only acceptable answer was a Tax Code that had higher marginal tax rates as you went up in the income levels.

For some reason, today, people have concluded that that is not necessarily fair and that there is another way to look at a progressive Tax Code. Again, for simplicity, if a person makes $100,000 a year and pays $10,000 in taxes, and somebody else makes $1 million and pays $100,000 in taxes, people believe that is fair.

I think what they believe is, as you eliminate deductions everyone is being treated equally and fairly in the system. And if you make $1 million and you pay $100,000, that is fair, and if you make $100,000 and pay $10,000, that is fair as well. So, that would be my response to your question.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Yes. Mr. Chairman, I would remark, too, we certainly have a first here, which is the very attractive letterhead of the Joint Economic Committee with a profile of Adam Smith, who I believe—and correct me if I am wrong—was a loyal subject of George, III. Now, are we to have foreigners on the letterhead of the U.S. Government?

Senator MACK. I would suggest it probably is not the first time.

Senator MOYNIHAN. Well, we could look into that. That is what the General Accounting Office is for. [Laughter.]

Senator MACK. I might remind you that there is an effort to reduce that organization by 25 percent. Maybe they will not be able to focus on that.

Senator MOYNIHAN. All right. Well, if we are going to have Adam Smith on the letterhead of the Joint Economic Committee, which was established by the Employment Act of 1946, and if we start with his most important work which was published in London in 1759, "A Theory of Moral Sentiments and The Wealth of Nations" was published, I believe, in 1776 and is useful for its exploration of comparative advantage.

But, as a work of societal significance, A Theory of Moral Sentiments is surely the more important. What would you think a study of that text would imply for your proposal?

Senator MACK. I have not the slightest idea. [Laughter.]

Senator MOYNIHAN. They just cannot get past that 1776 thing. We have a fixation.

You say at the University of Florida they were Keynesians and they taught progressive income tax rates. I thought the progressive income tax was something proposed by President William Howard Taft and produced the 16th amendment to the Constitution. Did Lord Keynes have anything to do with that?

Senator MACK. No. The point that I was making was that, at the University of Florida, in the economics courses I took, one was Keynesian economics and the other was in tax. A progressive tax code was seen as a tax code that said, as you made more income you would pay higher marginal tax rates.

Senator MOYNIHAN. Yes. Well, we had a progressive tax somewhere around the Civil War, did we not? I am pretty sure. We did. Then the issue of the Constitutional provision intervened. Taft thought he could impose one Constitutionally, but decided not to, to wait till the Constitution was amended.

Anyway, could I make the point, sir, not in any mode of disputation, but 73 percent of the American people now pay a higher amount of FICA tax, the Social Security tax under the Federal Income Contribution Act, than they do the graduated income tax. The FICA tax is a flat tax. I mean, it is a fact that for almost three-quarters of the American people, their most important tax is, in fact, a flat tax. Is that not the case?

Senator MACK. Yes.

Senator MOYNIHAN. How did that come about? I guess this committee imposed the rate, did it not? Franklin D. Roosevelt. There is another fellow we have got to get rid of.

Senator MACK. Put his picture on it.

Senator MOYNIHAN. No. I simply make the point, with respect to a flat tax, the American revenue system is now drawing enormous amounts of money from what is, in fact, a flat tax.

The notion that we have a hugely progressive rate structure, I do not think, would sustain close analysis, but I am sure we should have it. I thank you very much for your testimony, sir, and for what is certainly an inspired idea.

Why do we not have Hamilton in our letterhead? That would not bother anybody. He is a New Yorker.

The CHAIRMAN. I was thinking of Andrew Jackson.

Senator MOYNIHAN. Andrew Jackson. Well, there you are.

Senator MACK. I will now have to go back and read Adam Smith's first work.

Senator MOYNIHAN. A Theory of Moral Sentiments, London, 1769. It will take you some while, but then so will the flat tax. [Laughter.]

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. You know, it is a joy to be on this committee, and every morning to be greeted by a mini-seminar from the Senator from New York. It really makes service here much more interesting, and I thank the Senator from New York. I had no idea of Adam Smith's earlier work, and maybe I will even go read it.

Senator MACK. We could set up a class.

Senator CONRAD. Yes.

Well, let me get to questions. First of all, with respect to the flat tax proposal, let me ask you this. As I understand it, interest income is not taxed and if somebody was earning $100,000 of interest income, inherited, was getting $100,000 of interest income, they would pay nothing towards Social Security under this approach; somebody earning $50,000 of wage income who was working, would pay towards Social Security. Is that fair?

Senator MACK. The proposal I believe that you are referring to is the one that Senator Shelby and Senator Armey are proposing. I do not have a specific proposal that I am supporting at this time, but I think that you are correct with respect to the Armey-Shelby proposal.

Senator CONRAD. Would you think that is fair?

Senator MACK. My instincts say to me, again, if you are going to tax interest, in essence, at its source, then that source of income has already been taxed and should not be taxed again.

Senator CONRAD. Well, this is for Social Security. It has not been taxed for Social Security. I mean, I will tell you, I think this thing has got very serious problems right out of the box if what we have is a system that somebody earns $100,000 of interest income, is not working, and they pay nothing towards Social Security, and somebody earning $50,000 by working, does fully contribute to Social Security. It seems to me there is a great inequity.

Senator MACK. Would that income be taxed today——

Senator CONRAD. Yes.

Senator MACK [continuing]. For Social Security?

Senator CONRAD. No. Those people would have to be reached in another way.

Senator MACK. Well, but I think that is the answer to your question. I mean, they are not proposing—at least not that I am aware of anyway—that we treat it any different with respect to Social Security than present law.

Senator CONRAD. Let me ask you this. Do you think the system should raise the same amount of money?

Senator MACK. I think, generally, it ought to be directed on raising approximately the same amount of money.

Senator CONRAD. So that we are making a fair comparison, apples to apples comparison, in terms of tax systems. If we do that, most of the analysts would say that those over $70,000 a year of income would pay less, those under $70,000 would pay more. Just accepting for a moment that scenario, what would be your conclusion; is that a fair result?

Senator MACK. Well, as I said to the Chairman, if you end up with a situation where middle-income America is going to be paying a higher tax burden, I do not think you are going to pass it.

So, it seems to me you have got to find ways to adjust that burden. It has been suggested that you can do that through personal exemptions, through the level of personal exemptions and deductions.

Senator CONRAD. Let me just go to the testimony that we are about to get from Alan Auerbach, from the University of California at Berkeley. He says, "Virtually any flat tax would reduce the tax burden on high income individuals. If the poor also benefit through high exemption threshold and tax revenues remain the same, then even in today's magical world of budget analysis this means the middle class will face a tax increase." Why is that not so?

Senator MACK. Well, again, I think it depends on exactly how you structure it. If I remember correctly, Congressman Armey's plan would, in essence, take individuals and families up to around $36,000, $37,000 a year off the rolls. I have not seen the analysis of what that does at this $70,000 of income.

Senator CONRAD. Let me just say, the problem with that is he falls $180 billion a year short of the current revenue system, so he is way short of raising the revenue in the current system.

But, just as a mathematical model, if you think about it, if it reduces taxes on the wealthiest and you have a generous cut-off and reduced tax on those who are on the bottom end of the income scale, to raise the same amount of revenue the middle-income people have to pay more. Would you reject that outcome?

Senator MACK. As you say, or as I would indicate, I do not think you could pass a tax reform package which increased the burden on middle-income America. Again, I think it also depends on whose models you are using and how it is calculated. So, I am being a little cautious as to the response that I am giving to you. I want to look at the data before I draw that conclusion.

Senator CONRAD. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Let me say two things. That $180 billion estimate was based upon what they thought Congressman Armey's

proposal might be, and they assumed every worst assumption. There is no bill yet. He has not introduced a bill.

I will read again what he said in his testimony, although he is not here. "I would like my bill to be debated on the merits, not on the issue of revenue loss. If the Joint Committee on Taxation predicts a greater revenue loss than my figures indicate, the legislation can simply be adjusted by raising the rate, trimming back the family allowance, adding further spending reforms as offsets, or some combination of these. The revenue loss argument is a red herring."

So, he is willing to compromise in whatever fashion necessary to make this revenue-neutral. That does not answer the question you are talking about about progressivity, but I think it does answer the revenue argument.

Senator CONRAD. Let me just say, if I could, Mr. Chairman, obviously, if it does not raise the amount of revenue that is necessary to be revenue neutral, at a 17 percent rate, you go to a higher rate. That then alters who pays more and who pays less. I think, to be considered on its merits, the amount of revenue that it raises or does not raise has got to be part of the consideration.

The CHAIRMAN. Senator Murkowski, then Senator Bradley.

Senator MURKOWSKI. I would like to compliment Senator Mack. I do not know how many of us remember our economics course in college, let alone are prepared to have a test on it by the Senator from New York. I am glad I did not volunteer for a presentation on that side of the table this morning. Shelby did leave.

Let me reflect on this question of raising revenue adequate to fund our current budget. It seems to me that a flat tax can, in effect, be progressive even though the rate is flat.

The most attractive feature of a flat tax, from my perspective is that it would encourage savings. In other words, investments would not be taxed twice, they would be taxed once.

How do you factor in the value of that savings in increasing the capital available in the country for inventory increases, new plants, new equipment? Theoretically it would reduce the necessity of borrowing to fund our deficit, attracting capital into the country, and so forth.

It seems to me, Mr. Chairman, as we address the issue of a revenue loss or a target that we have to achieve through whatever tax reform we are going to have, you have to bring the value of that savings in and equate it somehow as to what that contribution is worth.

Only then are you reflecting the true merits of what a flat rate application would do to the overall economy. We are the largest country in the world in relation to many activities, but we are the lowest in savings because we have a conceptual application that discourages savings.

I wonder if you would comment on just how you feel the flat tax would increase the pool of capital, and what is that worth, how do you equate that?

Senator MACK. Yes. I do not know that I can give you that answer. There are several people out there who have done studies with respect to capital formation, what the impact would be on interest rates, the pool of savings that would result from it.

I am not in a position to be able to make any kind of definitive statement today with respect to that. I have heard some indicate that you would see interest rates some two percent lower. That is a rather significant savings to the average family, in the form of mortgage rates, and so forth.

A flat tax, as I envision it, has no tax on capital gains, and, in essence, no double taxation on dividends, which would encourage savings and investment. I think, again, it is a difficult thing to evaluate. But I see high capital gains rates as a wall or a barrier between present investments in old technologies and this potential investment in new technologies.

This barrier, this tax rate, capital gains, freezes in people in investments and old technologies. America's future, and our kids' and our grandchildren's future, is going to be based on the ability to move that locked-up capital from the old investments and allow it to flow into the development of new technologies. To me, that is the key to the future. In my mind, it is clear that a flat tax will do a great deal to increase the pool of savings and investment in this country.

Senator MURKOWSKI. Mr. Chairman, I would appreciate your consideration on a hearing at some future time to address the value of what the increased savings would mean to offset, potentially, the revenue that would be lost. In other words, what is the multiplier; how can we factor that in?

I am sure you have had that experience; I have not.

The CHAIRMAN. You mean the estimates?

Senator MURKOWSKI. Yes.

The CHAIRMAN. Well, we have had some; we may have more. This is what I asked Connie about earlier. How do we know, where do we find, who can we say knows for sure, here are the accurate estimates? I do not think we will every know. Part of this, finally, is done on faith. There is no way you can predict it.

Senator MACK. I think also what happens is that hopefully there is a range. You get enough people involved in the debate and some on the extremes on both sides are going to be thrown out and you are going to end up with a range in which people are going to make a decision where in that range they are going to come down. So, I do think it is important that we get as much input on the aspect of the question that was raised by the Senator from Alaska.

The CHAIRMAN. I think you are absolutely right. But I have also discovered this, you can hire almost any study you want with just a slight wording of the questions changed a bit.

I would hate to think that we get into this and each side who either wants it or does not want it starts to hire different estimates so that they have got plenty of people on their end of the range from which you are then going to average.

We will never solve this question, and that is one of the reasons we have always finally ended up with the Joint Committee's figures, at least, that we all used. Do we all always agree? No. Are they better than most other figures? Usually. Are they wrong on occasion? Often. Are they any more wrong than anybody else on occasion? No.

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman. Senator Mack, welcome to the committee. Mr. Chairman, I was reminded of a personal experience when Senator Shelby brought out his card that his flat tax could be placed on. During the mid-1980's I used to travel around the country with such a card and talk about how, if we got lower rates, we could end up with a whole income tax return on this card. I still believe the best possible tax rate is the lowest possible tax rate.

So, I figured I made the big time when I went on David Letterman, and I took out my card and I said, see, if we did this Fair Tax, which is what I called it at that point, we could have the whole income tax return on this card. At which point David Letterman looked somewhat incredulously and said, "Do we have any response from the audience?" At which point, one of his minions brought out a giant, dead fish and put it in front of me.

I think, if we begin to look closely at this flat tax, that it is going to resemble the dead fish, which does not mean you should not look at it carefully, which does not mean that those who support it do not have the best possible intentions and are not dedicated public servants, but there are some basic things we want to look at.

I mean, for example, when the rate was 90 percent, when it was 70 percent, when it was 50 percent, when it was 28 percent, we have raised basically the same amount of revenue, about 19 percent of GDP.

What has changed, of course, are the loopholes, those that are in, those that are not. So, it is always attractive to focus on the rate side, but I assume anyone would say that a flat tax is all right, but there is a rate at which even a flat tax would not be acceptable. Would you not agree, Senator Mack?

Senator MACK. Absolutely.

Senator BRADLEY. I mean, if you had a flat tax at 42 percent, that would not exactly achieve your objectives, would it?

Senator MACK. That is correct.

Senator BRADLEY. Therefore, it is very important to know, what are the exclusions, credits, and deductions that you are going to place in a Tax Code, because what you choose to place in the Code drives the rate. The more you put into the Tax Code, the higher the rate has to go. And, if you are arguing a flat tax, the higher the flat tax has to go.

So, just based on your own sense, I wonder whether certain things that are in the Code now, you would actually put in a flat tax. For example, would you retain the deduction for the interest on home mortgage?

Senator MACK. No, I would not.

Senator BRADLEY. You would not.

Would you retain the deduction for employer-paid health insurance?

The CHAIRMAN. Do you mean the deduction or do you mean the inclusion in income?

Senator BRADLEY. Inclusion in income.

Senator MACK. I would keep it as an inclusion in income.

Senator BRADLEY. You would include what an employer pays into your income.

Senator MACK. We see that as a legitimate business expense.

The CHAIRMAN. Wait. We are talking about two different things. You are talking about deduction versus——

Senator BRADLEY. I am talking about, your employer pays $3,000, $4,000 for your health insurance. That is now not included in your income, it is a tax expenditure. Would you include that in an individual's income, thereby eliminating that tax expenditure?

Senator MACK. I do not know. I have not thought about that.

Senator BRADLEY. All right.

Would you include the deduction for property taxes?

Senator MACK. I do not know. My inclination—and when I started out I thought for sure I was going to be able to answer every question that you had with respect to that—mortgage deduction, charitable deductions, I think would be eliminated. I would try to eliminate as many deductions as possible, but I would have to give some thought to these different aspects. I do not have——

Senator BRADLEY. And I appreciate that you might not have looked at the whole Code. But I just wanted to make the point that there are some things that people have kind of taken for granted.

I mean, for example, you have a pension. Your company invests the pension, the pension earns income every year. That earning of income is your benefit, but it is not taxed to you. It is one of the biggest tax expenditures that exists.

If you were doing a flat tax to get that rate down to 17, 18, or 19 percent, you would have to say, what my pension fund invests in, the amount of income it makes this year, that increase is taxable to me in the year that it is achieved.

You would have to say employer-paid health insurance, all those millions of Americans out there who now have health insurance and their employer pays $5,000 or $4,000 a year, under a flat tax, that would mean my income would go up $4,000–$5,000 a year.

If I am a Social Security recipient and I have income excluded, that means that I would not be able to exclude Social Security income. Mortgage interest deduction, property tax deduction, charitable contribution.

I mean, this is just getting started. But you can see, if you end up bringing all that in you can keep a relatively low rate, but if you exclude it all the rate is going to go back up to a level that you might not find acceptable.

For example, Senator Specter says you could earn $25,500 before you get any taxable income. But, of course, he includes employer-paid health, he includes the pension build-up, so that the real wage income that somebody earns is probably around $17,000, which means, under current law, they are eligible for the Earned Income Tax Credit. However, he eliminates that, too, so they end up worse off. It is a complicated subject.

Senator MACK. Yes. When you started with your story about the card I was reminded also of back during the debate in 1985 when the person in a town meeting stood up and said, he had a single card that we could use for income tax that had two lines on it. One was, state your income, the second was, send it all in. We do not want it quite that simple.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman.

Certainly at the outset I want to, if I can, pick up where Senator Bradley left off. Certainly we all want to see tax fairness and tax simplification. If anything, the complexity of the Code is one of the things that aggravates people the most.

Nobody likes taxes to begin with, so that makes this a difficult subject to talk about. But we want to make certain that the Tax Code is fair among individuals and that there are not huge disparities based on geography, wealth, or any particular characteristics of the individuals involved.

Senator Bradley asked you about things that would be included in the base. My question to you is, how would State and local taxes paid be treated; and what about the differences that would occur between people who live, for example, in high-tax States, or low-tax States, or who live in cities, suburbs, or rural areas that would have different local tax rates? How would you handle the differences in treatment? It sounds like a person who lived in a city in a high-tax State would be the worse off and someone who lived on a farm in a low-tax State would be the best off in the proposal.

Senator MACK. Yes. I have not concluded, as I indicated to Senator Bradley, on all the different issues with respect to what would be deductible and what would not. I think that his point is absolutely on target. If we have too many exclusions, then the rate gets to the point where it is not acceptable by a large enough number of people to support passage. But I have not concluded on that.

Senator MOSELEY-BRAUN. Well, certainly the issue of State and local taxes, I think, is an important one that we focus in on, if, for no other reason, that I think that a lot of the frustration that ordinary taxpayers have about the tax system—and, of course, being the Federal Government you can focus on that more easily because it is bigger—is that it is the cumulative impact of taxes at the federal, State, and local level that frustrates people the most.

I mean, we went through a period in this country when people were promised tax cuts, and they kind of got them on the Federal level, but the net result in terms of the shifting of expenses was that, taxes got raised at the State and local level and they were no better off.

I mean, most folks will tell you they are paying, between the Social Security tax increases to which Senator Moynihan refers, and the State and local tax burdens, I daresay that is a lot higher at the present time than your Federal income tax, for most individuals.

So, my question becomes, how do you work out disparities in that area, Senator.

Senator MACK. Well, again, the Armey proposal basically excludes from a Federal tax families of four, I think around $36,000. That is a substantial increase in the number of families that would pay no Federal income tax under that proposal. So, I think that goes a long way to——

Senator MOSELEY-BRAUN. But for a family of four under $36,000 that is not a whole lot. That really is a family struggling to get by. But we are talking about middle class working people.

A family living and working in New York, for example, should not be treated any differently than a family, husband and wife, earning $75,000 between them, or $50,000 between them, which is

not a lot of money. These are not rich people, these are working people. If they live in New York they should not be treated any differently than if they live in Louisiana, Rhode Island, Washington, or Illinois.

Senator MACK. I do not think that they would be under this proposal. Then I would also encourage them, if they would like, we would love to have them move to Florida. [Laughter.]

Senator BRADLEY. Careful there. Careful there.

Senator MOSELEY-BRAUN. Yes. You have to be real careful there.

Senator MACK. I withdraw that comment. [Laughter.]

Senator MOSELEY-BRAUN. Well, let us talk about Florida for a second. What about gifts and bequests, will they be included? I mean, let us say grandpa decides to move to Florida and leaves everything.

Senator MACK. If grandpa were leaving everything to me I would want it to be excluded.

Senator MOSELEY-BRAUN. Grandfather is going to leave everything to you. Well, you do not need it already, Senator Mack. But what about that? What about gifts and bequests, are they included?

Senator MACK. As I say, I have not gone through all the various items to determine what would and what would not be included.

Senator MOSELEY-BRAUN. I came in with your testimony and I do not know, quite frankly. Was Representative Armey here earlier; did he testify?

Senator MACK. No. Senator Shelby was here.

Senator MOSELEY-BRAUN. So it was just you and Senator Shelby and you got to stay to answer the questions.

Senator MACK. Right.

Senator MOSELEY-BRAUN. Just lucky, I guess.

Let us talk about savings for a minute, because certainly savings and investment is something that is central to the future economic health of our country and something we want to encourage.

If we move to a flat tax proposal, because of the offsetting nature of the income and substitution effects, is it your belief that a consumption tax would produce an increase in saving or not?

Senator MACK. Well, I think there are two different questions there. It is reasonable to conclude, if you had a tax that was based on consumption, that savings would benefit. I would make the argument that, while I have heard some refer to a flat tax as a consumption tax——

Senator MOSELEY-BRAUN. Did I say consumption? I am sorry. You are right. I did not mean to confuse that. With regard to the flat tax proposal you are testifying about today.

Senator MACK. We believe that a flat tax would encourage savings and investment. My own personal feeling about a flat tax is one of the reasons that I have been supportive of it, is though it does not provide a premium, if you will, for either savings or consumption, it really allows the individual to make the choice about how they believe they should be spending or investing their money. There is no predetermined action as a result of the Tax Code.

A flat tax, though, I believe, would encourage savings and investing. There would be no capital gains tax, for example, there would be no double taxation on dividends. I think that would encourage savings in the country.

Senator MOSELEY-BRAUN. Well, my light has gone out. so I will not ask any further questions at this time. Thank you.

The CHAIRMAN. I might add, for Senator Moseley-Braun, just one fact. At the moment, a family of four that makes $36,000 pays taxes. Under Congressman Armey's proposal, they would not pay taxes. In that sense, they would be taken off the tax rolls.

I used the figure earlier. At a 19 percent rate on a flat tax you take off about 13 million people off the tax rolls that now pay taxes, and they are all lower income people. So, on any flat tax proposal I have seen, it probably favors almost anybody making someplace between $30,000–$40,000, they are going to pay infinitely less than they pay now, or pay nothing.

Senator Breaux?

Senator BREAUX. Well, thank you very much, Mr. Chairman. Thank you, Connie, for the time that you have spent here and your testimony.

I tend to favor more of a consumption tax than a flat tax, and I think we should not be taxing productivity in this country but should be taxing consumption, instead. A flat tax has always been very interesting to me. The problem, is making sure that it is progressive.

Do you feel that the flat tax can be made progressive, would that be one of your goals, or does your flat tax move away from progressivity in the U.S. Tax Code?

Senator MACK. Well, I move away from what I view as kind of the accepted concept of progressivity that has been, I think, again, fairly well-accepted in this country. But, as I mentioned earlier, surprisingly, when you ask people today whether an individual paying, let us say, 10 percent on $1 million, $100,000 in taxes, or 10 percent on $20,000, $2,000 in taxes, most people in the country today think that is progressive and fair, and I agree with them.

Senator BREAUX. On that, someone who makes $1 million would be paying the same percentage as someone making $10,000 a year.

Senator MACK. That is correct.

Senator BREAUX. Well, that is a dramatic change in the whole history of how we have looked at the Tax Code in this country.

Senator MACK. Well, I do not know that I would say it is dramatic because, in essence, that was the effort that was made in 1985–1986. Clearly, there was a movement towards a flatter Tax Code at that time. So, I would argue that there is movement in the direction of a flat tax, not away from it.

Senator BREAUX. But if we do that, Connie, does it not ultimately mean that those middle income and lower incomes are going to be paying more of their income, and those in the upper brackets will be paying less, in order to get the same amount of revenues?

Senator MACK. Well, we got into that discussion several times this morning. Again, I think, (A) it is going to depend on whose models you are looking at, (B) what deductions, credits, and so forth are part of any new Code. So, I do not think you can just automatically conclude that middle income is going to be paying a higher tax. And, as I have said several times, I think if we come out with a plan that, in fact, is scored that way, I do not think it passes.

Senator BREAUX. But, in a pure flat tax that would be true. The question is, do you add things that make it more progressive? Then, as Senator Bradley pointed out, what do you stop adding?

When you start adding all these things and make it more progressive, then you have gone away from a flat tax and you are back into the situation that we have now with a Tax Code with many exemptions, depending on the taxpayer's income category. That is the problem we have.

But I appreciate it. You obviously have spent a lot of time on this, and being with us this morning is a major contribution. We thank you for it.

The CHAIRMAN. I have no more questions. I would hope that the committee does not have any more. We have another panel coming.

Senator MOYNIHAN. Mr. Chairman, may I simply report the happy, but not altogether coincidental, fact that the Library of Congress has a first edition of A Theory of Moral Sentiments? Word just came in. [Laughter.]

Senator MACK. I appreciate that. I look forward to sitting down and discussing that book with you, after many years of study on my part.

The CHAIRMAN. Thank you very much, Connie, for coming. We appreciate it.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. I would ask unanimous consent to place in the record a statement of Senator Helms, who has been a long-term proponent of the flat tax, since 1982, and I would ask that his statement be included in the record.

[The prepared statements of Senators Helms and Mack appear in the appendix.]

The CHAIRMAN. We now have a panel of Dr. Alan Auerbach, Bruce Bartlett, and Joel Slemrod. We appreciate, gentlemen, your patience in waiting.

We will start with Dr. Auerbach, who has been before this committee before, and who was, for a number of years, the Deputy Director of the Joint Tax Committee.

Doctor, good to have you back with us.

STATEMENT OF ALAN AUERBACH, PH.D., ROBERT D. BURCH PROFESSOR OF TAX POLICY AND PUBLIC FINANCE, UNIVERSITY OF CALIFORNIA AT BERKELEY, BERKELEY, CA

Professor AUERBACH. Thank you very much, Mr. Chairman. I am very pleased to be here to discuss flat taxes. I should say that my intent is not to argue either for or against flat taxes; in some sense, I think the devil is in the details.

I would like to comment on several of the issues, including some that have been brought up today, that really should be considered in any serious debate about the merits of flat taxes.

As you said in your opening remarks, there are certain things one thinks about as central to any flat tax proposal. In my mind, what flat taxes have in common are, first, a single marginal rate considerably below the top marginal rates of today's income tax; second, very few deductions and exclusions from the tax base; and, finally, a very high exemption level for families, below which individuals would not be subject to tax.

Now, this general structure immediately gives several advantages. The low marginal rates reduce tax distortions, not only encouraging labor supply, but also discouraging tax avoidance activities.

The single marginal tax rate further reduces avoidance through income shifting. A broad tax base which makes the low rate feasible from a revenue standpoint, also greatly simplifies tax filing, and reduces the system's interference in economic decisions by eliminating a host of tax expenditures present under current law.

The high exemption threshold makes the flat tax more progressive than it otherwise would be, and further simplifies tax compliance by eliminating the need for a large segment of the population to file a tax return.

I now will just summarize my testimony. In it I come to the following conclusions. First, as typically conceived, the flat tax is equivalent to a consumption-based national sales or value added tax, rebated below a taxpaying threshold.

Although that point has been raised in the discussion today, its equivalence is often missed, and, indeed, is sometimes obscured by differences in the method of tax collection, such as whether taxes are remitted by businesses or individuals.

Under most flat tax plans, there is an individual component and a business component, but the fact that the wage tax is being collected from individuals rather than businesses does not change the fact that the tax is a consumption-based value added tax.

There are some other differences, but, in general, these differences are not as important as the basic character of the tax. You should be suspicious of any discussion or analysis that attempts to portray one type of flat tax as being particularly different from a consumption-based value added or sales tax because of differences in level of collection, or, for that matter, what it is called.

Whether it is called a business transfer tax, or a subtraction method tax, it has basically got the same tax base and will have the same economic effects: the same progressivity, the same economic distortions, the same effect on the Consumer Price Index.

Another point that has been raised today is that, as consumption taxes, flat taxes encourage private saving and investment by exempting capital income from tax. It was also brought up that we are not even sure to what extent that will happen, but it is also important to point out that there are other effects that will help determine what the effect on national saving is when we make a tax change.

The two that I would point out are, first, what happens in the transition, the extent to which we have generous transition provisions that provide windfalls and perhaps encourage consumption rather than saving, and perhaps more importantly, what happens to the level of revenue, that is, what happens to government saving?

There has been discussion already this morning about whether existing proposals are revenue-neutral or not—and it certainly appears that some of them may not be—and there has been a suggestion that perhaps one could bring them back to revenue neutrality with adjustments.

I would make the point that there is nothing magical about revenue neutrality. Indeed, one of the arguments for a flat tax, for broadening the tax base, for lower rates, is that then gives you a less distortionary vehicle if it is necessary to raise taxes further.

I know that is not something that is very popular to be talking about right now, but frankly, I think it will be necessary in the future; it will be more necessary if you have a tax cut this year.

The CHAIRMAN. I might say, in Congressman Armey's testimony, he regards that as a virtue, that if we are going to raise taxes, the public is going to know we are raising taxes. He thinks it would be a strong deterrent to our raising taxes.

Professor AUERBACH. I think it cuts both ways. It certainly will be less distortionary. It is much easier to raise taxes for a lower marginal tax rate.

Finally, let me reiterate the point that Senator Conrad made, that you simply cannot have the same degree of progressivity as you currently have under a flat tax. I would remedy that simply by adding additional rates.

Most of the benefits of flat taxes do not come from a single rate, they come from the broad base and relatively low rates. Whether you have a couple of rates or a single rate, I do not think it makes a lot of difference. It may not have the cachet that a single rate has, but I do not think it gives you that much advantage.

Finally, in conclusion, I would say that a broad-based income tax with low rates and certain exclusions, or exemptions, or incentives for saving, is not all that different from a flat tax.

Where you end up does not much matter if you start by junking the system, going to a flat tax, and moving back, or starting from the current system and moving in the direction you wish to go.

But, either way, you are going to have to make the same hard decisions about the tax expenditures that you have to give up in order to get to the low rates. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Professor Auerbach appears in the appendix.]

The CHAIRMAN. Next, we will take Bruce Bartlett, who is a senior fellow at the National Center for Policy Analysis.

Mr. Bartlett?

STATEMENT OF BRUCE BARTLETT, SENIOR FELLOW, NATIONAL CENTER FOR POLICY ANALYSIS, ALEXANDRIA, VA

Mr. BARTLETT. Thank you, Mr. Chairman.

Since my time is limited, I want to emphasize one critical point that I think is very necessary for the committee to understand, at least insofar as we are talking about the Hall-Rabushka proposal, which is the underlying proposal that Senator Specter's plan, Senator Shelby's plan, Congressman Armey's plan, are all based on, and it is all laid out in this book, "The Flat Tax." I hope it is available to the committee.

My point is that we must look at this proposal as an integrated whole. We cannot just look at the wage tax part of the Hall-Rabushka plan separate from the business side, any more than I think it is correct for us to look, as we unfortunately do today, at the individual income tax as completely separate and distinct from

the corporate income tax. There is a Chinese wall between the two that I think is very distortive in terms of how we view tax incidence.

We all know that corporations do not really pay taxes. Individuals pay taxes. We are just not quite sure who those individuals are. They may, to a certain extent, be the shareholders of the corporation, the employees of the corporation, or perhaps the consumers of the corporation's products. There is no hard-and-fast rule on this.

As a consequence of this, the Joint Tax Committee does not attribute to individuals any share of the corporate income tax in their distribution tables. I think this creates a lot of problems when you try to move towards a fully-integrated system, such as the Hall-Rabushka system, in which you cannot look just at the business side and compare it to the corporate income tax, you cannot look at the wage tax side and compare it to the individual income tax, and try to figure out what the distribution is. You have to look at them together.

It is very important to understand that the revenues that would be raised under the business tax under the Hall-Rabushka would be about three times higher than the current revenues from the corporate income tax.

This is where you get the additional revenue to reduce the rates, and why the distributional implications are not so much toward benefitting the rich as they might appear at first glance.

It is also important to understand that a lot of income that is currently not taxed would be taxed under this system, but it would not necessarily be taxed in the same way. So, for example, you hear it often said that under Hall-Rabushka or Armey-Shelby, no taxes would be paid on interest or on capital gains. But all of that income is taxed on the business side.

The business side is essentially a withholding tax. So, if a business realizes capital gains, they are taxed. If a business realizes dividends from another corporation, it is taxed. So it is very important to look at the flows of income through the combined corporate and individual tax systems. I think this is especially important for the distribution analysis.

I think it is relatively easy to figure out the aggregate revenue effects of this kind of tax proposal because it is pretty straightforward. But what really worries me is what happens when the Joint Committee tries to do a distribution table and you see, as I believe Senator Conrad mentioned, that it looks as if we are giving a huge give-away to the rich, when we are really not. We are taxing much more of their income, but on the business side.

I would be willing to argue—and perhaps my colleagues would disagree—I think that the entire burden of the corporate income tax essentially falls on wealthy people; they own the capital.

And, to the extent you are broadening the base of business taxation, you are broadening the tax base for wealthy people, basically. So, I think that this is a much fairer system that it might appear at first glance.

Incidentally, I would mention that a friend of mine, Frank Luntz, has done some polling on this. And he did a focus group a few weeks back in which he asked many questions about what people

thought about the fairness of something like the Hall-Rabushka system.

It was very interesting that all these people thought this was a vastly fairer system than the current system, for an interesting reason. There are many people out there that believe the rich in this country do not pay any taxes at all. They really believe that. They believe that anybody who is a millionaire is a fool to pay a nickel in taxes today.

Now, this is clearly not correct. The IRS's data make it very clear that we have progressive, effective tax rates and that very, very few people with high incomes evade taxes altogether.

But it is a perception that is widely believed and, therefore, by eliminating all these deductions from the Tax Code, including mortgage interest, including charitable contributions, they believe that this is the way to really get the rich to pay their fair share. They really believe that. So, it is not as unfair to the middle class or lower middle class as some people would make it seem. To the average person, this is really the way to soak the rich. So, I will conclude there.

[The prepared statement of Mr. Bartlett appears in the appendix.]

The CHAIRMAN. Thank you.

We will conclude this panel with Dr. Joel Slemrod, who is professor of economics, business economics and public policy, and director of tax policy research, at the University of Michigan.

Doctor?

STATEMENT OF JOEL SLEMROD, PH.D., PROFESSOR OF ECONOMICS, BUSINESS ECONOMICS AND PUBLIC POLICY, DIRECTOR OF TAX POLICY RESEARCH, UNIVERSITY OF MICHIGAN, ANN ARBOR, MI

Professor SLEMROD. Thank you, Mr. Chairman.

Replacing the income tax with a flat tax would make the 1986 tax reform look like a technical corrections bill. Because of this, it is a proposition that must be preceded by a deliberate conversation about its impact.

This conversation should begin by considering what exactly is meant by flatness in a tax system, and by examining the advantages and disadvantages of each separate aspect.

The first aspect is having a single rate, rather than graduated rates. This change by itself, with no change in the tax base, would certainly shift the burden of taxes from upper income families to lower- and middle-income families.

Whether this is a good idea or not is not entirely a matter of economics; it is also a matter of fairness. If asked to design a tax rate schedule, most Americans choose graduated rates, though they probably do so without contemplating their disincentive effects.

A single rate system would not directly reduce complexity because once taxable income is computed, calculating tax liability from the tax tables is a trivial operation, whether there is one or several brackets. It would, though, facilitate withholding of tax liability at source.

A second aspect of flatness concerns the tax base. Our system is now an awkward mixture of a revenue raising system, plus scores

of incentive and distributional programs, and is much more complicated than if its only function were to raise revenue.

Unfortunately, programs that are piggy-backed onto the tax system are often thereby obscured, and often would never be enacted as stand-alone policies.

Deviations from a clean tax base are justified by supporters, either as necessary to accurately measure ability to pay, or to encourage socially desirable behavior. Some of these arguments are sensible, others are not.

In my judgment, eliminating all of these features would, on balance, make the system more equitable, and rationalize the allocation of resources. Note, though, that a clean-based system can be accomplished independently of what is done with tax rates.

Whether the tax base is income or consumption is not commonly associated with flatness, but to economists a consumption tax imposes a uniform—call it flat, if you like—tax on current and future consumption. But calling a consumption tax flat by no means settles the highly controversial question of whether it is superior to an income tax.

While most economists would agree that an income tax penalizes savers, a consumption tax which does not include bequests or inheritances favors those generally high-income families who can pass on some of their wealth. On a year-to-year basis, a consumption tax appears to be much more regressive than an income tax with the same rate structure.

Finally, a shift to a consumption tax can especially penalize the elderly. The economic case for a consumption tax rests largely on its impact on saving and investment. On this crucial point, the empirical evidence is mixed, so that a change to it does not guarantee a big boost in saving and investment, and my best guess is, there would be a modest increase.

But, because there are more direct ways to increase national saving, lowering the deficit, the likely, but not assured, prospect of a higher saving rate is not a reason by itself, I think, to undertake a wholesale transformation of the tax system.

Taxing consumption without a single rate or a clean base does not promise much simplification. The graduated personal consumption tax, featuring unlimited and unrestricted IRAs, would further complicate, not simplify. However, a single-rate clean-based consumption tax like the Hall-Rabushka scheme, now widely known as the flat tax, would vastly simplify the tax system.

Although no country operates such a tax, its close similarity to a VAT suggests this to be so. Note, though, that no country levies a substantial personal tax on labor income while exempting all capital income, as does the Hall-Rabushka flat tax.

I suspect that this would fail the "sniff" test that most Americans apply to judge what is fair and what is not fair. Nor has any country had to confront the difficult issues concerning the transition from an income tax to a consumption tax.

Although the Hall-Rabushka tax would be much simpler, I believe that the same is true of a single-rate, clean-based income tax system, or even about a two-rate, clean-based income tax system.

I believe that Congress ought to debate whether we should have a single-rate tax, Congress should debate whether we should have

a clean-based tax, and it should debate whether we should have a consumption tax. But, what I want to emphasize today is, choosing among these aspects of flatness is by no means an all or nothing proposition.

From a tactical point of view though, I see much to be gained from the Congress debating which aspects of flatness are not desirable rather than considering which, if any, steps towards flatness to take.

In closing, I offer the example of Hercules, who, as penance for having killed his wife and children in a fit of madness, was given 12 tasks of immense difficulty. The fifth of these tasks was to clean in 1 day 30 years of accumulated manure left by thousands of cattle in the stable of Aegis.

The analogy to the tax system, I fear, is obvious. Hercules did not attempt to clean out the stables one shovelful at a time. Instead, Hercules diverted two rivers through the stables, ridding them of their filth at once.

There is much to clean in the tax system, Mr. Chairman, and contemplating a Herculean approach is an appropriate way to begin the national conversation about tax reform. Thank you.

[The prepared statement of Professor Slemrod appears in the appendix.]

The CHAIRMAN. Dr. Slemrod, I understand your comparison, but I am not sure what you are recommending.

Professor SLEMROD. What I am recommending, Mr. Chairman, is that this panel and this discussion today is the right way to think about how to make the tax system better, to contemplate a completely clean tax system, and talk about what it is about that that we do not like, what deductions and exemptions we feel strongly should be there.

The CHAIRMAN. Well, let me ask you this question, because Senator Bradley, indeed, went through this when he was doing his Fair Tax. And I remember his advising me when we were doing tax reform in 1986 about the volatility of the mortgage interest deduction.

Are you suggesting that we ought to look at the Tax Code and say, there are some things so valuable, so worthwhile to society, and we should foster those things through the Tax Code rather than appropriations and leave them in; is that what you are saying?

Professor SLEMROD. Let us take the R&D credit as an example. If we believe that there are important spill-over effects in research and development, there is a strong economic case for subsidy.

Given that we already have a tax system, if we are going to have already a transaction between private citizens and government, from a purely administrative standpoint it makes sense to put the R&D credit through the tax system rather than having a whole separate administrative system to get these subsidies.

The CHAIRMAN. But on that argument, to the extent we want to encourage children, it is worthwhile to put dependency deductions in the Code; to the extent we want to encourage charitable contributions, to put them in the Code; to the extent we want to encourage home ownership because that makes a more stable commu-

nity, put them in the Tax Code. Then there is almost no end to what we put in the Tax Code.

Professor SLEMROD. That is precisely the debate we should have.

Senator MOSELEY-BRAUN. Mr. Chairman, your first question was specifically on the mortgage interest deduction. I would really like to hear your response to that issue. I mean, you went and talked about R&D, but the mortgage interest deduction really is kind of a very special and particular issue. If your response to the Senator's question could touch on that, I would appreciate it.

Professor SLEMROD. I would be happy to respond. Let me just clarify, though. My closing statement was not about where I think the tax system ought to be. I did not, in my remarks, favor a single-rate, clean-based consumption tax.

My point was a tactical one, that it makes sense to begin a debate by starting from that point of view and think about what we think is so valuable that is not consistent with that philosophy that we want to put back.

In my view, to respond to your question, Senator, the tax system should not be in the business of favoring owner-occupied housing over rental housing, or favoring housing over other kinds of capital.

In the current tax system, owner-occupied housing is favored over other kinds of capital and I personally think that is not the kind of margin the government should be involved in moving one way or the other.

The CHAIRMAN. So if we went to a quasi-flat tax, you would eliminate the mortgage interest deduction.

Professor SLEMROD. Yes.

The CHAIRMAN. All right.

Mr. Bartlett, let me ask you, you do not include capital gains as income in the base in your proposal. I understand the argument on corporate capital gains, it is a business tax anyway, it has been taxed once.

I do not quite understand the logic on individual capital gains. If I buy a stock this week for $100, I sell it in 3 months for $200, how is the $100 gain already taxed in the business cycle?

Mr. BARTLETT. Well, take a share of corporate stock. If the stock goes up it is only because the discounted future flow of after-tax income that is associated with that share of stock has gone up in the view of shareholders.

The CHAIRMAN. Well, no. They go up and down wildly and gyrate wildly for reasons that have nothing to do with the success or failure of the company.

Mr. BARTLETT. Well, that is true. But in the long run I think that economists would argue that a capital gain simply represents the discounted present value of whatever flow of income is associated with that asset, whether it is a piece of machinery or a share of stock.

The CHAIRMAN. So on average over the years it reflects the business activity of the business you buy stock in.

Mr. BARTLETT. That is right.

The CHAIRMAN. If it is a bad business, the stock does not do well, if it is a good business, it does well.

Mr. BARTLETT. Right. So as long as you are taxing that flow of income on the business side, taxing the capital gain is, in effect, a double tax.

The CHAIRMAN. Do you agree with that, Dr. Slemrod?

Professor SLEMROD. Yes. The analogy I would make, as Professor Auerbach mentioned, the Hall-Rabushka flat tax is very similar to a value added tax, which is very similar to a retail sales tax, other than regarding administrative issues.

So capital gains would be taxed in the same way a retail sales tax would get at it. You have the capital gain, you have more money. When you consume you will pay the tax. In the same way, when you consume out of any other kind of income you would pay the tax.

The CHAIRMAN. Well, when do you consume the capital? Mr. Bartlett would not tax it at all. If you sell the stock and take the money you would not tax it, right, Mr. Bartlett?

Mr. BARTLETT. Not for individuals.

The CHAIRMAN. No, that is what I mean.

Mr. BARTLETT. But it would be on the business side.

The CHAIRMAN. No, not for individuals. That is not what you are saying, is it Dr. Slemrod?

Professor SLEMROD. It would not be taxed at the time of the capital gain, but it would be taxed when the individual who received the capital gain went to spend the money, because prices would be higher.

The CHAIRMAN. Oh, I see.

Professor SLEMROD. In the same way a retail sales tax would tax.

The CHAIRMAN. So you would not tax it as a capital gain or as income.

Professor SLEMROD. Correct.

The CHAIRMAN. All right. I see what you are saying. It will be taxed in the higher price.

Professor SLEMROD. Exactly.

The CHAIRMAN. Now, Dr. Auerbach, you have raised the issue, fairly, of progressivity. I think there is no question we can take care of the poor. Almost any of the flat taxes we are considering, I am just going to take a guess, anybody under $30,000 or $40,000 is better off than they are now. You would say that anybody probably over $100,000 is better off than they are now.

Can you correct that with a simple dual or triple rate of 18, 20, 22 percent, or 15, 20, and 25 percent; would that sufficiently take care of the argument against progressivity?

Professor AUERBACH. I think that is a matter of judgment because you are never going to be able to replicate on an individual-by-individual basis the burden of the current system, but I think you can, probably, with three rates.

In a sense, you are going through the same calculations you went through in 1986 and you found then that three rates—two and a half rates—was the way to do it. One thing worth pointing out is, there are two issues of progressivity here.

One, is the issue of the flatness, which you were just talking about. The other, is the issue of a consumption-based versus an income-based, which has also come up.

One thing I would say, is that looking at annual measures of consumption and income probably overstates the regressivity of a consumption tax.

The CHAIRMAN. Say that again.

Professor AUERBACH. Looking at annual comparisons of income and consumption probably overstates the regressivity of a consumption tax because consumption tends to be smoother over time than income.

The CHAIRMAN. I saw that in your statement.

Professor AUERBACH. Yes.

The CHAIRMAN. One year you make $200,000 and consumption is a small percentage of your income. You are an author. The next year you make $40,000, you have roughly the same consumption, and it is a high percentage of your income.

Professor AUERBACH. Right.

The CHAIRMAN. All right.

Professor AUERBACH. The point is, we also do this over the life cycle. We have a lot of retired people who are not particularly poor. They have a fair amount of accumulated assets. Their income will not appear as high as it did earlier in their life, because they will be retired.

An annual distribution table will show them as looking poor, and consuming a large fraction of their income. We do not think of those people as poor, at least we should not think of those people as poor, in the same way as somebody who has that income every year.

This was discussed at some length in a Joint Committee pamphlet that came out a couple of years ago on distribution issues and, in particular, spent a great deal of time analyzing the consumption tax and talking about the appropriate way to look at the distributional burdens of a consumption tax, including allocating the corporate tax. I agree with Mr. Bartlett, business taxes should be included in analyzing distribution.

But, in answer to your basic question, yes. Taking account of the appropriate way of comparing income and consumption in terms of distributional effects and the flatness of the rate structure itself, one could probably get it right by going to a multiple rate structure.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I am constrained to remind Dr. Slemrod that the Herculean approach that he recommends would be a clear violation of the Clean Water Act. [Laughter.]

Senator MOYNIHAN. And, in addition, would deprive American farmers of an environmentally friendly form of plant nutrient. Now, think about that.

Professor SLEMROD. Thank you, Senator.

Senator MOYNIHAN. But I would say to the Chairman and my colleagues, there is one subject that interests me more than any other one, and that is our savings rate. It is sort of a central economic phenomenon.

I have no feeling for causality here. It is something profoundly important in which we are different from the rest of the world and in ways that are foreboding. The Japanese have a 20 percent savings rate, we have about a 2.5 percent savings rate.

I do not know whether it is societal, cultural in the sense that after you have accumulated enough capital you begin just consuming, or whether it is, in some way, a response to the laws we pass, principally in this committee and Ways and Means.

Could I ask Drs. Auerbach, Bartlett, and Slemrod, who have given us wonderful testimony, do you feel the present revenue structure, income tax structure, inhibits savings, encourage savings, or makes no difference?

Professor AUERBACH. I think that there are marginal effects.

Senator MOYNIHAN. Marginal.

Professor AUERBACH. The 1980's represent a sobering counter-example in the sense that the things we emphasize when we talk about the incentives to save is that a consumption tax, by not taking part of the return to capital, gives you a higher after-tax rate of return and encourages investment.

We had very, very high real rates of return in the 1980's, not just because of lower marginal tax rates, which were brought down in 1981 and again in 1986, but also because of very, very high real interest rates which we do not have now, and we did not have before. Yet we did not have an increase in the private saving rate.

Senator MOYNIHAN. Yes. Nothing happened.

Professor AUERBACH. Something did happen, we had a decline in the private saving rate.

Senator MOYNIHAN. We had a decline. Right.

The CHAIRMAN. With the IRAs.

Professor AUERBACH. My own personal view, getting to your societal issues, is that we are, in some sense, the victims of our own success with the social safety net. One of the remarkable things we have done over the years is to reduce old-age poverty considerably. My sense is that one of the things that this has done is cause people to be less scared about what will happen to them in retirement.

In that sense, our current policy of not doing anything about the long-run fiscal problem that we have is probably going eventually to be successful at increasing the national saving rate.

Senator MOYNIHAN. That is wonderful.

Dr. Bartlett?

Mr. BARTLETT. Well, the current system is clearly not neutral.

Senator MOYNIHAN. As long as people know Social Security is going to go bankrupt, then we will have this positive effect on private savings. I see.

Dr. Bartlett?

Mr. BARTLETT. The current system is clearly not neutral with regard to saving. I think one can assume, if you simply treated saving the way we treat other forms of income, you would get a higher saving rate; how much, I do not know.

But I would like to make a couple of points about the saving problem because it always comes up. That is, the way we measure the personal savings rate is we measure total income, measure total expenditure, and we just assume that the difference is saving. That is what you see when you see the figures for the saving rate that the Commerce Department publishes every month.

Now, that excludes a lot of what people reasonably think of as saving. If the value of your house goes up, in your mind you have more capital, more wealth. We do not measure that at all. I would

also point out that there is another measure of saving which gives you a slightly different picture.

The Federal Reserve publishes a measure of saving in which they go into financial assets, they look at how much the value of stocks, and bonds, and other savings accounts has gone up and they measure the savings rate from the bottom up rather than as a residual, and they consistently come up with a figure that is several times higher than the very low rate that we commonly see.

Senator MOYNIHAN. That is important.

Mr. BARTLETT. So I think there may be some measurement problems here, but I do not deny that there is a saving problem. I think it is the gross national saving rate that matters anyway, and that includes corporations, and we tend not to think about that. I think most economists would agree that the real problem with saving is negative government saving, which we call the deficit.

Senator MOYNIHAN. The deficit.

Dr. Slemrod? I am sorry. We are almost out of time.

Professor SLEMROD. I agree with Professor Auerbach, that the major reason why our saving rate is much lower than many other developed countries is not because of the tax system, it is for other reasons.

Although I do think that the way we tax saving and investment is partly the answer, I think eliminating all tax on savings and investment would probably increase the saving rate but, because the evidence is so mixed, we just cannot be sure. If that is the only reason to move the tax system from an income tax to a consumption tax, we should not undergo a wholesale transformation of the tax system.

Senator MOYNIHAN. Thank you very much. Very helpful.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

Dr. Slemrod, I am looking at your testimony on page 11, and you say, "No nation levies a substantial personal tax on labor income, while completely exempting capital income in the form of interest dividends, rental income, and so on."

You go on to say, "I have serious doubts that this aspect of the Hall-Rabushka tax would pass the "sniff" test most Americans apply to judge what is fair and what is not." I would like you just to expand on that if you could, and explain in layman's terms for people who might be listening, what the point is you are making there. How does that relate to the flat tax proposals that are before us?

Professor SLEMROD. All right. I would be happy to respond to that. Let me, first, say that many European countries have very substantial consumption taxes in the form of value added taxes, so there is certainly precedent for a tax essentially the same as the Hall-Rabushka tax being levied at the rates we are talking about here. But those European countries, in addition to that, have personal income taxes, often with quite graduated rates.

What is being proposed here is to replace our income tax system with a tax of the Hall-Rabushka form on the personal tax.

Senator CONRAD. Well, maybe instead of calling it Hall-Rabushka, nobody knows what that means other than eight people in this room——

Professor SLEMROD. Fine. When I say Hall-Rabushka, I refer to the original authors of this plan. In the personal tax system, the base would be wages and salaries and disbursements from pensions. It would not include interest dividends, capital gains, rental income.

Senator CONRAD. Basically the flat tax proposals that we have before us.

Professor SLEMROD. Yes. I think—and this is a matter of judgment—that most Americans would find it to be unfair that one family earning $50,000 of wages and salaries would pay a significant amount in tax, and then the family across the street with $50,000 of interest or dividends would pay absolutely no tax.

You quoted from my testimony, but you did not complete the sentence. Let me complete the sentence. "It might not pass the 'sniff' test, notwithstanding economists' arguments about how the business tax mitigates this problem."

What Mr. Bartlett has said is correct, you can think of the business tax as operating as a withholding tax on some of that capital income. I am saying that argument would not overcome the "sniff" test that Americans would apply.

Senator CONRAD. It was really along those lines that I was questioning Senator Mack earlier. I think if you had a circumstance in this country where somebody was very wealthy and was living just off interest that they had gotten from inherited wealth, and perhaps they are having $250,000 a year of interest and capital gains income, and they do not pay anything.

And somebody who is earning $50,000, family with both husband and wife working—I understand the arguments about the business income side, but I will tell you, I think most Americans would have a real problem seeing that as a very fair system. Is that what you are saying?

Professor SLEMROD. That is what I am saying.

Senator CONRAD. Professor Auerbach, if I could go to your testimony. I had referred to that in the questioning of Senator Mack as well. Getting to the question of, how does the burden fall, you made the point in your testimony, that under any of these flat tax proposals, those at the top end see their tax burden reduced.

In many of them that are before us, people at the bottom end see their tax burden reduced. So, if you are going to raise the same amount of money, the middle-income people in this country, the middle class, have to pay more. Is that the point that you were making? And maybe you can expand on it.

Professor AUERBACH. Yes. It has the advantage, unlike most economic analysis, that we can be fairly certain about it, because it is really a matter of arithmetic if you think of those three classes. Then, of course, different proposals will identify the winners and losers differently, depending on how high the exemption level is.

The higher the exemption level, the more the middle class crosses over into the winning category, and the lower the gains of the people at the top because the higher the average tax rates will have to be in order to compensate for that high exemption level.

But I have taken this always, from the time I was in graduate school, to be one of the problems of what we used to call linear income tax, or a single-rate tax, or what is now called a flat tax. You

cannot have what I think of as progressivity, which is not increasing marginal rates, but increasing average rates. The highest average rate you can have, even on the very highest income, is that single flat rate. So, if that flat rate is low the average tax rate is going to be much lower than the current system.

Senator CONRAD. I thank the Chairman. I thank the witnesses.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Dr. Auerbach, as I hear you talk, I am reminded that this business is always a choice among competing principles of simplicity, equity, and efficiency. I mean, it is pretty easy to have a simple system, but if the simple system ends up in increasing the tax on middle class Americans then it is clearly not an equitable system.

That is why I was interested, from your judgment you think that the best way to go is to get to a system with as few rates as possible, but more than one, and with as few deductions, credits, and exclusions as possible that are considered politically palatable. Is that correct?

Professor AUERBACH. Yes. Right.

Senator BRADLEY. And you think that such a system would produce more economic growth and greater efficiency in the allocation of capital?

Professor AUERBACH. Well, of course, it would depend on what exclusions remained. For example, the mortgage interest deduction was an example where, from an efficiency point of view, I agree with what Dr. Slemrod said, that it is causing a misallocation of capital.

I think there are compromises here. One does not have simply to get rid of an exclusion or deduction or keep it; if one is concerned about it from an equity perspective one can cap it. The mortgage interest deduction is already capped now, but at a very high cap. You could lower that.

Indeed, Senator Specter's flat tax proposal would cap mortgage interest deductions at $100,000 of debt. I take it the idea there is, from an equity perspective, there is concern about not getting rid of this entirely, but from an efficiency perspective we would get a better allocation of capital.

So, if you get rid of at least the marginal effects of a lot of these deductions and exclusions, yes, you will have a more efficient tax system.

Senator BRADLEY. Dr. Slemrod, I take it your point is that Americans are the best-housed people in the world, in part, because of the mortgage interest deduction. But the flip side of that is also a paltry investment rate, generally, in the businesses of America. Is that correct?

Professor SLEMROD. That is correct.

Senator BRADLEY. If you had, over 5 years, $308 billion—which is what the mortgage interest deduction is—do you figure it could be spent more profitably somewhere else, is that it?

Professor SLEMROD. Whenever we put something in the tax system to encourage some activity it inevitably discourages something else.

Senator BRADLEY. Dr. Auerbach, if you were looking at the proposal that Mr. Bartlett recommended and you were looking at the

business side, which is, for most people, the most complex adjustment, what would you say, from your perspective, were the three most problematic elements of the business side?

Professor AUERBACH. I actually do not view it as particularly problematic because it is just a value added tax. Every discussion of flat taxes should start from the understanding that, just as a value added tax taxes capital income once, labor income once, with a deduction for capital goods purchased to make it consumption-based, it does it the same way. As far as I understand it, the business component is just that same piece that would exist under a value added tax.

Senator BRADLEY. Is that how you see it, Mr. Bartlett?

Mr. BARTLETT. It is not like a European-style value added tax, which is the credit invoice method, but it is what is called a subtraction method value added tax.

Senator BRADLEY. Right.

Now, under the proposal that you have suggested there is non-deductibility of interest. Is that the idea, that business cannot deduct interest?

Mr. BARTLETT. That is right.

Senator BRADLEY. Well, have you thought of what effect that might have one some of our financial institutions, banks, insurance companies, that deduct interest under regular course of business? I mean, we would not want to take a step that might shock the financial system or destroy insurance companies and, therefore, the policies that millions of Americans have.

So what is your response to the potential shock when you say to a bank that, in the normal course, borrows and deducts the interest as a part of their business, or if you are in real estate and you deduct mortgage interest, that they can no longer do that?

Mr. BARTLETT. It is symmetrical, because at the same time you are eliminating the taxes on the interest received so that, in the aggregate, you are not really changing the treatment of interest that much. You can get neutrality in terms of saving either through what is called the municipal bond method, where you tax the saving and you do not tax the interest, or the IRA method, where you get a deduction and then you pay taxes when you make the withdrawal, and basically they are just switching. So, in the aggregate it is exactly symmetrical, to a large extent.

Senator BRADLEY. So if a company receives the same amount of interest that would equal the amount of taxes it would save through the interest deduction, then that is where you say there is neutrality.

Mr. BARTLETT. Right.

Senator BRADLEY. But if a company does not receive as much interest, then you have a net increase on tax on that company, right?

Mr. BARTLETT. Well, interest rates will adjust. I mean, municipal bond interest rates are a couple of percentage points lower than taxable bonds.

Senator BRADLEY. They will adjust on the basis of deductibility?

Mr. BARTLETT. Yes, they will.

Senator BRADLEY. Yes?

Mr. BARTLETT. All rates should be the same under this system. You would not have differential rates for taxable and non-taxable bonds.

Senator BRADLEY. I thought it had to do with, full faith and credit of a government is better than full faith and credit of you and me in the market.

Mr. BARTLETT. Well, it depends on the government, I suppose. If it is Orange County, you may have some problems.

Senator BRADLEY. Yes, that is true.

One last question. On the individual side then, let us say that you are trying to buy a home and you have interest, you cannot deduct that interest now. Is that right?

Mr. BARTLETT. That is right, under this system.

Senator BRADLEY. Under your system.

Mr. BARTLETT. Right.

Senator BRADLEY. And in terms of middle class, if you have $20,000 income and you are taking the $5,000 that employers pay in health, now your income is $25,000 for tax purposes. If you have a pension and your pension earns income, and it earns, say, the equivalent of $5,000 or $10,000 in taxes, now your income is $30,000, but you only have wages of $20,000.

Mr. BARTLETT. That is not quite how it works. If I could explain, what would happen is for a business that has employees, they would only be able to deduct the cost of cash wages and salaries paid, so that the fringe benefits, in effect, would be part of the taxable income of the corporation.

Senator BRADLEY. Right.

The CHAIRMAN. You mean the fact they cannot deduct it increases their gross profit that there would be a tax on?

Mr. BARTLETT. That is right. So it would be taxed on the business side unless employees and employers negotiate with each other to change the mix. Many employees may choose to have more cash wages and fewer fringe benefits. But it would not be as though you are suddenly being attributed a certain amount of income that you would not otherwise have.

The CHAIRMAN. Yes, it would, I think.

Senator BRADLEY. It certainly would. I mean, if you had an agreement with your employer, or you just said you negotiate out a certain part, he pays a certain part that he would pay for you, that would come through to you as income.

Mr. BARTLETT. That is right. But what you were saying is——

Senator BRADLEY. That is what the exclusion is. That is the biggest exclusion under the income tax system. It is $398 billion. Now, if you eliminate that, somebody is going to take that into income.

The CHAIRMAN. Well, but let me ask you if what you are saying is this. $5,000 the employer is now paying for health insurance. The employer deducts it, it is not taxable income to you.

I think what Mr. Bartlett is saying is, given that circumstance, the employee might say, if it is now going to be taxable income, in that case, give me the $5,000, pay the taxes, and I will buy my own health insurance or I will shop around. I think that is what you are saying.

Mr. BARTLETT. Well, you have to sort of look at the first order of facts and then see what would change as time goes by. All I am

saying is, it is not as though you would suddenly be attributed income that you did not actually get, which I thought was what you were saying. That would not be the case. I mean, it would be from the employer's point of view. He is suddenly going to have a larger after-tax wage bill than he currently has.

Senator BRADLEY. Well, if you are able to negotiate that.

Mr. BARTLETT. The first order fact is that the businesses would pay more, not the individuals. That is all I am trying to say.

Senator BRADLEY. Well, I think the perfect world you are describing presumes that businesses would automatically flow through the benefit to the worker, but that will not happen unless there is a worker able to get the benefit from the employer. If you look at where wages have been since 1973, they have been flat or declining in real terms, so that does not make you very positive.

Mr. BARTLETT. Well, one of the reasons why they have been flat is because workers have been choosing to take more of their income in the form of non-taxable benefits.

Senator BRADLEY. Right. Precisely. Precisely.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. The conversation has gotten real exciting. On page 26 of the committee print that was given to us and prepared by the Joint Committee on Taxation, there is a chart.

This chart purports to show the flat tax versus a graduated tax, the marginal tax rate above a $20,000 exemption. This is a graduated rate as opposed to approximate, our current tax system. Do you gentlemen see the chart?

What it shows in the first instance, I think, is something Senator Conrad has been talking about, or kind of interested in, which is, at the highest levels, $345,000 a year income, the rate falls from here to here, so the higher income taxpayers have a huge drop in tax liability.

At the lower end—it is kind of funny that this would be lower end, because down here where there is not so much of a drop, this is $90,000 a year annual income and below—is where there is almost confluence between the present tax system and the flat tax proposal.

The difference gets larger as you exacerbate income, this differential. Clearly, according to this chart at least, there is a huge difference in the operation of the flat tax proposal on the marginal rate versus what we have.

Now, I want to get back to the conversation that was going on about health insurance and the like. Obviously, one of the principles of the flat tax—again, I am not trying to weigh one side or the other, I just want to get the benefit of your expertise in this area—is to apply the same tax rate to similarly situated people.

I have a star right here with the group, the $60,000-90,000 income group, working people primarily. You might find two people working in a family in that category.

If one family, Family A, for example, has medical expenses, somebody gets sick, we are doing a flat tax now so we do not have deductions and everything, and that is essentially counted as income, as part of the calculation. So Family A has got a huge medi-

cal problem, somebody is sick in the family, Johnny has special health needs, or whatever.

In Family B, everybody is hale and hearty and there is no health problems and, ergo, no medical expenses beyond the occasional bottle of aspirin. Those two families are not bring treated the same anymore, are they?

Mr. BARTLETT. Well, they would be if you had insurance. I mean, that is why we have insurance, so that everybody gets treated more or less the same.

Senator MOSELEY-BRAUN. Well, but if you had insurance. It is kind of a big "if" in today's climate. I mean, this is the second river. Maybe that is it. We have found the second river for Hercules. We are going to clean up health care and the Tax Code simultaneously, right? Is that it?

Senator MOYNIHAN. Way to go. Do it on reconciliation.

Senator MOSELEY-BRAUN. Right now, that is not what we have.

Professor SLEMROD. Senator, can I respond to that? I think I agree with what you are driving at, that one of the reasons our tax system is complicated is that we require tax liability to be personalized to some aspects of family situations, such as involuntary medical expenses. There is a good argument that that should be deductible from the tax base before tax is calculated, but it makes the system more complicated.

In thinking about flat taxes we have to make decisions about whether the complexity that this causes buys fairness that we think is worth it. So, having some kinds of fairness causes complexity. On the other hand, it works the other way.

A complex tax system, in itself, can cause unfairness because some people take advantage of it, some people learn the rules better than others. But it is a complicated interaction between what we ask the tax system to do and how complex it ends up.

Mr. BARTLETT. The interesting thing I would just point out about this chart is that it shows that a flat rate tax is, in fact, progressive.

Senator MOSELEY-BRAUN. But not as progressive as the graduated tax.

Mr. BARTLETT. No. No.

Senator MOSELEY-BRAUN. Right.

Mr. BARTLETT. But, I mean, it is not like a straight line across the middle, which I think is what some people imagine a flat tax is, because if you have a personal exemption, you create de facto progressivity.

I would also point out that this looks only at the current individual income tax and compares it to just one part of the flat tax, which is the wage tax part. As I said earlier, I think it is extremely important for you to look at the business side as well in order to get a true idea of who is paying what.

Senator MOSELEY-BRAUN. But that is another whole argument. I mean, there are people in this country who make $345,000 a year in wage income. We are not talking about coupon clipping and the interest on capital investments or whatever, this is just wage income.

Mr. BARTLETT. Well, there are not that many. Most people who make a lot of money get it through unearned income.

Senator MOSELEY-BRAUN. Yes. I would not disagree with that. But there are a lot of people who, just on wage income alone, would still fall in this category. Frankly, based on this chart, they do real well.

Mr. BARTLETT. Yes.

Senator MOSELEY-BRAUN. Yes.

The CHAIRMAN. Go ahead.

Senator MOSELEY-BRAUN. Thank you. One last question.

With regard to some of the technical issues—and I do not know, frankly, if we are far enough along in this debate. I want to commend the Chairman again for holding this hearing, because certainly we have a lot of ground to cover in this regard.

And I hope we are not in the process of rushing to judgment on anything, because we do have a huge task and we need to go and look at the technicalities, but there is the transition from what have got to what you are proposing as the ideal.

And I think Senator Bradley kind of started to touch on it, the transition having to do with, what do you do about bonds, and what do you do about interest income, what do you do about deduction of interest on property.

I just want to put this question out, and perhaps you would want to send me something in writing on this, because it is kind of technical.

I serve also on the Banking Committee. The question has been raised about the taxation of financial institutions particularly, and that it might be particularly complex based on the fact that some financial services charge an explicit fee, others have other ways of the costs being calculated, some of which may or may not be evident, may be just reflected in reduced earnings on deposit, or something like that.

Would it be possible for you gentlemen to respond to the question of how you see the transition and the taxation under this new proposal, or how somebody sees the taxation under this new proposal, on financial institutions and these other transition issues that were raised by Senator Bradley? Thank you.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I just want to thank you, and thank our panel. It is always wonderful to have people here who respect one another's views, even when they differ. They know where they agree, and find there is more agreement than difference.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Chairman, I would just like to thank the panel. I think that the betting wisdom is, this is a year when we are only going to do deficit reduction, but I think that holding this hearing and generally getting to focus on the issue of a tax system with the lowest possible rates and the fewest loopholes might very well present us with an opportunity sooner than most people imagine. I hope so.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

I would like to, if I could with this panel, go back to a question I was exploring with Senator Mack, because I think it is an impor-

tant question to raise with respect to fairness. That regards the impact of Social Security.

If we had a circumstance where somebody is earning a half a million dollars a year and their income all comes form interest and capital gains, they would pay no income tax under this proposal and no Social Security tax.

Of course, it is true they do not pay Social Security tax now. That is part of the point. They do not pay Social Security tax because Social Security is on wage income. That is our FICA.

If we had a family earning $50,000 a year, all wage income, they would pay both Social Security taxes and income taxes. Is that not how it would work, Dr. Auerbach?

Professor AUERBACH. Yes. You have described exactly how it would work.

Senator CONRAD. Do you think that is fair?

Professor AUERBACH. Well, you have really got two separate questions, which is, do I think the Social Security tax is fair, and do I think the flat tax is fair? I think the answer about the Social Security tax cannot be considered without thinking about the benefits.

I think, under the current tax benefit structure, the Social Security system is progressive. That is, the benefits are more progressive than the tax is regressive and so, on balance, that is not a bad deal for lower-income people.

Turning to the flat tax there, I think there is more of a problem. But I am not sure that it becomes an even worse problem because of the existence of the Social Security tax. I think it is a problem that stands on its own and can be dealt with through progressivity, having more than one rate. As I say, it may be——

Senator CONRAD. But then we do not have a flat tax.

Professor AUERBACH. Well, but I think that is more an issue of advertising than an issue of economic substance.

Senator CONRAD. All right.

Mr. Bartlett?

Mr. BARTLETT. I would just make the points that the benefits you receive from the Social Security system are directly linked to what you pay in. If you pay in nothing, you get out nothing.

So, under your scenario, it is true the person would not pay the tax, but they would not get anything either. And, as Professor Auerbach said, if you look at the two sides of the system, the benefit and the tax side together, it is a very progressive system.

So I do not think you can isolate just the tax side. I am also thinking about the benefit side, which is why I think you should not try to deal with Social Security in the context of tax reform because it just becomes too difficult, I think. You should deal with them separately.

Senator CONRAD. Part of the problem with that is, we have a system in which we have a payroll tax to support Social Security, partly on the promise that the money is going to be used for that purpose.

Unfortunately, the surpluses are being used to finance other operations of government. We all know we are on a course that is not sustainable. The Entitlements Commission has told us we are going to have an 85 percent tax increase or 50 percent cut in bene-

fits if we try to stay on this current course. I mean, it is a course that does not add up.

I predict to you that people who have paid into Social Security on the basis that they were going to get a certain return, a replacement for the income they earned during their lifetime, are going to be mighty surprised, because it is not going to happen.

Dr. Slemrod, did you want to comment?

Professor SLEMROD. Because the flat tax proposals that I know do not change materially how the Social Security system is treated, I think your question comes back to the question of whether a tax only on labor income at the personal level is fair. I already discussed my doubt that it would pass the "sniff" test.

Whether it would pass an economist's vision of what is fair, is a complicated question. You would want to think about this over a lifetime rather than year by year; you would want to think about how bequests and inheritances are treated; it is a controversial issue, it is a difficult issue. I talk a little bit about in the testimony I submitted, but it is absolutely a valid and important issue that we should be talking about.

Senator CONRAD. Let me just say, I am not asking a theoretical. I know of a circumstance, a wealthy family, parents are retired, their income all comes from interest income and capital gains income, well over a half a million dollars a year.

Their own children are in the second category, family earning $50,000, pay Social Security taxes, pay income taxes, and under this scheme, their parents, who have 10 times the gross income, much less the net income, would pay nothing. I just tell you, I really wonder if people would see that as a very fair outcome.

I thank the Chairman.

The CHAIRMAN. I thank the panel. We are adjourned.

[The prepared statements of Congressman Armey, Senator Specter, and Ms. Melendez appear in the appendix.]

[Whereupon, at 11:46 a.m., the hearing was concluded.]

FLAT TAX PROPOSALS

THURSDAY, MAY 18, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:35 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Grassley, D'Amato, Nickles, Bradley, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. We will call this committee to order.

Senator Specter will be coming along in about 15 minutes, but if you do not mind, Congressman, we will get started because we have got another panel coming behind you.

I doubly appreciate you coming. I know you could not be here before, and you sent a statement. I appreciate you coming in person. You have been a champion lead on the flat tax. The flat tax is a view I share. For those people who say, oh, it is impossible, it cannot be done, I do not buy that argument. You move when the iron is hot, and sometimes it gets hotter quicker than people realize. I am delighted to have you with us today.

Why do you not go ahead?

STATEMENT OF HON. RICHARD K. ARMEY, HOUSE MAJORITY LEADER, AND U.S. REPRESENTATIVE FROM TEXAS

Congressman ARMEY. Well, thank you, Senator. Let me say, I do have a formal statement that I would ask to have put in the record.

I have seen your panel. This is going to be a very good hearing, which I can tell you from looking at the quality of the panel that follows my own. As far as this particular testimony, I guess we will roll the dice and hope that we do not embarrass us before the coming panel.

But you are absolutely right about that. Over a year ago, I made a determination. I think we are clear on this. I do not think anybody can quarrel with the proposition that America is fed up with the Tax Code as we know it.

I just do not think the American people will much longer tolerate the Tax Code as it exists today, and there is a broad-based, growing clamor for tax reform on the part of the American people. I saw that over a year ago and began to examine what might I offer as an alternative.

My staff and I talked about many alternatives between myself and my staff. A flat tax was something that I remembered from the mid-1980's and recalled its popularity in the mid-1980's. So we determined that we would go back and study it.

We rediscovered the works of Professors Hall and Rabushka, we examined the efforts that had been made in the 1980's, and we determined that this was an offering that ought to be made.

So, after several months of hard work, we offered the flat tax on June 17th of last year, and I did with some curiosity. How would America respond? I must say, Senator, I believe America has responded in just these 11 months much more broadly, much more enthusiastically to the flat tax than anybody might have dared to hope for last June.

I get a great deal of mail on the flat tax, and I hear a great deal about it from people as I travel. In addition to that, there have been a great many people in the press that have written editorials on the flat tax.

One, in particular, is Scott Burns, who writes his column on the financial pages of the Dallas Morning News. It is syndicated. Scott was amazed to discover that, within just two weeks of a single column on the flat tax, he had received over 5,000 letters on the flat tax.

From all of this mail and correspondence, and from focus groups and other efforts to discover, we have determined that there are a few basic reasons why the flat tax is embraced by the American people.

First and foremost, the American people see a flat tax as a simple, honest, fair Tax Code. Of course, you know the poster child for the flat tax is the postcard-shaped size form of 10 lines where people can file the form. The simplicity, I think, is obvious.

The honesty of the flat tax is very important and very much reassuring to the American people in that they know they will get a tax bill that they can understand and that their neighbors will get one. Fairness is extremely important. The key response is, everybody thinks it is correct that we should all be treated the same.

Now, there are many instrumental reasons for the singular tax rate that reflects back on simplicity, but the fairness, I think, has been one of the most exciting things that I have seen.

I would like to tell a quick story. I was walking out of a hotel in Dallas, Texas and the fellow that parks the cars—this is not a high-income person, this is a very usual wage earning American citizen—approached me and said, Congressman, I love your flat tax. The reason I love your flat tax is, it treats everybody the same.

It is fair. You have one rate and I do not have to listen to all of this class-conflict baloney that I am hearing these days. I think that gentlemen spoke for America in terms of this uniquely American attitude about fairness. Fairness is treating everybody the same.

A flat tax, because of the manner in which it treats savings and investment, and the fact that it ends double taxation on earnings that are generated by capital in the production process through business enterprise will be an enormous boon to economic growth.

That boon will be further, I think, enhanced by the flat tax in my iteration because we end the estate tax. It is a fundamental

thing. American mothers and fathers will work harder to build an estate if they know it is going to their children and not the government.

I think it is just a very fundamental fact if, given the choice between the government and my children, most Americans will say, I love my children best, which is the normal response.

The other thing that I think enhances the economic growth potential of a flat tax is the fact that we lower the marginal tax rate for the most mobile people in our producing community. There are a couple of other very important growth components in the flat tax as I have put it out.

One, is expensing capital. I consider this extremely important for the high-growth, high-technology area of our economy in such areas as telecommunications and computers because the march of science and engineering knowledge is at such a rapid pace that one must have the capacity to have a rapid turnover of capital just to remain competitive in these industries. By expensing capital, you give business that greater flexibility for that purpose.

Finally, the American people like the neutrality of the flat tax. The flat tax says to the American people, we trust your judgment. You do not need to be engineered by the government with respect to the critical decisions to save, consume, or invest.

Even within these categories, the flat tax has the decency to respect the discretionary ability of the American citizen with respect to what they consume, how they save, and where they invest. So I offer it for you. I am clearly available to answer any questions you have.

The CHAIRMAN. If you do not mind, we will let Senator Specter go, and then we will ask you both some questions.

Congressman ARMEY. Absolutely.

[The prepared statement of Congressman Armey appears in the appendix.]

The CHAIRMAN. Senator Specter.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman. I begin by complimenting the Finance Committee for holding this second hearing on the flat tax.

Congressman Majority Leader Armey and I testified yesterday before the Joint Economic Committee, and I thank you for holding the hearings because I believe that if we have sufficient public attention paid to the flat tax, that there is an excellent chance that it will gain the momentum to come to the floor and to be acted upon.

I know that the Chairman has been very interested in the flat tax for a very, very long period of time. I have been interested in it for some time, and, because I was more interested in it last year, I conferred with our distinguished colleague, Congressman Armey, late last summer, early last fall, and studied the issue in some detail.

I talked to the Chairman in some detail, and talked to the technical experts, and Professor Hall, and yesterday to Professor

Rabushka, about the specifics and studied their books, and am convinced that it is an idea whose time has come.

It has enormous appeal, starting with the pro-growth aspects on the solid economic base, for the conclusion that interest rates will be lowered by 2 percent and that the Gross National Product will be increased by $2 trillion over 7 years, which would be an enormous increase.

That is accomplished by virtue of the fact that all income is taxed at the source, at the same rate for business and for individuals, so there is no incentive to shift income back and forth.

And, as a result of taxing all business at the source, there will be, as Professors Hall and Rabushka analyze it, an additional $245 billion in taxes which will be paid by business which will enable individuals to pay less tax.

And business has an offset because it is calculated that there will be $165 billion in savings on just computing the tax and there will be a tremendous additional savings on availability of capital on lower interest rates and on the expensing item, which Congressman Armey has already talked about.

The CHAIRMAN. Let me make sure, Arlen, I understand. Under your flat tax, business will pay about $245 billion more than they are paying now, but will recoup about $165 of it by lessening their expenses?

Senator SPECTER. By reducing the costs of compliance.

The CHAIRMAN. Of compliance. The $245 billion can, therefore, be used to have a slightly lower individual flat tax than you might otherwise be able to have because of this additional revenue.

Senator SPECTER. Precisely. Precisely.

The CHAIRMAN. Thank you.

Senator SPECTER. The capital accumulation is really astounding as it works out because there is no tax on dividends, interest, or capital gain. It is fairly obvious why there can be no tax on a capital gain and dividends, since that has already been taxed once.

The elimination of the tax on interest is achievable because, where there is no interest deduction, where the company has what had been a dollar, it is really an 80-cent dollar, since they would have been able to deduct 20 cents on interest payments.

So, when the recipient of the interest gets a dollar's worth, it is really only 80 cents. It is sort of involved, but it does work out that there is a realistic base for not having any tax on dividends, interest, or capital gain.

The problems that the dollar is having now would be alleviated by virtue of the fact that we will not have to borrow so much money from foreign sources and the dollar would be determined on a market which is really the only way the currency stability can be obtained in the long run.

The simplicity is enormously attractive, and Congressman Armey referred to the postcard. This is it. This is a copy of the postcard, Senator Packwood.

Pardon me. Senator Packwood is looking at his copy of the postcard, but I am glad the cameras are trained on Congressman Armey and me and our copy of the postcard. [Laughter.]

Senator SPECTER. But it really is a 15-minute job, 10 lines, about as simple as it can be. The statistics are that it would save 5.4 billion hours in time, with a total savings of $200 billion every year.

That is the most anguishing time that most of us know about, filling out our tax return. I do mine each year and go over my last year's return, and there are always changes; always a matter of figuring it out again and going back to the regulations and the instructions to try to find out what has happened. It is a ceaseless issue of controversy.

We all get these IBM printouts from IRS about owing $74.12. It would be a lot easier to pay the money than to look it up, but we cannot do that. We have got to look it up and go back to last year's return, and rethink it, and recalculate it. Invariably, the computer is wrong.

It is my hope, Mr. Chairman, Senator Grassley, and Senator Nickles, that we will move forward on the flat tax. I think it would do the country a world of good and do the Congress a world of good.

Right now, we are going to have a ferocious battle, starting this afternoon, as to whether we are going to include a tax cut on the budget resolution or not. That has been a source of controversy, including our Republican caucus yesterday afternoon. I think if we moved on the flat tax, it could well be less controversial and satisfy more interests and have tax reduction.

My proposal differs from Congressman Armey's in the respect that I have added 1 percent to the 19 percent which Hall-Rabushka has. Actually, Congressman Armey starts at 20, as I understand his plan, and moves to 17. He can address, if he chooses, the issue of tax neutrality. Hall-Rabushka is deficit neutral at 19; mine is deficit neutral at 20.

On the figures from Joint Tax that, by allowing two deductions, one for charitable contributions up to $2,500, it is a cost of $13 billion a year, and allowing interest deduction on borrowing up to $100,000, it is a cost of $35 billion a year.

I have added those two deductions, which does not make it exactly flat, but I think that much is necessary if we are to have a practical chance of getting it passed, since those two deductions are so deeply ingrained in the American psyche. There is a great deal more to say, but let me conclude at this point and respond to questions.

[The prepared statement of Senator Specter appears in the appendix.]

The CHAIRMAN. Well, let me tell you how ingrained it is in the psyche. Here is the Realtor News. "It is War!" Roughly the size of the Pearl Harbor headlines. "NAR battles for home ownership. Preserve the mortgage interest deduction." Arlen, yours is not satisfactory anyway. They want to keep it at $1 million. They do not want it lowered at all.

Senator SPECTER. I thought they wanted it raised, Mr. Chairman.

The CHAIRMAN. Well, when it was set at $1 million they vehemently opposed that then. But I do not think it matters if it is $100,000, $200,000, $300,000, or $500,000, they are going to be unalterably opposed to it.

Congressman Armey, let me ask you a question. The only deduction you have on your personal side, as I recall, is spouse and children.

Congressman ARMEY. Right.

The CHAIRMAN. We could go to a 12-percent personal flat tax if you did not allow that deduction. I have run these figures over and over, and am able to get to a 19 percent flat tax—this is personal, not business—allowing roughly 16,000, individual, 32,000, joint, so you have no marriage penalty, but I did not put children in it. But the difference in just adding that one deduction, plus spouse, is the difference between the rate having to be 12 percent and 19 percent.

Is the reason you put these in that you simply feel it is not fair to tax somebody making $10,000, $12,000, $13,000 on a flat rate and that you have got to give some exemption for people in that income class?

Congressman ARMEY. Well, this, of course, is always going to be, as you search for deficit or revenue neutrality, a question of rates change or change in family exemption. My reasoning for having the family exemption, which, in my version, is very generous, if pretty fundamental. We have a government in the United States today that pretty well guarantees to every American citizen, whether they earn or not, a minimum standard of living for a variety of income support programs.

It seems to me that if I will say to somebody who is unable to work and earn their own living that we have a minimum level of income below which this government will not allow you to fall, that we can then say to the family that earns their income, you have a minimum amount of income that you can hold, first and exclusively, for the support of your family before you assume any liability to support the government. I believe the American family thinks this is necessary and fair.

Of course, as you know, we can talk about what is the appropriate level of that, but I do think it is important to acknowledge to the American family that your obligations to support your family come before your obligations to support the government.

The CHAIRMAN. Well, let me ask you further, then. I just saw this in the paper today. This is the Christian Coalition Contract With America, in which it says it "in concept" favors the flat tax, but then they say, one, the $500 tax credit for children, which, of course, is a slight exception to the flat tax; $2,000 homemaker IRA.

How do we sell flat tax? I understand why they are interested in these particular things. I understand why the realtors are interested in this. I understand why the charities have a different interest. Can we mobilize enough people to overcome all of these individual separate interests?

Congressman ARMEY. If I might, and I do not want take all of the questions, but this is something, of course, I studied a great deal. If you take a look at the realtors, if you take a look at the desire to have the family IRA, the reference point is the existing Tax Code.

The very basic thrust of flat tax is, we change that reference point. We take this Tax Code in which these things are necessary and precious to us and we say, such a Tax Code should go away; give us a simple, direct, honest Tax Code where these things are

neither necessary, nor precious. And, if I might just add, say to the Christian Coalition, as I would say to the realtor were my interest, that which you expressed, I would ch(stead of the tax-complex economic stagnation Tax Code \ today, the tax-simple growth world that you get with the flat tax.

If I were a realtor and if my living depended upon real estate transactions, I would be a fan of the flat tax and I would be demanding it, because, in a growth economy where savings increases cause interest rates to go down and more people have better jobs because of increasing productivity, the natural non-tax incentivized desire to own your own home is going to be manifested in more, better, bigger home purchases.

Finally, let me just say, the American dream is not owning your own home, the American dream is getting your kids out of it. [Laughter.]

Congressman ARMEY. You get your kids out of your own home when they have a good job being created in a vital economy that they can go to where they can get their own home.

The CHAIRMAN. I agree.

Senator Specter, do you want to comment?

Senator SPECTER. Yes, Mr. Chairman, briefly. When the Christian Coalition proposes the IRA for homemakers that other women have, I think they are exactly right. If women who have jobs outside the home have an IRA, I think that women inside the home should have an IRA as well, within the brackets where it is permitted. But, if the IRAs are eliminated, as they would be under a flat tax, then the fairness would be present where they are treated equally.

I think Congressman Armey puts his finger on the pulse, and that is, it takes just a little·re-education and re-thinking for the American people to give up the deductions, which are social engineering, to try to get people to undertake certain conduct by virtue of the tax deductions.

The genius of the American people, historically and traditionally, has been productivity. If we are left with freedom to produce in accordance with our talents, without the regulatory system and without the hindrance of government, there would be a rising tide for all of the boats.

There are many realtors who agree with the flat tax concept. They have had their convention in town. Key people from my State and key national leaders are for it, although a group came to talk to me the day before yesterday totally opposed to it. But I think, when they find out the potential for increased productivity and lowering of the interest rate and more money for people to buy houses, they can be persuaded. Thank you.

The CHAIRMAN. I will make a comment, and then turn to Senator Moseley-Braun.

When we did the Tax Reform Act in 1986, I went back and looked at the history of the Tax Code, and you can predict exactly what happened. When it was first passed, the rates were so low nobody cared about deductions. As I recall, the rate was either 1 percent or 5 percent, personally, on incomes over $500,000.

Then as the rates got gradually higher, we began to put in deductions to encourage the kind of activity that we feared the high

rates would discourage. Because we then cut our revenue a bit, we raised the rates a bit higher, whereupon we put in more deductions to encourage the activity that the higher rates discouraged. That went on for a number of years.

Then we got into the further battle of using the Tax Code to particularly favor certain kinds of businesses or industries over other kinds of businesses or industries, and then everybody wanted their piece of the tax deduction pie. I suppose the worst we ever did was when, in 1981, we just unconscionably favored real estate in the investments.

To their credit, the National Realty Committee, which represents the large developers and large apartment house builders, came in and testified against it. They said, we are going to tell you exactly what is going to happen.

You are going to have people get into this business for tax reasons, not business reasons; you are going to drive down the values of property to begin with, and you are going to have a lot of bankruptcies. They were absolutely right in their opposition in what we did in 1981. It is no wonder that we caused, eventually, a recession in the real estate industry.

Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. Thank you, Congressman Armey, Senator Specter. I am delighted to see you.

I have some questions relating to your testimony here today. Certainly everybody, I think, recognizes the need and the interest of the American people in achieving simplicity with the Tax Code. The Code, as it is now, is entirely too complex and we do have to work on tax simplification.

But I am concerned that the proposals that you have promoted here sacrifice fairness for simplicity. And, Senator Specter, you referred to freedom of Americans to make productive investments.

We sacrifice an awful lot in going forward with a proposal that I do not see has necessarily been thought all the way through. Specifically, I am concerned about the impact on the economy as a whole with getting rid of the mortgage interest deduction.

You have an exception in your plan, Senator Specter, I guess, that gives a little bit back. But the minute that you remove the mortgage interest deduction, certainly that is going to cause ramifications in the real estate industry. We saw what happened in 1986 when real estate went down; the entire economy suffered from it.

Similarly, if we remove the charitable deduction, that would have the effect of huge dislocations in the way that we provide for the social safety net, if you will, and the kinds of activities that charities undertake will change patterns of behavior in regards to charitable giving.

Then with regard to the elimination of the deduction for State and local taxes, that would set up disparities just based on geography and where Americans live.

So my question is, have you looked at or developed the numbers and the impacts of the transition? Assuming for a moment that we did figure out that it made sense to move from an income tax base to a flat tax or consumption tax, have you figured out, or have you

looked at the transitional impacts on our economy as a whole from that change?

Senator SPECTER. I believe that it has been considered, Senator Moseley-Braun. The one item which may require some special adjustment would be on existing mortgages, to have a transition period down to $100,000. The items which you specify are matters of concern as to how they will be handled.

I think the fairness issue is fundamental. If you take a look at the Hall-Rabushka model, which I have used, so that a family of four would pay no taxes at all up to $25,500, and Congressman Armey has a little larger exemption, that would be about half the taxpayers in America.

The statistics most recently for 1992 by the IRS show that people with adjusted gross incomes of $25,000 account for 54 percent of the tax returns. It is a little different because it uses adjusted gross income as opposed to total income, but that lowering of taxes on individuals is made possible by virtue of the fact that business is taxed $245 billion more under the Hall-Rabushka formula.

And the very wealthy will be paying taxes, in many cases for the first time, because of the shelters and the tax loopholes are eliminated; no more will they be possible. The millionaires will pay 19.3 percent on their income. Now, that is a much lower rate than the top bracket now at 39.6 percent, but if you are not paying it on any base, it turns out to be zero.

I think that in some of the big industrial States, like yours, or mine, or New York, the non-deductibility of State and local taxes will be a problem, but I think it will be more than offset by the rise in the economy, by productivity and by savings which will be engendered. It requires a lot of very new thinking. I had the same questions that you are stating today.

I had been intrigued by it for a long time and finally decided to take a very, very close look at it. I read a very attractive article and noted that the first bill had been introduced by Congressman Armey. I called him up and then I started to read the materials.

And, as you know, it is a big step to go onto the Senate Floor and introduce a bill and put your name on it. You have to be pretty confident that you know what you are doing. I feel confident enough about it to put the bill in, S. 488.

Congressman ARMEY. Senator, if I might, the question of fairness is very important. If your definition of fairness is special things for special people in an unlimited supply, you will love the existing Tax Code. It has got a break for everybody but me. That is one of the reasons why I give myself a break. That is probably the biggest explanation for the size of the underground economy today.

If your definition of fairness is that everybody gets treated the same, then you will love the flat tax. The existing Tax Code takes over $400 billion worth of income and says, that is not even in the tax base. We do not even subject it to the Code, while it takes a similar amount of money and says, we will tax this double, and even triple. That is not fair.

If you take the question of renting or buying, I have to ask you, why is it fair to give to that family that can afford to make their housing payment in the form of a purchase a break that is not given to that family that cannot afford that and must make their

housing payment in the form of a rent? That does not strike me as fair.

So fairness, I think, is a very elusive term. But I must say, fairness to me, and I think the American people will tell you in resounding terms, fairness is, treat everybody the same, and the flat tax does that.

We studied the charity issue, and if I can just very quickly tell you, one of the things we first discovered was 50 percent of charitable contributions are not deducted in the Tax Code today, and most of that is what is given to church and synagogues.

Second, we discovered that in the 1980's when the tax value of the charitable contribution went down, charitable contributions more than doubled. What we deduce from the literature on charity and the empirical experience we have had with it is, charity is in the hearts of the American people and the amount is determined more by the levels of their incomes and their expectations about their future than it is by the Tax Code.

Most of what you find in the Tax Code today either further incentives or disincentives a natural volition found in the hearts and minds of real people. Most people, when left alone, without bias by government Tax Code, will do more of the better things and fewer of the not-so-good things to do.

Senator MOSELEY-BRAUN. Mr. Chairman, if I may, I guess what I would like to have a response to is, if you can, do you have any empirical evidence, any numbers, any statistics, any projections, regarding the impact on the economy from the transitional effects with regard to these flat tax proposals?

It is one thing to give theoretical or philosophical speeches about this, but, if we are talking about a serious Tax Code change, then certainly I think we ought to do it on the basis of facts and hard evidence as opposed to just speculation.

Senator SPECTER. Senator Moseley-Braun, it is really hard to quantify, in an empirical sense, the transition because there will be some very significant changes. And the projections have been made by the economists, which I think provide the best answer we can to the very important questions which you have raised. They project a reduction in interest rates which they think will provide a tremendous stimulus to the economy, and also to capital accumulation.

Some countries—I believe Japan and Germany—have limited, if any, personal tax on capital gains. We have had proposals. We used to have a capital gains tax at half, and there have been proposals to lower it on the theory that we will have as much revenue with the lower rate because of more transactions. So, they project an enormous accumulation of capital.

And, as Congressman Armey says, if you have full deductions for capital assets in the first year, called expensing, there will be a great incentive for businesses to go out and buy new equipment and to expand. So, on the increase in productivity, there are some very strong, tangible indicators that that will occur.

My calculation for $100,000—we had hearings before the Joint Economic Committee yesterday—Congressman Quinn was more inclined to favor my approach than no deduction for houses. $100,000 will cover many of the houses, perhaps most of the houses, which

are purchased. And, for the middle income taxpayer, $2,500 is probably more than sufficient on charitable contributions. I think that is the best that can really be said about it.

Congressman ARMEY. If I might. First of all, the empirical data on the 1980's I cited with respect to charity is empirical data. We have studies by, for example, Professors Auerbach and Kotlikoff, that say that, if you end double taxation of some income, you could increase GNP by a full percentage point. This would translate into a 3-percent increase in output, or nearly $750 billion in additional income for each American.

When you add the effects of more work, you find that Professors Hall and Rabushka estimate that a flat tax would increase per capita income by $1,900 by the year 2002. One of the things that we must understand is, the flat tax gives everybody an opportunity for greater income in a growing economy.

My own view, again, is that the transition from this Tax Code to another—of course, the Chairman, Senator Packwood remembers, the last transition we had in 1986 inspired a wonderful book called Showdown at Gucci Gulch.

This is terribly, terribly troubled waters, and it would be waters that I know we will all enter very carefully, with a keen eye to what is the fair way to make the transition from one Code to another, while at the same time we manage to care properly for those who earn it without necessarily kowtowing to those who merely yearn for it.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. What would be the impact on the underground economy? We are losing revenue, maybe, of $100 billion or more because of the underground economy. I suppose maybe I think of it this way: lack of enforcement or not being able to enforce for the underground economy is why we lose the revenue; we do not get it as income.

So would it be easier to enforce a flat tax from that standpoint, or no different at all?

Congressman ARMEY. Well, I appreciate your question. I, too, have thought about it.

First of all, the underground economy comes, really, in two component types. One, is patently illegal activity.

Senator GRASSLEY. Yes.

Congressman ARMEY. If you are talking about pushing drugs, or something like this, this is a matter of law enforcement. I can just about guarantee, criminals will not pay taxes. They just seem to have a habit of not doing so.

Now, on the other hand, the underground economy that, frankly, is more troubling is the normal, decent, law-abiding American citizen that looks at the Tax Code as he sees it and says, this is unfair; everybody gets a break but me. I do not even understand the breaks people get.

I am 54 years old, I have a Ph.D. in economics, I have had a reasonably successful life, and it still escapes my understanding how somebody can make a tax advantage out of giving away $1,000 when they can only write off $300 on their taxes.

There must be some magic for rich people. I do not know what it is, but I know it ain't right. So the attitude is, if the government

is going to give a break to everybody but me, then I have a right to give myself a break. There is a self-justification there.

Then, in addition to that, they take a look at the Tax Code and they say, Lord, have mercy; it takes so much time to enforce this Code that it is equal to what it takes to produce every car, truck, and van in America. There are so many data points here.

Take a step family. I defy anybody to count up the number of times a stepmother or stepfather will find their stepson's or stepdaughter's Social Security number show up on different forms that go into the IRS someplace. Just a simple, little thing like that.

So they say, well, you know, it is a burden supporting stepkids. I know my ex-wife is taking them as a dependent, but I can take them too, because if anybody wants to keep track of little Billy's Social Security number in the IRS paperwork mill today is just going to go nuts trying to find it. So, we have both got it. And it is all right, because everybody else got a break from the government.

So, if you do the flat tax, two things happen. One, the first thing you must understand, and you cannot escape understanding, this is fair. I am treated the same way as anybody else. If my brother-in-law is making three times as much money as I am, he still fills out exactly this form. There are no hidden breaks, no breaks, it is just a fair deal.

Two, if I tried to cheat in a system like this, there would be so few data points to be tracked that they would certainly find me out. Now, if I have no self-justification for doing what I am more likely to get caught doing, I am less likely to do it.

So, I say in a very real sense, the flat tax bets on and reinforces the goodness of the American people rather than betting on the guile of the Federal Government. I think it is a winner and I think the underground economy will dissipate to virtually nothing with a flat tax.

Senator GRASSLEY. One other point. When there is a positive to something, there is always a negative. In this town, if it is easier to raise taxes it is more apt to be done. We also have the pattern of the value added tax of Europe. And I know you are talking about two different things, a flat tax and value added tax, but they have one thing in common. They start out with very low rates. When you start out with very low rates, it is a lot more politically easy to raise those rates. Is that a problem?

Congressman ARMEY. It is not a problem for the flat tax because everybody gets the same rate and you cannot raise it without everybody knowing. A value added tax——

Senator GRASSLEY. Well, but you go from 13 to 14. It is just kind of like boiling a frog slowly; it will die.

Congressman ARMEY. It may be. There is no guarantee. No Congress can ever protect the American people from a future Congress. It is a sad thing. But if a future Congress wants to raise the flat tax rate, the visibility of it is so evident, you have got to know everybody in my district is going to know it and they are going to be mad. Value added tax is hidden from the people who pay the tax and, of course, the value added tax even increased in England under Margaret Thatcher.

One thing you have to understand, politicians will have an uncontrollable impulse to do what they can get away with. With the value added tax, they can get away with it.

Senator GRASSLEY. No.

The CHAIRMAN. Actually, Congressman Armey, it is not always a bad thing. This Congress can protect the country from past Congresses.

Congressman ARMEY. That is right.

Senator SPECTER. If I may respond very briefly to the questions raised by Senator Grassley.

Senator GRASSLEY. I am sorry I did not give you a chance on the first one. I did not think you were ready. I will be glad to listen.

Senator SPECTER. I was ready, I was just deferential. [Laughter.]

Just a sentence now. I think, as to the underground economy, a lower rate will help. There is less incentive to cheat. But I think there is going to be an underground economy, to some extent, no matter what you do. When you talk about value added, I think about the excise tax on boats. It killed the industry. I would not like to see an add-on which would be such a deterrent from buying anything.

When you talk about raising tax rates, my sense is that the current public attitude is likely to be with us for a long time, Senator Grassley, about not raising the rates, and that does have some influence on the members of the House and Senate.

Senator GRASSLEY. Thank you, Senator Specter.

The CHAIRMAN. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you. Thank you for holding this hearing. I thank Congressman Armey and Senator Specter for their initiatives. I compliment them for it, too. I think they have greatly added to the debate of a fairer Tax Code. I think there is strong support to change to simplify the Tax Code, and I think they have been real leaders in it and I thank them for their initiatives.

A couple of points about the specifics, because I am very interested in trying to make some of these things happen. To both of our panelists, you say it is a flat tax, but I look at it as two rates. You have a zero rate, and a higher rate; 20 percent or 17 percent. The zero rate for a family of four goes up to $36,800.

I personally think that is too high. Maybe I am wrong, but I kind of feel like everybody should pay something. You are exempting a family of four from any income tax liability whatsoever unless they have income up to $36,800. I do not know what percentage of American people that is, but it is high. It is a lot.

So, I would just take a little issue on the issue of flat tax. Most all tax proposals do have a zero rate. I am sure if I co-sponsor one it will have one, but I do not think it would be that high of a deductible or that high of an exemption. I just think that is too high. Any comment on that?

Senator SPECTER. Senator Nickles, my plan follows Hall-Rabushka, which has the rate of $25,500 for a family of four on an exemption, which I think is about the right line.

Senator NICKLES. I apologize. I thought you had the same plan as Congressman Armey.

Senator SPECTER. No. Ours differ in some respects, but, in principle, we are on the same wavelength.

Congressman ARMEY. Let me just say again, Senator, this is, of course, one of the two points at which you could adjust a flat tax. Obviously, there will be about 10 million people off the tax rolls, low-income Americans.

My own view of the matter is—and I would go back to the issue that was raised by Senator Moseley-Braun—is it fair for a government to say to people who are unable to earn a living for their family, we will give you this level of living, and then to say to those who earn, but, at the point of first dollar, you must make your contribution to the support of the government.

So I hold to the belief that, at some level, we should say to the family in America that is earning a living for themselves, we honor your right to put your family first. Now, we may talk about that level, there may be compelling reasons to adjust that level, but it seems to me it is a necessary thing.

We talk about, well, gee, the realtors may come in and put on so much pressure trying to keep a provision in the Tax Code that is made obsolete by the Code, but if we want to pass it, we may have to.

Well, if you want to pass it you are going to have to have the support of the American family across this broad Nation. If that family says, I get it, this government understands my obligation to my family comes before my obligation to Washington.

Senator NICKLES. Let me ask a couple of other questions. I just wanted to make that point. I thought that, personally, was too high. Senator Specter, yours is at $25,000 for a family of four, and yours is at $36,000.

Senator SPECTER. $25,500.

Senator NICKLES. Certainly that is negotiable.

The other, I guess, really big thing in the package that is a little difficult, maybe, that I am wrestling with, I have been more inclined to say we would tax all income, including dividends, interest, capital gains, at the same rate.

Congressman ARMEY. You do in mine.

Senator NICKLES. Well, let me just ask you about that. I would like a further clarification because, as I was interpreting yours—and I think I know where you are coming from, but you can help explain it—you would exempt dividends and interest when received, and capital gains when received, from the tax.

Congressman ARMEY. Yes. The object of the flat tax is to capture all income and subject it to the Tax Code. The Tax Code really has two exemptions: the family exemption and new capital formation. But everything is in the base.

Now, I will give you an example. Ross Perot apparently still owns a large amount of stock in General Motors. General Motors generates earnings. Those earnings are taxed at the 17-percent rate. When those earnings are then distributed to the owners of the firm, including Ross Perot, they are not taxed a second time.

Senator NICKLES. Under your proposal.

Congressman ARMEY. Under my proposal. So the upshot is, we have done the fair thing in taking every dollar's worth of income earned in America and taxing it one time.

Senator NICKLES. From the political side you are going to be hit very, very hard, that this is a very large benefit to those people

that have wealth, that have stocks, that have investments that earn dividends and interest because those would not be taxed that second time, which they presently are.

Congressman ARMEY. I believe that even a large number of Perot backers will resent the fact that he, himself, does not personally file the forms on which he pays his taxes, and that will be something we have to deal with.

Senator SPECTER. Senator Nickles, the plan is really not regressive because it eliminates tax shelters and loopholes that the rich now use. And, by having business pay $245 billion more in taxes, a figure which we outlined in the opening statements, it is possible to give reductions to people at the lower end of the income scale, and the very wealthy will end up paying an effective rate of 19.3 percent on a 20-percent flat tax, and many of those pay nothing now because of shelters and loopholes.

Senator NICKLES. Both of you think your programs are revenue neutral to today's income?

Senator SPECTER. Mine is.

Congressman ARMEY. I get mine within around $40 billion, by our estimates. We are continuing to look at that. We realize that this is going to be a very important test to be met by the time we can push the buttons and pass it.

Senator NICKLES. I appreciate it. I thank both of our colleagues. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Congressman Armey and Senator Specter, I thank both of you for coming forth with your plan to attempt to bring a fairer taxing system to this country. I think that is what the aim is. I am particularly intrigued by the idea of exempting out working families at various levels, whether it is $25,500 or whether it is $36,000. I applaud that, because I think that what we want to do is encourage people to become part of the work ethic.

If we are talking about welfare reform, as we are, it seems to me a key ingredient. And we talk about workfare, not welfare. If we mean to give substance to that by attempting to minimize the loss of revenue for people at the lower incomes, I think we do a great deal there. So I think that is probably, in my view, the greatest strength that you have in your plans.

Congressman ARMEY. If I might, Senator, just very quickly. Given the importance of the family exemption, under my plan if you had a family of four—and Senator Moseley-Braun, I think you will find this interesting—that makes $36,800, they pay no income tax.

Senator D'AMATO. Yes.

Congressman ARMEY. If they have $50,000, about four percent of their income is paid in taxes. If they have $200,000, about 14 percent of their income is paid in taxes. So, their share of the tax burden, in terms of total taxes, goes up, while they still all have the incentivizing constant rate.

Senator D'AMATO. Well, I want to applaud both of your initiatives as it relates to exempting the lower areas. I also share a concern that, in our attempt to do it in the manner in which we do now, which is by the Earned Income Tax Credit, we have seen, and

some surveys indicate, that there may be a tremendous fraud rate, going into 30 or maybe 40 percent. That is horrendous. That is absolutely unacceptable.

And, while we want to encourage Americans to work and keep more of their monies, if we embark upon a program that is being violated to the extent that we are sending monies to people, a government check, and they are not entitled to it, I mean, that is just simply making a mockery of those people who are paying their fair share.

There are two elements of the flat tax that come to my mind. One, we have heard discussed, is the deduction as it relates to mortgage interest for those people who own homes. I believe I share a concept with some that home ownership should be encouraged. I understand that when we begin to make variations, why, then we do not have flat tax, we do away with it. That is the tradeoff.

But I just share with you that that is a concern of mine, because I believe it is the cornerstone for bringing family, community, and neighborhoods together, home ownership. I just think we should encourage it wherever possible.

Congressman ARMEY. Well, let me just express my agreement with that. I think the lower mortgage rates that will follow the treatment of interest will be an encouragement.

Senator D'AMATO. Yes.

Congressman ARMEY. But it seems to me it would be virtually impossible for any government to put together a set of incentives that could discourage people from wanting to own their own home.

The CHAIRMAN. I might add just one fact to this, Al. I had the Savings and Loan Association check this for me. Canada has no home mortgage deduction. They have within 1 percent of home ownership than we do. They have a higher tax rate and they are within 1 percent.

So the argument that, without it, you would not have the level of home ownership, at least is not true in Canada, in a country that is probably as close to ours in terms of similarity as any other country.

Congressman ARMEY. And if Canada would get their tax rates down, they would close the gap on that 1 percent.

Senator D'AMATO. I do not mean to open a huge debate on that, but I think you have to look at demographics. You really just cannot use these kinds of percentages, you have got to be comparing apples with apples. We are hugely different, vastly greater in numbers in our country, in economic backgrounds and regions. But that is a concern.

I do not look to debate it, but I just share it with both my colleagues because I know they have made a genuine effort and contribution to improve our system. Lord knows, I think just about every American will tell you we should improve, we should simplify it, make it fairer. This is an attempt to do that.

You do not curse the darkness without coming forward with some light. And I think there is a lot of light in both your plans, but there is one other. I would just put it out, and then I would like, if time permits, to get your thoughts.

That is, if one comes from a State that is a high tax State in terms of real property taxes, in terms of city taxes, in terms of income taxes, because we have a large burden that we have undertaken for whatever reason, because many people come to this country poor and impoverished, landing in my State, and it is a State that has provided help, and opportunity, et cetera. And, while it is nice to say that, oh, we can cut everything, we just cannot cut everything away. I know the both of you agree.

I am concerned, as it relates to the impact on my State and similar States and cities—and I look to my colleague, Senator Moseley-Braun, and I am sure she shares this concern—that do we not place a great burden on the people who reside in those States as it relates to now doing away with something that may make it possible.

There is a difference between some being able to live there and not live there, and that is the ability to deduct their real property taxes, and their State income taxes, and their city income taxes, and their county property taxes, I think, in our case in particular. So, I have to share this concern.

If you put Alaska aside—and they have a unique situation—we are the highest tax State in the country. So, our Governor is working to try to change that and bring it down, but there we are. There are other similar States. For example, Illinois, California, et cetera.

Senator SPECTER. And Pennsylvania.

Senator D'Amato, I have been waiting for you to raise this issue, sort of hoping the red light would go on before you had come to it, only for the inference as to the intensity there. I think it is a problem, as Senator Moseley-Braun and I were discussing earlier, I think, in States like New York, Illinois, and Pennsylvania where we have the kinds of situations you allude to.

But I think the answer is that there is so much in line of productivity here, and so much chance to lower interest rates by 2 percent, generally, and to increase the Gross National Product by $2 trillion in 7 years, that the people who are paying those high taxes will see this as such a boon, and pro-growth, and opportunity for more profits and simplicity, that they will be willing to make the tradeoff when they have really made the analysis.

I think you will find, and your colleague, Senator Moynihan, being on the Finance Committee, a big burden to carry that burden of persuasion, because New York State does have the highest taxes.

I think the politics will be difficult. On home interest, whatever the statistics may show in Canada or otherwise, I believe there will be a great intuitive resistance to giving up home interest mortgage deduction, and that is why I have left it in my bill, along with a modest charitable deduction, really for middle-income Americans.

It is nice being a witness, and the light does not apply as it does to Senators. This is a reversal of form, Alfonse. But, after 14 years on the Appropriations Committee, it is a shock to see you on the Finance Committee. [Laughter.]

The CHAIRMAN. I am going to shut Alfonse here down here a minute and let Carol Moseley-Braun ask one last question, and then she has to leave.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

We were talking earlier about the whole issue of fairness. Again, examining the distributive effects of this proposal, someone who works for a living, who earns his or her income by the sweat of his or her brow, gets treated very differently than someone who inherits dividend income or inherits the ability to live off of just clipping coupons, or trust funds, or whatever. Under this proposal, the flat tax proposal, interest from dividends and interest is not taxed, whereas wages are. How can one justify this?

I mean, I understand, Congressman Armey, you talk about being taxed twice. But, if your great grandfather made the investments and set up the trust fund, then it is not taxed twice, it is only with regard to those people who live off of trusts and live off of coupon income. They would be in the zero tax category. So, there is a huge loophole here, it seems to me, for the very wealthy, and that does not seem to me to be fair.

Congressman ARMEY. Well, again, if I might go through this, I spent my formative years getting a Ph.D., invested in myself and my ability to generate wage income. When I earn my wages I get taxed on it once. My brother invested his money in his business, and when his business earns that income, it should be taxed only one time.

Now, whether or not I inherited smart genes from my father, or good-looking genes from my mother, or some other way or another was able to make a success through my person and my labor, is nothing to take as bias against me in the Tax Code no more than if I had had the good judgment to choose rich parents, which, unfortunately, I failed to do. So, I could not inherit wealth or resources, so I only inherited resourcefulness.

Senator MOSELEY-BRAUN. Are you saying that those of us who are smart enough to pick rich parents get off on this program and those who were dumb enough to be born poor, working class do not?

Congressman ARMEY. No, no, no. I am not saying that at all. No, Senator Moseley-Braun. If you are smart enough to pick rich parents, you ought not to be held prejudiced against as over and against somebody who might be smart enough to add on brain genes to the bill.

Senator MOSELEY-BRAUN. My prejudice is, you are getting zero taxes. You are paying nothing, right?

Congressman ARMEY. No, ma'am. I am sorry. Let me take you back to the beginning.

Senator MOSELEY-BRAUN. But is that true?

Congressman ARMEY. No, it is not true.

Senator MOSELEY-BRAUN. It is not true. All right.

Congressman ARMEY. That is what I am trying to get at.

Senator MOSELEY-BRAUN. Please correct me.

Congressman ARMEY. I probably just picked a bad way to try to exemplify it.

Senator MOSELEY-BRAUN. All right.

Congressman ARMEY. Let us take it from the beginning. It is a fundamental truism that all taxes are paid by people and all taxes are paid out of current income flows. Governments, of course, do not like people to know they are paying taxes, so they levy taxes in ways that will hopefully allow people to not see they are paying

taxes. In the case of these so-called business taxes, they have been fairly successful.

So what they have said now is if, in fact, you own business or a part of business, through stocks or bonds, that because we have successfully hidden the initial tax you pay when the business pays its taxes, which are assumed to be separate from you, we can now tax you twice.

What I have said is, it is fair to take all income that is earned and tax it one time. If you happen to be rich by virtue of inheritance, that is your good fortune; it happens. I do not know how you can stop people from inheriting.

In fact, in my iteration of the flat tax we do away with the estate tax so more people will inherit more. But you should still pay your taxes one time, and those taxes are paid one time.

Now, what bothers you, I think, is the fact that that rich person does not have to sit down at his kitchen table and fill out the forms by which those taxes are paid because the taxes are collected at the source. But it is an undeniable fact, they pay taxes.

Senator SPECTER. Carol, let me approach it a little differently, and perhaps we can continue this conversation on some of our stacked votes on the Senate Floor. The tradeoff, as I see it, arises from expansion and pro-growth, which I think is really present here, of a mechanism of encouraging savings in a whole lot of ways.

Senator MOSELEY-BRAUN. We all want to do that. That is right.

Senator SPECTER. I think that is really the benefit for the average working man and woman in America—if we have more capital investment and more job opportunities. That is really where we get to it. The core issue is, business is going to pay a lot more taxes by stopping leakage.

They are going to pay $245 billion more in taxes, which is a great deal on the scale. That is by eliminating exemptions and depletion allowances and many, many incentives for the social engineering for businesses, so they are going to have to work on lines which are productive.

It is hard to work through all of the processes on this single rate taxation. I would like to talk to you more about it. It does work out on the single tax approach. But, if you can have people buy more equipment and machines because they are deductible in the first year and not look for tax credits, to hire somebody special to look for productivity, that is why I think there is a very sound economic basis for it.

Senator MOSELEY-BRAUN. Arlen, I think you understand that we all want to promote savings and investment.

Senator SPECTER. Sure.

Senator MOSELEY-BRAUN. But the devil is always in the details on these things, and what may look at first blush to be fair, is not always best. I mean, one of our colleagues sat here and said that every American ought to contribute something, including those people who earn less than $28,000 a year. Yet, the response I think I just got from Congressman Armey was, if you just happen to inherit a bundle of money and you do not have to pay anything, that is all right.

Congressman ARMEY. No, ma'am, I did not say that. I said they do pay their taxes.

Senator MOSELEY-BRAUN. How so? If you inherit money and you are living off a trust fund, you do not pay a dime under this proposal.

Congressman ARMEY. No, ma'am. I have to again tell you, you pay your taxes one time. I do not want to tax them twice.

Senator MOSELEY-BRAUN. No, no. Congressman, if we were talking about your brother, who earned his money and put it into investments and got a dividend, that is one thing. That raises more of the double taxation question. I am talking about your cousin that never lifted a finger to earn a dime, did not go to school, but just inherited his money.

The CHAIRMAN. I think you are talking past each other.

Senator MOSELEY-BRAUN. I think maybe we are, too.

The CHAIRMAN. I think what Congressman Armey is saying is, you tax all money once.

Congressman ARMEY. Right.

The CHAIRMAN. If your grandfather paid the tax on it, that is the tax.

Senator MOSELEY-BRAUN. But your grandfather likely did not, number one.

Congressman ARMEY. No, no. May I try again, Senator? Let us say that my father died and left me 50,000 shares of General Motor stocks. Is that a lot of money; anybody know? I have no idea. It sounds like a lot. Let us say that is a whole lot of big money and I am rich. I am making my money by receiving my dividends from General Motor stocks that my daddy gave me when he died. Now, Senator Moseley-Braun is saying, when General Motors earns income and pays taxes on that income, that that is not me paying taxes.

Senator MOSELEY-BRAUN. Oh, no.

Congressman ARMEY. And yet I am saying I own General Motors. I just happened to get lucky my daddy bought it and he gave it to me.

Senator MOSELEY-BRAUN. Congressman Armey, I studied tax with Wally Blum at the University of Chicago who was known as an expert in this field. Quite frankly, the whole notion of double taxation is one that is a concern and is a problem with the current Tax Code, and we all want to see tax simplification, we all want to see some of the kinks worked out so this system is more progressive and fair.

But it just seems to me, it makes the conversation doubly difficult when we do not recognize that there are some holes and some problems here and there are some huge loopholes through which a lot of money will escape, and the burden will be put back on the bulk of Americans who earn a living. That is all I am saying.

Senator SPECTER. Congressman Armey might make a better point, Senator Moseley-Braun, if he emphasizes his large exemption of $36,000 of no taxes——

Senator MOSELEY-BRAUN. All right.

Senator SPECTER [continuing]. Because it has been shifted to business under the computation.

Senator MOSELEY-BRAUN. Thank you very much.

Congressman ARMEY. And let me just say again, there is not one dime's worth of income earned in America that escapes the Armey flat tax. Not one dime.

The CHAIRMAN. Let me ask one question that I do not understand. This is an economic question. You do not tax capital gains at the individual level.

Congressman ARMEY. No, it is taxed at its source, where the business earns the money that generates the capital gains.

The CHAIRMAN. All right. Explain to me how this happens, now. I do not understand. A guy comes to me and says, put up $50,000 in my business, I will put up the other $50,000, we will split the stock. The stock is $5 apiece, and we put up our money.

This is in January or February, and the company invents the hula-hoop and has tremendous profits for three or four months. The stock just shoots up to $50. I sell it, I get out, $500,000. I made $450,000. The company is bankrupt by the end of the year because it was a hot property.

How is that $450,000 taxed? The company did not pay any tax at all. They did not have any profits for the year.

Congressman ARMEY. The value of the stock is a reflection of the future earnings potential of the company. And when the company earns the money——

The CHAIRMAN. Well, in this case it is bankrupt by the end of the year, it is gone, it is not going to earn any money.

Congressman ARMEY. Well, I would have to study on that kind of an aberration. I do not know what to tell you about that. That is an aberration.

Senator SPECTER. I know what to tell you. You picked the one example that is so unlikely that it proves our point.

Congressman ARMEY. It is pretty hard. Yes.

The CHAIRMAN. I do not mean to prove the point, but we have all seen hot stock properties——

Senator SPECTER. It is the exception.

The CHAIRMAN [continuing]. That some stocks shoot up and shoot down. This price behavior has no particular relation to the earning power of the company, or probably even the expected earning power. They are just hot properties. I think I have heard two explanations for it.

One, is first I earn the money to buy the stock and I paid the tax on the money I earned, so it is not unlike interest from the bank; I put my money in the bank, they give me interest. That is the one argument. I understand that one. I do not understand the one where the business pays the individual capital gains.

Congressman ARMEY. Yes, that is difficult. Let me just say this. In that curious example, you said it is the old accounting principle, there is a debit for every credit. Well, you got a gain, but somebody else took the loss. So, from the economy's point of view, it was a wash. Now, what happened was, you just got a bonus for being smarter than the dumb guy that took the loss. I think I have weaseled my way out.

The CHAIRMAN. With that, I will let you both go. Thank you very much for coming. It has been very exciting and enlightening, and I appreciate you taking the time.

Congressman ARMEY. Thank you, Senator Packwood.

Senator SPECTER. Thank you.

The CHAIRMAN. Next, we will take Michael Graetz, the Hotchkiss Professor of Law at Yale University and former Assistant Treasury Secretary for Tax Policy; Laurence Kotlikoff, the professor of economics at Boston University who has appeared before this committee many times; Sheldon Pollack, assistant professor, Department of Accounting at the University of Delaware; and Dr. Rabushka, who is just finishing up testifying at Ways and Means and will be over here very shortly, and I am sure, as he is the last one on the panel, will get here in time for his testimony.

You are all experienced at appearing before this committee any number of times.

We will start off, Professor Graetz, with you.

STATEMENT OF MICHAEL J. GRAETZ, JUSTUS S. HOTCHKISS PROFESSOR OF LAW, YALE UNIVERSITY, NEW HAVEN, CT

Mr. GRAETZ. Thank you, Mr. Chairman. It is a pleasure to be here again to discuss flat tax proposals. I have a long statement. I will abbreviate it, but I would like to have it all included in the record. I will just hit the high points in the limited time available to me.

First, let me say that there is nothing uncommon or novel in flat rates. We have many flat rate taxes in the U.S. system. Most State sales taxes are at flat rates, although the rate differs from State to State. The wage tax under Social Security is a flat rate tax, the health insurance wage tax is a flat rate tax, and, until 1993, the Alternative Minimum Tax under the income tax was a flat rate tax.

The point that was made by Senator Nickles earlier is an important point, which is that even flat rate taxes have multiple rates. We have tax-exempt organizations, we have governments, we have companies that are in a loss position, and we have zero bracket taxpayers who will pay at a zero rate—even if there are only two rates: zero and whatever the flat rate is.

Multiple rates are not, of themselves, in the current income tax, a great source of complexity. Flat rate taxes neither promise a radical change in the American tax system, nor simplicity of design or compliance.

The key issues are: what is the tax base? what is included in income subject to tax? what deductions and credits are allowable? what conditions are required to get them, when are items of income included? and when are items of deduction allowed?

It is true, as was suggested by the earlier panel, that broad bases with low rates cause fewer economic distortions and can be made much simpler to comply with than narrow bases with high rates. That is true regardless of whether income, wages or consumption is the tax base.

It is also true, however, that even a proposal like the one that was before us earlier which taxes only wages has some important complexities. Examples include, the treatment of deferred compensation, the treatment of fringe benefits, the question how you distinguish independent contractors from employees, the treatment of stock options, just to name a few, that and this committee you have dealt with over the years. So, we do not eliminate all of the

complexities in the tax even with a broad base, and even by limiting the base to wages.

What is important about the proposals that were advanced here this morning and other proposals that have been advanced for flat taxes in the Congress is that they are taxes on consumption and not taxes on income.

The base of these taxes is sales, and the pre-tax rate of return from capital is equivalent to the post-tax rate of return from capital, so there is no reduction in the rate of return on capital from these taxes.

It is hard to fathom why none of these proposals are in the common form of consumption taxes in the world. They are not European-style value added taxes; they are not State-style sales taxes; rather, the collection of the tax is divided between business, on the one hand, and individuals on the other.

Professors Hall and Rabushka, in their book, which is the basis for the proposals that were before you this morning, remark that there are many economically equivalent ways to tax consumption. They know that their tax is a consumption tax.

I was reminded, when Dick Armey talked about taxes on business, of Ronald Reagan's famous line, that businesses do not pay taxes, people do. The question of the impact of a tax is not how it is collected, whether it is collected from businesses or not, but who bears the burden of it.

Here the base is basically sales minus purchases, and you collect tax from businesses in much the manner you collect the value added tax. The base, nevertheless, is consumption and people who consume bear the economic burden of it.

It may be that this proposal is designed this way, in part, to blunt opposition from Governors and mayors who, historically, have opposed consumption taxes in the form of sales or value added taxes at the Federal level.

But I would urge this committee to take seriously a point made Senator Lugar, which is that conformity between the States and the Federal Government has a lot to commend it. One ought to take seriously the sales tax method.

The principal difficulty with the choice of only consumption taxes really dates back to concerns about people who have lots of income paying no tax; Mr. Chairman you mentioned one such person earlier.

I am reminded of Joe Barr's revelation in 1969 that there were a number of people who had income over $200,000 who paid no tax, and that fact caused enormous political outrage in the country.

Mrs. Dodge, as you may remember, took a particular beating, having had $1 million of tax-exempt interest and paying no taxes. General Electric, in the 1986 context, took a huge beating because they were paying less taxes than their workers were. And Sam Walton, as I understand it from news accounts, would not pay much consumption tax under a consumption tax proposal.

I think there is a danger that the Congress might repeat Margaret Thatcher's error of replacing an extremely unpopular property tax with an even more unpopular community charge, which was what she did.

Therefore, I recommend in my statement other alternatives. In particular, I suggest that you could combine a consumption tax with an income tax narrowly targeted to a higher income taxpayers. I have a few calculations which, if you will indulge me, Mr. Chairman, I think are important enough to describe.

A 10-percent sales tax, value added tax, or other consumption tax, CBO says, will raise about $360 billion of revenue in 1998, which is about half of the $700 billion that would be raised by the income tax in that year. Thus, without any other revenues from broadening the income tax base, you can cut the income tax in half.

Now, since a consumption tax is not distributed similarly to the current income tax simply halving the tax is probably not the right way to go, but consider these additional facts.

Based on very preliminary data for 1993 from the IRS, tax returns with Adjusted Gross Income, or AGI, above $75,000 paid one-half of the taxes for that year, although they accounted for only 7.5 million of the 107 million tax returns filed, or less than 7 percent of the total.

This suggests that, in principle, without changing the income tax, a 10-percent value added tax would allow elimination from the income tax rolls of 100 million people with Adjusted Gross Income under $75,000.

Moreover, the people with incomes above $75,000 paid an average rate of 21 percent of AGI, so that you could substitute a flat-rate 21-percent tax on AGI for the current income tax above that level.

I suggest other possibilities along these lines in my statement. You can lower the threshold to $50,000 and adjust the rates, and so forth. In practice, this is not that simple. You have to be careful about cliffs and high marginal rates, as you know well, and I discuss that, but I do think it is possible with, say, a 10-percent consumption tax, to remove 100 million people from the tax rolls, and they would not even have to file a post card.

So, I think this is an important alternative that would maintain the tax on individuals who have income other than wages and who save a lot of money and do not consume. I think the challenge to this committee is to design a mix of taxes that promotes economic growth and simplicity and yet is fair to the American people.

There are only two other points I would like to make, if I could.

The CHAIRMAN. Go ahead, but I would ask you to close down quickly.

Mr. GRAETZ. All right. I will make them very quickly.

First, I think the committee ought to take a hard look at the details of this proposal. The Armey-Specter tax is disastrous, in my opinion, in its treatment of imports and exports, and I suggest that it might encourage foreign manufacturers in the United States to go back to exporting from their home countries. I will be glad to discuss that if the committee has questions.

The Nunn-Domenici proposal demonstrates a combination of negative rates on tax-exempt bonds and zero rates on other kinds of income, suggesting that it is just as easy under some consumption taxes, at least, to come up with preferences as it is under the current income tax.

My final point, is this. I think it is extremely important, if it turns out that this Congress is able to spend $150 billion, or $300 billion, or whatever the number ultimately is, on tax reduction this year—which it has been unable to do since 1981 and may well be unable to do again for a long time—to marry the long-term desires of this tax reform movement with the short-term tax reduction effort and to try to craft a tax reduction that would simplify the tax for small businesses and individuals and that would also help capital formation. I make a number of suggestions in my written statement along those lines.

Thank you, Mr. Chairman, for your indulgence.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Graetz appears in the appendix.]

The CHAIRMAN. Next, we will hear from Professor Kotlikoff, who has done extraordinarily good pioneering work in generational accounting, which, for those of you who are unfamiliar with it, he basically tries to figure out, what are you going to pay in taxes over your life span? That is truly frightening when you look at the demographics of what we are having to spend money on and who is going to have to support it.

Professor?

STATEMENT OF LAURENCE KOTLIKOFF, PH.D., PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY, BOSTON, MA

Dr. KOTLIKOFF. Thank you, Senator. Senator Packwood, I am honored to be here to discuss with you the economic effects of the flat tax of the type originally proposed by Professors Hall and Rabushka.

My testimony makes five points. First, the flat tax, like other forms of consumption taxation, would be very good for the U.S. economy. Its adoption would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

Second, the predicted economic benefits from a flat tax are substantial. Generic simulations of shifting from income to consumption taxation in the standard neoclassical economic growth model, the life-cycle model, produce long-run increases in the living standards ranging from about 10–20 percent. These simulations provide some sense of the beneficial economic effects of a flat tax, although much more detailed simulation studies are needed.

The third point is, the flat tax, like other forms of consumption taxation, increases saving, in large part, by redistributing from older generations with high propensities to consume, to younger and future generations with low or zero propensities to consume.

In redistributing from the old to the young and the unborn, the flat tax would offset to a small degree the enormous past and ongoing reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs, and which is the primary reason for the critically low current rate of U.S. saving.

The fourth point is, the flat tax is a much more progressive tax system than is currently believed to be the case. I was sorry that you did not allow audience participation during the back and forth

between Senator Specter, Congressman Armey, and Senator Moseley-Braun.

I wanted to intervene there and point out a very important factor in consumption taxation, namely that a consumption tax represents the combination of a tax on wages and a tax on wealth. There is really a one-time wealth tax associated with a consumption tax.

You can see this very clearly in the case of a retail sales tax. If you think about a millionaire who is going to spend his assets on consumption, when he goes to do that he will be paying taxes on his wealth. So, in effect, he is being taxed on his principal, not just the interest, which is the case under——

The CHAIRMAN. Give us an example on that. A million decides to——

Dr. KOTLIKOFF. A millionaire today decides to spend his millions on a vacation trip around the country, or buy 20 fancy Cadillacs and other things. Well, every dollar of the principal of his wealth that is being expended is going to be subject to taxation under a consumption tax.

The CHAIRMAN. This is assuming he is gradually liquidating his wealth by spending it.

Dr. KOTLIKOFF. Yes. Whereas, under an income tax, he is just paying taxes on the capital income.

Now, this is very clear to see in thinking about a retail sales tax versus an income tax, but a flat tax also taxes consumption and, therefore, wealth. The way the flat tax would tax wealth is by producing a capital loss in the market value of existing real assets.

The CHAIRMAN. Let me ask you, as long as I am the only one here. Why are most the incidents of taxation tables that we see on sales taxes, flat taxes, allegedly regressive?

Dr. KOTLIKOFF. Well, they unfortunately are not constructed by——

The CHAIRMAN. By you.

Dr. KOTLIKOFF. By myself or people who I would recommend construct them. They represent a very static form of distribution analysis. They are thinking about taxes relative to current income.

I think that for purposes of distributional analysis, most economists view the proper measure of economic well-being and resources to be consumption.

The CHAIRMAN. Let me interrupt you.

Dr. KOTLIKOFF. Yes.

The CHAIRMAN. The rest of you can address yourselves to this when you get to your testimony.

I have spent a lot of time with the Joint Tax Committee running these, and I am not going to cite their figures exactly because they have not finished, but I think I am within a half a percent or so, or $10,000 or so.

Assuming that you have an Armey deduction of $36,000 for a family of four, or I once figured it at $32,000 for husband and wife, you can get the very poor off the tax rolls.

But most of the tables that CBO, Joint Tax, or anybody else gives me indicates that taxes for people making $300,000, $400,000, $500,000, their taxes go down. Those making roughly $40,000–100,000, their taxes go up. Is that wrong?

Dr. KOTLIKOFF. Well, they are missing this large one-time wealth tax element of a consumption tax, so I think their tables are wrong. They are not taking into account, for example, the capital losses on the stock market that would be imparted by adopting the flat tax.

Let me say it this way. I think that if the advocates of the flat tax really understood the distributional implications of it there would be less support for it among them, and I think if the opponents of it understood it there would be more support for it, because it is a much more progressive tax than is commonly believed. It really does represent a combination of wealth and wage taxation. This is well understood by public finance economists who are teaching these things in graduate school.

If you just think about the fact that one's consumption over one's lifetime is being financed by one's human wealth and one's net worth, taxing consumption through time is like taxing one's human wealth, which is one's labor income and one's net wealth, and that is why it is much more progressive.

The fifth and last point I wanted to make here is, the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a flat tax, a retail sales tax, a personal consumption tax, electronic consumption tax—which I mentioned here the last time I testified—or a value added tax, is a question that can provide hours of interesting debate.

Each of the different methods of taxing consumption has its advantages and disadvantages, but it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in a debate about which is the best one.

In my view, any of the alternative proposed consumption taxes would be far superior, and actually far more progressive, than is our current system of taxation.

In closing, let me just say that there are parts of the testimony which, if you and your colleagues have time to take a look at it, that show the impact through time on different economic variables of switching from income to consumption taxation.

As I mentioned earlier, there is a long-run increase predicted of 10–20 percent of living standards, so there really are a lot of economic benefits from consumption taxation, and I certainly recommend it for the United States.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Kotlikoff appears in the appendix.]

The CHAIRMAN. Professor Pollack, I sense you are not quite as enthusiastic about the flat tax as some others.

STATEMENT OF SHELDON D. POLLACK, PH.D., ASSISTANT PROFESSOR, DEPARTMENT OF ACCOUNTING, COLLEGE OF BUSINESS AND ECONOMICS, UNIVERSITY OF DELAWARE, NEWARK, DE

Dr. POLLACK. Thank you, Mr. Chairman, for the opportunity to comment today on aspects of the flat tax which is under consideration by your committee. Representative Armey and Senator Specter have, I believe, offered very serious and thoughtful legislative proposals for a flat tax.

However, I would want to clarify several issues. And, in pursuit of that goal, I would like to consider specifically two often-made claims for the flat tax, namely that the flat tax is both a fairer tax, and a simpler tax, than the current tax regime. Thereafter, I will briefly comment on the revenue limits of a flat tax imposed within the context of a democratic electoral politics.

I personally would suggest a more selective incremental approach, the kind of approach that was used in the 1986 Act, as opposed to the all-out war now being waged on the income tax. Incrementalism is the appropriate model and mode of policy making for more cautious and responsible tax reform effort. Repeal of former Section 1071 of the Code and the House's first step toward the demise of the Alternative Minimum Tax, I think, represent the great possibilities of that approach as well.

First, with respect to fairness, it is commonly argued that the flat tax is fairer. We heard that from both Senator Specter and Representative Armey. Senator Specter has urged that the flat tax will provide for greater fairness among taxpayers, and Majority Leader Armey justified his proposals on the grounds that the flat tax represents fundamental fairness.

Such claims that the flat tax represents the embodiment of fairness, I think, ought to be treated with the same degree of skepticism that is due to those who argue that the income tax must be progressive in order to be fair. We heard that more commonly in prior Congresses, but I think the same level of argumentation is present.

The underlying proposition for that theory is a very specific notion of equality and justice, which went unexamined by the advocates of redistributive tax policy, and I think the same criticism ought to be aimed at those who argue simply that a flat tax is a fair tax.

It seems to me that fair-minded individuals can—and, in fact, do—disagree about the justice and fairness of tax rates. For example, one can posit that equity and justice dictate that all citizens ought to bear the burden associated with citizenship equally, implying, perhaps, a head tax, or that political equality dictates that taxes ought to be imposed in direct proportion to one's income.

Arguably, equity demands only that the tax laws be applied on a uniform basis to all taxpayers, with no special privileges granted for either wealth, social standing, office, race, or ethnic background.

Such notions of fairness are strictly confined to the level of process, and tax outcomes are deemed to be fair as long as the process by which they are made is unbiased and impartial.

My point, Mr. Chairman, is not to advocate any of those policies, although I personally adhere to the notion that justice implies that a tax ought to be imposed in direct proportion to one's income—people who make twice as much will pay twice as much tax. My point, however, is only to point out that it is a normative choice, just as it is a normative choice to choose an income tax base as opposed to a consumption base, and that these principles ought to be argued, for the sake of intellectual honesty, on the basis of moral and ethical principles rather than on simplistic appeals to fairness.

With respect to the claim of simplicity, proponents also argue that the flat tax will significantly reduce the complexity of the tax.

Most of us would agree with Professor Rabushka, who concluded in his book, The Flat Tax, that "the current income tax system is a nightmare of complexity."

However, it seems to me that complexity is attributable to many sources. For example, policy makers such as yourself implementing public policy through the Tax Code, efforts to reach a more precise economic definition of income, and attempts to achieve greater justice in the tax laws.

Senator Russell Long, of this committee, once said, "The complexity of our Code is in the main there, not because of mischief, but because of the effort to do more perfect justice."

I think that the flat tax simply does not solve the problem of tax complexity. We all know Section 1 of the Code is not a very complicated provision. In practice, a taxpayer merely looks up one's tax liability in the tax tables, and, if you have higher income, a simple mathematical computation is required; 55 percent of the taxpayers do not file an itemized deduction. Therefore, calculating 17 percent of one's taxable income will do very little to increase the simplicity of the Code.

On the other hand, it has been correctly pointed out that eliminating all of the special expenditures, preferences, credits, and economic computations required under the present Code will greatly simplify the tax system, but that is a very different issue, the pursuit of the comprehensive tax base.

The efforts to achieve it, I would suggest, will make the political effort to enact the Tax Reform Act of 1986 look like a cake walk compared to the effort to strip the Tax Code of every single itemized deduction and tax preference, to say nothing of removing or limiting the deduction for home mortgage interest.

Finally, with respect to the revenue implications of a flat tax, it seems to me that the revenue will come up short in the wake of the adoption of any flat tax which has great political appeal to the electorate and, hence, is politically feasible.

Since World War I, the income tax has been the single greatest source of Federal revenue. Revenue from the Federal income tax, corporate and individual, is projected to be $739 billion for 1995. Since 1985, the present Federal income tax has provided roughly 55 percent of Federal receipts.

Like it or not, the current income tax regime is an integral component of the Federal system, and political and economic reality require that any alternative must raise at least as much revenue.

I personally would like to see the overall level and scope of the activity of the Federal Government reduced significantly, but fiscal responsibility suggests that, until that is achieved, any alternative tax must be proven to be revenue-neutral and not based upon some assumptions with respect to future economic growth.

The Treasury Department has already estimated that Representative Armey's proposal would produce significantly less revenue than the current regime; I believe the number was something like $185 billion a year short.

They calculated that a 25.8-percent rate would be needed to render Representative Armey's proposal neutral, but such a tax would have very little political appeal, and therein, I think, lies the bind.

At a rate sufficient to be revenue-neutral to satisfy the apparently insatiable appetite of the electorate for public goods, a flat tax will not be very attractive politically.

To satisfy those who believe that the poor should pay low tax or a lower rate, as well as those supplier-siders who believe that the industrious need additional tax incentives to be industrious, I think the flat tax will have to be set at such a low rate that it will fail to raise sufficient revenue.

The present system really represents a compromise of these and a number of other moral and political demands. A tax system based on only one big idea—for example, a flat rate—will fail to satisfy many other important goals and interests, revenue being but one.

Therefore, in conclusion, I would like to argue simply that there is an accumulated wisdom in the income Tax Code, accumulated over its 80-year history, albeit with considerable unwanted baggage.

This accumulated wisdom will be swept away by these truly radical flat proposals. The preferable alternative is an incremental approach, a strategy for limited, gradual tax policy making.

After a decade of great instability and constant changes to the Tax Code, the propriety of marginal and gradual change should be all the more obvious. Simply seeking to put the tax return on a postcard would seem to me to be offset by the great disadvantages inflicted on the economy by adopting a too-radical approach without knowing its specific outcomes in advance.

Former Chairman Rostenkowski once said, "Fundamental reform almost always runs the risk of making things worse." At risk is the $700 billion to be raised by the current income tax regime for 1995.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Pollack appears in the appendix.]

The CHAIRMAN. Professor Rabushka, you have arrived just in time to be the clean-up batter.

Dr. RABUSHKA. Well, I am dripping wet because I have just run across the mall from the House Banking Committee.

The CHAIRMAN. Is it pouring rain, or what?

Dr. RABUSHKA. No, I just perspire freely in hot weather.

The CHAIRMAN. All right. Go right ahead. Are you ready to go?

Dr. RABUSHKA. Yes. I have been ready to go for 14 years.

STATEMENT OF ALVIN RABUSHKA, PH.D., SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CA

Dr. RABUSHKA. Anyway, let me thank you for inviting me to be here today. As you note, I have missed what has come before, but I heard Majority Leader Armey yesterday when I followed him at the Joint Economic Committee, so I think he may have touched base on some of the central issues.

The CHAIRMAN. Did you hear Senator Specter also yesterday?

Dr. RABUSHKA. Yes, I heard him yesterday.

The CHAIRMAN. I want to ask you one question.

Dr. RABUSHKA. Sure.

The CHAIRMAN. Because he bases his tax on yours, except he has added 1 percent to take care of charity.

Dr. RABUSHKA. Correct.

The CHAIRMAN. Then he says that his tax, based upon yours, shifts roughly $245 billion to business, off of individuals. I am curious, if you would comment on that, if you agree with that.

Dr. RABUSHKA. Yes. I am happy to answer that, first, before I make some general remarks.

The CHAIRMAN. All right.

Dr. RABUSHKA. In fact, if I can precede that with kind of a short, one-minute opening remark.

I found the most difficult part of discussing the flat tax, as my colleague, Bob Hall, and I have set it forth and have not changed it for 14 years, is that very few people have taken the time to learn the details of it.

Now, it is simple, but simplicity takes time to understand as it relates to the current Code, because the current Code is God-awful complicated, and no one understands it.

So, on this backdrop, apart from encouraging everybody to read the book, and my formal statement is basically the guts of the book, chapters three and four, because that is the whole plan, it turns out that today we tax the corporate tax and then we tax a substantial part of business income through the personal tax. Half of all business income never shows up on those tax returns. So what has happened is, a lot of business income that were drawn into the tax base to lower the rate overall escapes taxation in the current system.

Now, what we do in creating a single tax, but reported in two forms—one form, a business form, and one form, a wage form—and if it were not for the desire to inject a large measure of progressivity through, allowing personal allowances well in excess of the standard deduction in today's personal exemptions, one would not even need that. In some countries individuals do not file, the business files for them. Many working people in England are in that situation.

But I do not want to confuse the issue in thinking there is a wage tax and a business tax. There is a single tax on GDP cash flow, which is reduced only by investment outlays, and then shifting the burden of paying the tax on labor to the individual recipients of that labor income.

So what happens is, in our reconceptualization, it turns out that business income combines both the corporate income—that business income currently reported on individual 1040's—and the business income that is not now today incorporated either in the corporate tax or in the personal income tax. Those numbers add up.

The CHAIRMAN. What kind of income is that?

Dr. RABUSHKA. Well, if you look at what it is, for example, that is not in the tax base, how do you get from a smaller tax base to a larger tax base, what items do you start adding into it? Well, the biggest items would include, for example, fringe benefits.

The CHAIRMAN. All right. I see.

Dr. RABUSHKA. Let me go further. State and local taxes. That would further broaden it.

The CHAIRMAN. I thought you meant just business income that is not included one way or the other.

Dr. RABUSHKA. Well, of course, a lot of interest is not taxed. What we do is change the tax treatment of interest so that we tax it more effectively; other business income is double taxed. But, in effect, what we do is broaden the base all the way out to the Gross Domestic Product. This is kind of a back-door way of getting to, sort of, the explanation of how the system would work.

I guess what I would like to do, if I can kind of go to the front part of the statement, maybe would be just to sort of highlight what we have tried to do here in putting together this notion of a simple flat tax.

Basically—and I want to be clear about this—Professor Hall and I decided not to enter into the debate on the relative size of the public sector. So we have done our best not to increase revenues, decrease revenues, but to keep them the same, as close as we could, as close as anybody could, though we will argue forcefully—and the evidence of Professor Kotlikoff and every other scholarly study we could find in the last 10 years says—that a flat rate levied on a base of consumption, largely, would produce substantially higher labor supply, higher capital response, higher entrepreneurial response, and, thus, more growth. I think that is an important part of it.

But what we have set out to do was to radically simplify the Code, thereby dramatically reducing compliance, complexity, evasion, avoidance, dishonesty, and converting a Nation of petty criminals into honest, law-abiding citizens.

We have set out to reduce the rate as low as possible commensurate with not getting into a debate on increasing or decreasing the deficit and the size of government, and then dramatically providing the proper investment incentive.

And, in our view, you reduce from the tax base each year the marginal increment to capital, but most people are then confused and say, we do not tax capital income. That is not true. In all subsequent years, the returns to that capital income is taxed in the form of higher business income, in the form of higher productivity through labor.

The CHAIRMAN. This is the way the capital gains tax is paid?

Dr. RABUSHKA. Well, what happens is, to be absolutely clear about that, when you tax business income once——

The CHAIRMAN. Yes.

Dr. RABUSHKA [continuing]. A dividend would simply be a second tax on that received by individuals and a capital gain would simply be a double tax on the retained earnings of the business. In either case, the earnings of the business will be fully taxed and, therefore, no one has to pay any attention to the subsequent payout of that after-tax income.

The CHAIRMAN. I have to confess, I do not understand the theory of the individual capital gains being taxed by the retained earnings of the business.

Dr. RABUSHKA. All right. I will try to explain that. I think it is reasonably straightforward. Let us suppose we have two businesses. Business one pays a 19-percent tax and pays out the other 81 cents on its dividends. Well, you would see that that dividend——

The CHAIRMAN. I understand the dividend.

Dr. RABUSHKA. No. I know. But I want to make the example. I think it is easier to follow if you start from the dividend and go through. All right. At that point you are taxing the dividend a second time if you tax it in the hands of the individuals.

But suppose every penny of the after-tax income is retained in the business. That finances an expansion of the business. The business expansion is going to grow and lead to future higher earnings. Those higher earnings will generate the higher revenues at the same rate.

Therefore, if you tax the appreciation on the underlying capital asset, which is simply a paper claim to the after-tax earnings, you are going to double tax a single stream of earnings. Similarly, for the inheritance tax, if you do not repeal it you then double tax a stream of after-tax earnings.

So, one of our very simple rules is, try not to tax income flows more than once. In our current system, part of the problem is the double tax of those streams of earnings. That has a very adverse effect, in our view, on investment saving and growth.

The CHAIRMAN. Yes. But I am sorry, I do not understand yet.

Senator BRADLEY. I do not either.

The CHAIRMAN. Bradley comes to me. He says, I want to go into this business, and he will put up $50,000, and I will put up $50,000. We divide and take half the stock. He goes into the business of making hula-hoops and it is a hot property. My stock, which was $5, goes to $50. I get out at this stage, having now made $450,000.

His business is a hot property, and by the end of the year it is bankrupt. The people who bought my stock have lost it all, but, of course, under a flat tax they do not get any deduction.

Dr. RABUSHKA. Correct.

The CHAIRMAN. Where is my $450,000 profit capital gains taxed?

Dr. RABUSHKA. Well, that is not income as defined in the National Income Accounts. What that is, is a transfer of assets. While you held it, you held a claim to the after-tax income of the business.

Now, it was your good luck to collect it and his bad luck to lose it. In the aggregate, it is a wash. But if you were to pay a tax on that, you would have been paying a tax at a time on a claim to the after-tax income of the firm, which had already been taxed.

I think what you are doing is putting this in an example as if you were going into a casino and gambling, but there is a big difference. The difference is, you are, as a stockholder, holding a claim to the income of the business.

The CHAIRMAN. Well, I understand I am holding the claim. I have not liquidated yet; if I do not do it quickly, there is no business.

Dr. RABUSHKA. Most businesses fail. I mean, that is the capitalist system.

The CHAIRMAN. I understand that.

Dr. RABUSHKA. And some businesses succeed.

The CHAIRMAN. Mike, do you want to jump in? You are shaking your head.

Mr. GRAETZ. Well, I am shaking my head for two reasons. One, is it is simply not taxed under this system. It is not in the National

Income Accounts. But the answer to your question is that this particular gain is not taxed.

It is offset in some theoretical sense in that somebody else is experiencing a loss that they cannot deduct. But if the idea of a tax system is to distinguish the winners and losers, the concern that is driving your question seems important.

The second point is, that unlike an income tax at the business level, since this is a consumption tax, it gives a deduction for purchases of investment assets. That means that retained earnings of the business are not being measured as business income.

There is a good debate about how much of this is true. On average, in the economy, if business capital gains are taxed, then it is true that taxing the gain at individual level again is a double tax. The corollary of that is, if business-level gains are not taxed and you do not tax the individual-level gains, then you never tax the gain.

This is an issue we struggled with a great deal in the Treasury report on Integration that we issued in January of 1992. And chapter seven of that report attempts to try and distinguish the cases where business income is actually taxed from the cases where business income is not taxed.

But, unlike the existing income tax, when you give a deduction for capital purchases, as Dr. Rabushka's plan, and the Specter-Armey plan do, you are not measuring capital income at the business level in the same way that you do if you allow only a deduction for economic depreciation of assets, which produces a tax on income at the corporate level. So, in theory, the answer to your question really turns on whether or not the income has, in fact, been taxed at the business level.

The CHAIRMAN. And you say it has not.

Mr. GRAETZ. Well, it depends. Sometimes it has and sometimes it has not. All I am saying is, in the example you put forth, it has not been taxed at the business level. It may be true that somebody out there has experienced some offsetting loss, but there is not a double tax on that gain, there is no tax on that gain. It is a legitimate question.

There are all sorts of important examples. Another example that is maybe more common is where the value of the corporate assets increase, but are not liquidated, and they are not taxed.

The CHAIRMAN. But is the theory of the offsetting loss that this poor devil who bought my stock, which is now worthless, cannot deduct it and, therefore, that is the offsetting loss against my offsetting income?

Mr. GRAETZ. Precisely.

Dr. RABUSHKA. I certainly would not want to advocate a Code where people start writing off gambling losses and losses of that kind in unlimited amounts, but I want to make a point that is left out of Professor Graetz's discussion. That is, when a business sells the capital assets, that is revenue. In other words, if you have a factory and you sell it, that is gross revenue.

So you are, in fact, putting back into the tax base any appreciation on your capital assets, expensed or not. So, real estate, real goods and services, are counted as part of the proceeds of the busi-

ness, so that the capital outlay ultimately then gets factored back into the tax base of business cash flow when, and if, they sell it.

Mr. GRAETZ. Not if it is reinvested at the corporate level.

The CHAIRMAN. Wait. Now I want to ask you something. We talk about the flat tax being simple. I am going to go out and try to explain this theory. I do not even understand it, let alone attempt to explain to somebody how simple it is.

Dr. RABUSHKA. Well, I have a relatively simple answer for that.

The CHAIRMAN. All right.

Dr. RABUSHKA. If you think the flat tax is complicated, take a look at form 1040, because nobody can explain that. So what I would say is, in the land of the blind, the man with one eye sees with a clearer vision.

I do not have any problem understanding and explaining this. I think what I wanted to say at the outset in the form of what would have been a formal statement is this, because I had the liberty of saying it this morning.

In fact, Senator Bradley showed up on June of 1982 at the very first Joint Economic Committee hearings on the flat tax, so he has been engaged in this debate for just 1 year less than I have on this particular issue.

That is, that what I have discovered is, I do not mind having a serious exchange of views on all the points that one can quarrel about, but about 75–85 percent of it is spent correcting misunderstandings, incomplete understandings, distortions, and so forth.

So what I have often found is, it is essential to have a good hour to two hours to explain the origin of the system, the rules for creating the tax base, the logic of it, and so forth. I am not going to deny that there is a series of interpretation and other problems.

There is no tax system anywhere in the world where you do not get into definitional problems, problems of interpretation, problems of rulings, problems of understanding.

The simpler it gets, the easier it is to resolve those issues; the lower the rates, the more the problems go away; the more integrated the system, the less you run into problems of double and triple taxation, and so on, and so on, and so on. I think I could persuade you, if we had enough time, that a whole lot of these separate, individual issues are better dealt with in this system than in the current system.

The CHAIRMAN. You do not have to convince me. I kind of like the flat tax. I just do not understand how to explain this portion of it. I can just see what happens when I go on television and I have to give about a 30- to 40-second answer that is understandable to everybody. Your answer is not that simple. I have read your book.

Dr. RABUSHKA. Well, I think what the problem is—and I understand the frustration in trying to explain it—is that owners of companies constantly change, but that at any point in time the man or the woman who holds the share of stock is holding a claim to the after-tax income of that business.

And so long as that business is being fully taxed at source, then whoever it is that holds that stock, in fact, were he to be taxed again on the change in that underlying appreciation, is being dou-

ble taxed on a stream of income that has been fully taxed at source.

Senator BRADLEY. Well, if I could, Professor, first of all, I think that you are brilliant and you have——

Dr. RABUSHKA. Thank you.

Senator BRADLEY [continuing]. Been a very effective professor. But there is this problem of getting over what you know to what the public has to know in order to give us some resonance to what we might say. I mean, James Joyce understood Ulysses, but not many other people did, and some have even read Ulysses. [Laughter.]

Senator BRADLEY. But I think that it is not an insignificant problem.

I was curious, do you have any other suggestions about integration of individual and corporate income tax systems other than the integration that Professor Rabushka has talked about? Anybody on the panel?

Mr. GRAETZ. Well, Senator Bradley, I spent a good bit of time when I was here at the Treasury working on an integration report that the Treasury released in 1992, and the ALI—the American Law Institute—under the leadership of Al Warren at Harvard, has also produced a document taking a somewhat different approach.

I think that this is an extremely important issue under an income tax. What we were talking about here today is moving from an income tax to a consumption tax. But, if you stick with an income tax, I think one of the great problems in the American tax system is the burden of taxation of corporate income. We have a chart in that Treasury report that compares the investments in corporations and the investments in housing in the United States compared to our trading partners.

Senator BRADLEY. Right.

Mr. GRAETZ. And because we often double tax corporate income and do not tax housing, we are generating a lot of investment in housing and not enough in corporations that could create jobs. So, I think this should be a priority.

Senator BRADLEY. Right.

Mr. GRAETZ. The reason it has not been is, the business community has other priorities, in particular, eliminating the tax on retained earnings by deducting capital investments.

Senator BRADLEY. Or a variety of other priorities that they want from the Congress.

Mr. GRAETZ. Or a variety of other priorities.

Senator BRADLEY. But my question to you is, if you were an individual taxpayer and you had an integrated corporate and individual income tax system, what would you suddenly be surprised to find was income for you? If you are a shareholder, for example, of a corporation, would the earnings of the corporation flow through to you as an individual shareholder?

Mr. GRAETZ. No, we believe that is impractical, particularly for large corporations. I believe it to be completely impractical for large corporations. There are really two ways to do this, I think. One, is to convert the corporate tax essentially into a withholding tax on interest and dividends that flow through to individuals and allow

a credit for the corporate tax as you do for individual taxes on wages.

Another, is to collect the tax, as Professor Rabushka suggests, on income at the corporate level and then treat that as the final payment of tax and not collect it again at the individual level. The third method, is to give a deduction for dividends to corporations.

There are very different effects of those three choices on capital supplied by foreigners, capital supplied by tax-exempt organizations, and capital that is not taxed because of tax preferences at the corporate level.

Senator BRADLEY. Yes.

Mr. GRAETZ. Those three issues and how you come out on those three issues really determines which of those three methods you would pick.

Senator BRADLEY. Well, I have always thought integration was a very interesting possibility, but that, again, the practicality of getting from where we are here to where we would be there has been too great. That is not to say insurmountable, but up to now, in part, because of interest on the corporation side, too great to get over. Maybe that is attention and interest.

If I could, I would like to go to some of the flat tax proposals. Under the various proposals that we have seen in terms of flat tax, is there any way to judge how an average family of four might be treated after the Specter-Armey, the Hall-Rabushka, or varieties of others?

The CHAIRMAN. Are you talking about incidents of taxation, up or down?

Senator BRADLEY. Yes, up or down. More tax or less tax.

Dr. RABUSHKA. Can I start?

Senator BRADLEY. Yes. And, if you could, I want to go through about five or six questions, so try to make it succinct.

The CHAIRMAN. I might say to the other witnesses, butt in also if you want in answering these questions as we go.

Dr. RABUSHKA. Let me preface that by saying that a fair and proper accounting would have to take into account the tax cut equivalent of the reduction and compliance and disincentive costs that all economists recognize are associated with the current system, that range anywhere from the high $100 billion to mid-$300 billion, and that is almost half of what we collect in personal income taxes. So, in some sense, the economy as a whole would get a giant tax cut from all the gains associated.

Senator BRADLEY. I understand that.

Dr. RABUSHKA. All right. But it is not unimportant.

Senator BRADLEY. I understand that, but that is not where I want to start.

Dr. RABUSHKA. I understand. But it is not unimportant. If that is left out, you leave out a substantial reason for moving.

Now, having said that, the problem in answering your question is twofold. On the one side, we really do not know the incidence of the corporate income tax today correctly, so whenever we try to assign it out by income groups, whether it is by adjusted gross income groups or by definitions of economic class groups, we make assumptions, in proportion to dividends, in proportion to something

else; we make passes at it, we are never really sure, we do our best. We then lump that into various income groups.

Now, in our situation, we do not really have a separate corporate tax and a separate personal tax, it is a single tax; part of it is borne by labor and wage income, other parts of it is borne by business and previous capital income. So, a correct model would attempt to look at that.

I do not know that we can say anything precise and concrete today, but I can tell you, certain things will result. At the top, if you have been an egregious user of tax shelters, you will pay more.

If you have done nothing but get wage and salary income, you will get a substantial break. The larger you are in that bracket and the more you go wage and salary, the bigger the cut; the more you have been in an aggressive tax shelter, the bigger the impact.

All right. At the bottom, depending on where you set the allowance level, you get a tax cut. You throw millions off the rolls. You roll on up to the $30,000, $40,000, and $50,000 range. You hit a crossover point in there, and then that crossover point may set certain groups at a disadvantage until you get higher up again.

The crossover point, in my view, is an important point, but in a few years, the effects of economic growth overwhelms that, so everybody is made whole in the sense that the higher growth compensates the short-term people in that crossover group.

So that is, I think, at this point the fairest statement that I could make about the distribution, pre-and post-, were we to go to, say, the Hall-Rabushka variant.

Dr. KOTLIKOFF. Let me just intervene as well on this, if I can, Senator.

Senator BRADLEY. Sure.

Dr. KOTLIKOFF. I have a response to the previous exchange here. I do not know if you want to go back to that.

Senator BRADLEY. No. Try to keep it on this issue, otherwise we are never going to get through.

Dr. KOTLIKOFF. All right. At some point, perhaps we can talk about that privately, because I think there is a clear way to respond to the question you had, Senator Packwood.

As I mentioned in my opening statement, there are some important issues here that are not being considered in the kind of standard distribution tables that are being calculated by the CBO, the Treasury, and the Joint Committee on Taxation.

These have to do with the one-time implicit wealth tax that would arise from the introduction of a flat tax. A consumption tax, which a flat tax is an example, really constitutes a tax on wages and wealth, because when you take your wealth and spend it—i.e., when you spend your principal—you are going to pay taxes on your principal.

Senator BRADLEY. Sales tax is a wealth tax?

Dr. KOTLIKOFF. Yes. It is surprising, but that is actually what it is.

The CHAIRMAN. He is presuming spending of your accumulated wealth.

Senator BRADLEY. Oh. So, of course, you then mean you would tax everything at death.

Dr. KOTLIKOFF. No. The people that inherited——

Senator BRADLEY. Oh. All right. How is that the case then?

Dr. KOTLIKOFF. Well, if your children inherit the wealth, when they go to spend it, they would be paying taxes on it at that time.

Senator BRADLEY. Oh. So the more you have to pass on, the more your children have to spend, theoretically.

Dr. KOTLIKOFF. And also the more taxes they will have to pay.

Senator BRADLEY. So it is kind of a rolling accumulation of wealth.

Dr. KOTLIKOFF. It is equivalent to a one-time tax on your wealth, and a tax on your human wealth, which is your wages. That is what is financing your stream of consumption. If you think about the flat tax, it is instituting a consumption tax, through the back door, and there is also a wealth tax associated with it. It has to do with the decline in market value of existing assets that would arise from a flat tax.

Right now, if you have an asset, a piece of capital that has received economic depreciation, it has got a basis which is equal to its market value, therefore, if you sell it under the income tax there is no capital gains, at the business level, to be paid. Under the Hall-Rabushka proposal—the original proposal—if you sell your asset you cannot deduct the basis, so there is going to be an immediate increase in taxes due on that asset. Even if you do not sell it, the market value of the company will decline in reflection of this liability.

So when we institute this flat tax there is going to be a one-time reduction in values of existing assets that is going to show up in the stock market, and that could be on the order of 10–20 percent. This is not being included in these distribution tables—this tax on wealthy people.

As I said earlier, if the supporters of the flat tax really understood the capital levy effects of it, they would be less supportive, and if the opponents of it really understood that it incorporates a tax on wealth, they would be more for it.

Senator BRADLEY. In one minute, can you repeat what you just elaborated on? You are on television now, the camera is on, you have a minute. You have 200 million people watching you, this is your chance. What would you say?

Dr. KOTLIKOFF. Consumption is paid for out of wealth and wages, ultimately. When a millionaire goes to spend his wealth he is going to end up paying taxes, if we have a retail sales tax. I cannot do it in a minute. [Laughter.]

Unless I practice.

Senator BRADLEY. You are always honest, I will give you that.

Dr. KOTLIKOFF. Let me practice and I will get back to you.

The CHAIRMAN. Well, on that theory then, every table on the incidence of taxation that we have seen on retail sales taxes is wrong.

Dr. KOTLIKOFF. They are all wrong.

The CHAIRMAN. All right.

Dr. KOTLIKOFF. First of all, the whole idea of thinking about incidence——

The CHAIRMAN. So that is an easy way to explain it, you just say they are wrong. [Laughter.]

Dr. KOTLIKOFF. Yes. That is absolutely right. They are wrong.

Mr. GRAETZ. Senator Bradley?

Senator BRADLEY. Yes, Professor Graetz, and then Dr. Pollack.

Mr. GRAETZ. Can I just emphasize, in one minute, what Dr. Kotlikoff is telling you? Wealth is taxed when it is spent, if it is spent, whenever it is spent.

Senator BRADLEY. Right.

Mr. GRAETZ. And there is an implicit tax on wealth to the extent that the value of assets, such as corporate stock or housing, go down, which he tells you will occur under this tax because you are moving to a consumption tax.

But, at the same time, we have heard that interest rates are going to drop by a substantial amount, that economic growth is going to go up, and that the value of your housing is not going to be depressed by this tax, and the value of your corporate stock, it seems to me, may well go up in the transition rather than down.

So, the question of how you distribute this depends on what you believe about the wealth effects on assets. He has a model, and I do not want to fight him about his model at the moment, but it has some unrealistic assumptions.

Senator BRADLEY. Right.

Mr. GRAETZ. In fact, the Joint Committee on Taxation——

Dr. KOTLIKOFF. But, Michael, let me just say that a lot of the things——

Senator BRADLEY. Wait, wait. I want to hear Professor Graetz.

Dr. KOTLIKOFF. All right.

Senator BRADLEY. I think it is beginning to get clear. [Laughter.]

Mr. GRAETZ. Thank you, Senator. It is at least getting shorter. There is a chart which I have in front of me, which shows the Joint Committee distributing this tax in both ways, in the way that Professor Kotlikoff suggests——

The CHAIRMAN. You are talking about distributing a corporate tax?

Mr. GRAETZ. No, this is a consumption tax.

The CHAIRMAN. All right.

Mr. GRAETZ. Distributing a consumption tax, both to wealth and wages, as he suggests, and just to consumption.

The CHAIRMAN. You mean, they have two different charts.

Mr. GRAETZ. Two different tables.

The CHAIRMAN. All right.

Mr. GRAETZ. And if you distribute it to wealth and believe that it taxes wealth, as Professor Kotlikoff suggests, you do not get nearly so much of a tax reduction at the top end of the income distribution.

Senator BRADLEY. All right. Now, let me ask you this, just to kind of try to see if I understand this. My name is so and so, and I have a billion dollars. I am a wealthy man. Now, I cannot chew any more tobacco, or I cannot drink any more liquor, or I cannot do anything more than a poor person, so I cannot spend all of that, and I am going to pass that on to my heirs. Then they are going to have, assuming they are not profligate, adding to that, $2 billion, and pass it on, and pass it on, and pass it on.

Mr. GRAETZ. Right.

Senator BRADLEY. Now, you are saying that if we institute a consumption tax, that it is really a wealth tax because the $1 billion

that I have before the consumption tax is imposed will decrease—this is what Kotlikoff says—if I have corporate stock and residences. So, it is a wealth tax because it assumes that the portfolio values decline because of the application of a consumption tax; is that right?

Dr. KOTLIKOFF. Well, the flat tax is not going to allow you to deduct your basis when you sell the assets.

Senator BRADLEY. Right.

Dr. KOTLIKOFF. So that is very important.

Senator BRADLEY. But is that not the way the wealth tax works?

Dr. KOTLIKOFF. That is how it works.

Senator BRADLEY. All right. Now, you say that if you put in this tax, of course, at the same time the argument is that there is a tax on wealth because assets are income tax-sensitive, progressive tax-sensitive, will decline in value, then you argue at the same time the proponents state that we will have higher economic growth. So you say higher economic growth will bring all asset values higher so the decline from $1 billion to $900 million will not take place and, therefore, there will not be a commensurate tax on wealth.

Mr. GRAETZ. Well, let me be precise. I think the question is a very difficult and unknowable empirical question as to whether and which values will decline or not, and the only tax on existing wealth will occur if values do, in fact, decline. I think we all agree that there is no tax, under a consumption tax, on the second billion dollars that is accumulated after the imposition of the tax. That is, it does not tax new capital, it only taxes existing capital.

Senator BRADLEY. Right.

Mr. GRAETZ. And only to the extent that the value of the existing capital goes down.

Senator BRADLEY. We have to hear from Professor Pollack, and I know the Chairman wants to move on, I think.

Professor Pollack?

Dr. POLLACK. My comment was to suggest that perhaps your difficulty understanding the proposal is because it starts out and is being sold as a flat tax, 17 percent. What it entails, then we are told, is integration of corporate tax for publicly traded C corporations. That is something Treasury has been struggling with since 1967, if not longer. Professor Graetz has been part of that.

It also now, we are told, includes a switch to a consumption tax, and we have to figure out the economic ramifications on capital markets, on international exports.

This is not the kind of proposal your committee is used to dealing with, which is really more in the mode of repealing Section 1071, what is the revenue estimate of that. Here you are being asked to recompute in your mind the entire economic system, the integration of corporate taxes.

As the only practicing tax attorney, I think, on the panel, I had to struggle through the 1980's every time you people amended the Tax Code when we were left to digest relatively, comparatively simple bills.

Senator BRADLEY. Right. But I think that you raise a very important point, and that is—and I would like to know from each one of you—what do you have to say to those who are in our current system, whether they are a home owner, dependent upon a mort-

gage interest deduction and a property tax deduction, or whether you are a charity depending on contributions from people who can get a charitable deduction?

Dr. POLLACK. Or if you hold municipal bonds that are tax exempt now.

Senator BRADLEY. Or if you hold municipal bonds that are tax exempt, or if you get employer-paid health insurance and suddenly you have got more income, or if you have a pension that your company is investing in and making money, and suddenly that increases tax to you each year.

So, I think when you advocate the flat tax, in theory, you can make an argument that there are always professionals that disagree with each other, but in terms of actually making this happen in the real world, would this not be significantly disruptive to the economy as a whole where you find millions of people who have invested in their homes, assuming they can deduct their mortgage and property taxes, and other people who have made significant decisions? I am not talking about certain sectors of the economy, but the broad mass of people. What would you say to that?

Dr. RABUSHKA. Can I answer that?

Senator BRADLEY. No, I want to hear from other people first, then you last. Just in order, right down.

Dr. RABUSHKA. No problem.

Dr. POLLACK. Notwithstanding the great respect I have for my friends who are economists, the limits of human reason suggest we do not know what the outcome is and there will be many areas impacted in the economy that nobody has even thought of yet.

Consider the example of municipal tax-exempt bonds. It is just now sinking in how that market would be affected. We do not even know what the effect would be on C corporations, publicly traded companies. Moving from one system to the other, the impact would be enormous.

For that reason, I have urged a gradual approach to Code section by Code section rather than rewriting an 80-year accumulated Tax Code which does represent solutions to specific problems that arose over 80 years, as opposed to wiping the slate clean and starting from scratch and not really having an assurance of what is going to be on the other side the day after you enact that legislation.

The CHAIRMAN. Bill, I do want to shift to a different topic, if I can, as to what Michael said at the end of his testimony, that this will be bad. I do not know if he said for trade, or for American exports, or a flat tax would drive American businesses overseas. I did not quite get the point you were making, but do I sense it right?

Mr. GRAETZ. Well, let me see if I can just explain it quickly and clearly, although it will take a little more than a minute.

The way the Hall-Rabushka version of a consumption tax applies, is that it applies on an origin basis rather than a destination basis. Economists often say that exchange rates will adjust to take care of that difference, but the point is, if you compare the treatment of an automobile manufactured and sold in the United States, that sale is taxed in full. The full value of that sale is included in the tax base. If an automobile is manufactured in the United States and sold abroad, everything is included in the tax base except for the foreign dealers mark-up.

If an exporter for a foreign country imports automobiles into the United States—because the way the tax is calculated you deduct purchases from sales—the only thing that is taxed on foreign cars is the dealer's mark-up.

This was an issue, you may recall, Senator, in connection with the proposed energy tax in 1993 with respect to how exports would be adversely affected as compared to imports because of the inability to rebate the energy tax on manufactured goods at the border. It was an issue of great concern to American businesses.

It may not be of great concern in economic theory or in principal if you believe this compensating effect about exchange rates, but this proposal is different in important ways. The Hall-Rabushka/Specter-Armey tax is different on this ground in an important way than most countries' consumption taxes, which are imposed on imports and forgiven on exports. This is a very important detail in the proposal, and that is why I raised it.

The CHAIRMAN. Go ahead.

Senator BRADLEY. Well, do any of you want to comment?

Mr. GRAETZ. I would comment on this transition question that you have raised.

Senator BRADLEY. Yes.

Mr. GRAETZ. I think that the transition question is extremely important, and I think that, in general, you can say that people who have under-taxed assets, or assets that are not subject to the income tax under the current system, will come out differently than people who have over-taxed assets in a transition to a consumption tax.

So if you have pensions or tax-exempt bonds, those assets will not enjoy their relatively favorable treatment which they now enjoy, so they will be worse off. Housing, I think, will be worse off for the same reason. If you have corporate stock that pays a lot of dividends, the value of that corporate stock may decline, in fact.

That is why I say it is an empirical question. I think you have got to worry about the transition when you are making this kind of dramatic change in the tax system and try to evaluate these questions.

Senator BRADLEY. Right.

Mr. GRAETZ. They are very difficult, but they are very important.

Senator BRADLEY. Larry?

Dr. KOTLIKOFF. I will just add to that. Michael says my model is unrealistic, or has some features that lack reality. But, really, these issues of transition and these wealth effects and these change in market values of housing and stocks that I am raising, really do not relate to my model, it just relates to any very simple, straightforward, asset pricing analysis.

If you, in one case, are allowed to deduct a basis and on the other you are not, Wall Street is going to understand that. Believe me, it does not have to do with any issues of growth or whether growth occurs, it is whether or not you are allowed this deduction.

Now, there will be a lot of revaluations of different kinds of assets. If you think about somebody who has put a lot of money into IRAs, and Keoghs, and taken deductions at high tax rates, now they are going to be able to realize this pension income at a lower tax rate. That is a benefit. That is not a negative, Michael, to peo-

ple who have pensions. That is a windfall. There are a variety of different kinds of windfalls.

That is why the distribution analysis that is being done basically is not getting at the meat of the issues, and that is why it has to be done much more carefully and in much more of a context of——

Senator BRADLEY. Based upon what he said, Professor Rabushka, in your 19-percent tax proposal, I think in your book you have its effect on income levels. I wondered, basically, just reading from what I think is your chart in the book, it shows that income levels below basically $100,000 would pay more tax, some 3 percent more, 5 percent more.

It means $2,228 more if you earn $58,000; $1,863 if you earn $93,000. When you get to $123,000 in income, then you actually get a tax cut of $318, when you get to $500,000, you get a $44,000 tax cut, then when you get to $1.4 million, you get a $151,000 tax cut.

Now, on its face, when you looked at this chart and you say, essentially, everybody is going to be paying more tax except people who make more than $100,000, who are going to pay significantly less.

When you get to $1.5 million, they are going to pay 10 percent less, and when you get to $3 million they are going to pay 13 percent less, which means almost $500,000 less in tax. I mean, are we missing something? Because on its face I would say this chart alone would say this is just not going to pass.

Dr. RABUSHKA. Let me say that I think you are reading from the 1983 book, and I would be happy to leave with you the 1995 book, because the table that I have from the new book is——

Senator BRADLEY. You corrected that?

Dr. RABUSHKA. No, no, no. Let me explain to you exactly what happened. Actually, I wanted to put that in the context of the answer you did not let me give a moment ago. That is, how do you explain this stuff? Well, chapter five of the book has 66 questions that Bob Hall and I have heard on most occasions we have ever spoken—we estimate about 1,000 times between us—and they fall under the categories of deduction for charity and interest, for housing, for intergovernment relations, for MUNI bonds, for treatment of wage income, for all the associated current aspects of that, for treatment of business income, for nonprofit institutions, for inheritances, for transitions, for unused depreciation, for home owners, and the like.

And what we tried to do was give a 1–3 paragraph answer with a maximum one-minute time, and I would have subtitled this chapter: "A Press Kit and a Politician's Tool Guide to Understanding, Explaining, Agreeing, or Disagreeing With the Flat Tax." And I do want to assure you, every single question that has been raised here is in those 66 questions and answers.

Now, I want to get to exactly the one you raised. Since 1983, the economy has grown. What we did is, we kept the expensing provision intact, which means you subtract from the tax base the full capital consumption allowances. By doing that, we get to a base of consumption through the vehicle of what appears to be an income tax. Then what we did was to leave the rate at 19 percent—we liked that number—and we plowed every penny of economic growth since 1983 into higher allowances.

So, originally, if you added up the family allowances that we had in 1981–1983 when we originally proposed the plan then revenue neutral, and we stay revenue neutral but we take the extra growth, we get much, much, much larger allowances, and so the distribution improves dramatically on the bottom, meshes out a little better in the middle, still does not look good on the top, but, as I indicated, in the top it matters a whole lot where you get your income from.

Senator BRADLEY. Right. So you are saying that this chart in 1983 was right and that is what the distribution was when you published the book in 1983.

Dr. RABUSHKA. That was a best pass with all of the assumptions associated with problems, associated with——

Senator BRADLEY. Right. Right. I am just trying to get the facts. Applied to the economy in 1983, this distribution chart that essentially increased taxes on anybody under $100,000 and dramatically cut taxes over $100,000 was what the Hall-Rabushka flat tax produced.

Now, you confronted this and said, as I just suggested, this does not look like it is going to sell, and you made some changes in your proposal. What changes did you make to make it less regressive, less a give-away to people who make more than $1 million a year; what did you do?

Dr. RABUSHKA. Well, we did not change the structure of the proposal in any way. I want to be clear about that. We could have, for example, kept lower allowances and dropped the rate to 17 percent.

Senator BRADLEY. All right. Just tell me what you did.

Dr. RABUSHKA. Well, as I said, the only thing we did, is we went back to the National Income and Product Accounts and we simply took the economic growth that occurred in the 1980's and early 1990's, and we asked, if that growth were apportioned out in the form of additional personal allowances—that is, in current terms, the equivalent of increasing the standard deduction on the personal exemption—and we made that then the basis of the wage form, what you would have is exactly the identical tax proposal, but it turns out that you would have a larger personal allowance than you had when we had a smaller economy.

The CHAIRMAN. Well, then let me ask this. I see where Bill is going with it.

Therefore, it becomes slightly less regressive because you have higher personal allowances, and, therefore, if somebody was in the $70,000 bracket and paid more taxes they might now pay less taxes just because of a higher personal deduction.

Dr. RABUSHKA. Correct.

The CHAIRMAN. It does not solve the problem, does it, of the millionaire. The millionaire is probably still going to pay less taxes. I understand.

Dr. RABUSHKA. Correct. That is correct.

The CHAIRMAN. If he had an absolute plethora of loopholes——

Dr. RABUSHKA. Correct.

The CHAIRMAN [continuing]. And is paying on his $1 million of income $20,000 in taxes, his taxes are going to go up.

Dr. RABUSHKA. Correct.

The CHAIRMAN. All right.

Dr. RABUSHKA. Correct. Correct.

The CHAIRMAN. But, to the extent that your taxable income is $500,000, $600,000, from whatever source derived, it is finally your taxable income, your taxes are probably still going down.

Dr. RABUSHKA. Well, what I would say is, the incentives are now correct and people are rewarded for the economic activity that makes them more productive.

Senator BRADLEY. I mean, any time you are the author of a book you can write the plot any way you want and have it turn out any way you want. [Laughter.]

The fact is, here is 1983 to—when was this published?

Dr. RABUSHKA. 1995.

Senator BRADLEY. 1995. All right.

And you are saying, all of the economic growth of that period you took and stuffed into the lower and middle class. Yet, if we know anything about the period of 1983 to 1995, it is that the benefit of that growth was disproportionately shoved to the highest income levels. I mean, study after study will show that. So, I mean, this is contrary to the reality. The reality is, economic growth went up, not down.

The CHAIRMAN. Yes. But that is two different things, is it not?

Dr. RABUSHKA. Yes. They are not talking about what we have done by way of redefining the personal allowances, and what you are describing is happening to the economy.

Senator BRADLEY. Did you raise the income level for the personal allowances from 1983 to 1995?

Dr. RABUSHKA. Yes.

Senator BRADLEY. So that is a change.

Dr. RABUSHKA. No, no. I understand it is a change in a plan.

Senator BRADLEY. Right.

Dr. RABUSHKA. It was not the change in the economy.

The CHAIRMAN. What do you mean, Bill, did they raise the income levels?

Senator BRADLEY. Well, in 1983 you had a family allowance, or whatever, right?

Dr. RABUSHKA. Right.

Senator BRADLEY. That kicked in up to a certain income level, right?

Dr. RABUSHKA. Well, it was much lower, and I do not remember the exact number. But what happened was——

Senator BRADLEY. All right. So my point is, what you did was, you raised the family allowance to a higher income level.

Dr. RABUSHKA. Correct.

Senator BRADLEY. So that is how you changed it. That is all I was trying to find out——

Dr. RABUSHKA. Oh. I am sorry. All right.

Senator BRADLEY [continuing]. Was how have you changed your plan.

Dr. RABUSHKA. Well, what I indicated was, we increased the personal allowances which is the counterpart to today's exemption in the standard deduction.

The CHAIRMAN. That, I think, is a legitimate change.

Senator BRADLEY. Yes. That is the answer. I am sorry I did not make myself clear.

Dr. RABUSHKA. I thought I said that.

The CHAIRMAN. You need to produce $500 billion of revenue. As the economy grows, you can do two things. You can lower the rate——

Dr. RABUSHKA. Correct.

The CHAIRMAN [continuing]. Or you can keep the rate where it is, and, to the extent the rate now produces more money than $500 billion, you can increase the allowances and make it come out at $500 billion.

Dr. RABUSHKA. We chose the latter.

The CHAIRMAN. I understand that. But it does not quite solve the upper, upper problem of those who do not have everything sheltered.

Senator BRADLEY. Right.

The CHAIRMAN. They are going to pay more.

Senator BRADLEY. Right.

Dr. KOTLIKOFF. Well, not if you take into account their capital loss. If you are a millionaire and you lose 20 percent of your wealth the day this thing is passed, that is, in effect, a $200,000 tax.

The CHAIRMAN. It is a $200,000 wealth loss, which you may or may not suffer.

Dr. KOTLIKOFF. It is hard to see how you cannot suffer this.

The CHAIRMAN. Well, you can now buy $300,000 yacht rather than a $500,000 yacht. I understand that loss, because you do not have as much money, you do not have as much wealth anymore as you used to have.

Dr. KOTLIKOFF. Right. The consumption of accumulated wealth will be taxed again under a flat tax unless there are transition rules that would allow you to exempt previously taxed wealth.

Senator BRADLEY. Well, those are Tax Code details. We will leave it to them.

Mr. GRAETZ. You have also compensated for this wealth loss by eliminating the tax on future capital income.

Dr. KOTLIKOFF. No, you have not. You have not compensated at all, Michael. That is quite wrong. There is going to be a one-time wealth levy on all existing capital. Any economic analysis you look at, it does not really depend on the model, is going to show this. This is just an issue of arbitrage.

Mr. GRAETZ. The point is, whether the person is better off or worse off is the question.

Dr. POLLACK. If they cannot agree and they are both proponents, it is hard for you to predict.

Mr. GRAETZ. He may have less wealth, but he is able to accumulate that wealth much faster in the future because there is no tax on the capital growth of that wealth.

The CHAIRMAN. Let me ask you all a question then. Bill, who is the godfather of the 1986 Tax Reform bill, had three rates. This was sort of to take care of progressivity. What is the terrible harm on a flat tax of having three rates?

It is the same base that you have got, you simply say, all right, in order to take care of the progressivity—Dr. Kotlikoff, I know your wealth argument; I am trying to solve the problem we have of these tables—I realize the zero rates, that nobody pays if they have the deductions up to a certain amount, 15 percent, 20 percent,

and 25 percent on certain levels of income. It adds a modest complication.

Dr. POLLACK. Senator, we really started off, in the 1913 income tax, with a flat rate, and then was added a surcharge.

The CHAIRMAN. Yes, that is correct, during the war.

Dr. POLLACK. If you look back, and I have been looking historically at the explanations in the floor debates for the great increases in the progressivity of the income tax, it is all attributable to war measures.

By 1918, the War Revenue Act of 1918 increased a 65 percent surcharge that pushed the top rate, with the regular rate, up to 77, and we went up to 92 percent during World War II. So what we are, in a historical context, really struggling with, is how to bring down the rates from their war-time highs.

I think Senator Bradley's efforts in 1986 was a compromise. It had to be seen as an effort to flatten the tax and do some broadening of the base, and it made sense within the context of revenue neutrality. Here we are moving into uncharted waters, scrapping the entire system, adopting integrated systems, as well as a different tax base altogether.

And, if the proponents cannot even agree as to the economic consequences, and they are much more versed in the economics analysis than we are—I am only a tax lawyer who has to apply these laws with my clients or explain them to my students—if we cannot even understand the transition, I think it just suggests that, perhaps, it is too radical a change.

Dr. KOTLIKOFF. Let me just respond to the issue of two rates, or more than two rates. One concern is, people sheltering money between their business and the individual levels, and a flat tax eliminates that game playing, which is something to be said for it.

Another concern has to do with the size of effective marginal tax rates. There are very few American households, including welfare recipients, who are not in effective marginal tax brackets of 50 percent or above. Think about a welfare recipient. If they earn a dollar, they are probably going to lose a dollar or so in benefits, even after the Earned Income Tax Credit.

The economic distortion associated with very high marginal effective tax rates rises with the square of the tax rate. It is a non-linear relationship. In getting tax rates down, as you were trying to achieve, Senator Bradley, in the mid-1980's, you were really helping to reduce this economic distortion significantly.

I am certainly for progressivity. But I think that the flat tax is going to be a lot more progressive than is commonly believed because of its implicit taxation of wealth. I am just trying to get across that point, but we have to think about the costs of that, and the cost has to do with economic inefficiency.

Dr. RABUSHKA. May I respond briefly to that? Two rates have a half-life of 2 years. We just saw that. In 1986 we had two rates, then we had three rates, now we have five rates. And anybody who believes the two- or three-rate system will remain more than 2 years again will have forgotten history. In fact, the United States is replete with flat rates on sales taxes, Social Security taxes, licenses, property, ad valorem, and the like, and they are much more durable.

The CHAIRMAN. You think, maybe justifiably, that danger will not happen with a flat rate because you have to raise it on everybody?

Dr. RABUSHKA. Exactly the point. The second feature of the flat rate is administrative simplicity. Part of the problem with taxing business at one level and people at two or three levels is, you have to match the returns. You have to make sure the business income at one rate, in fact, ends up correctly allocated to people at the multiple rates.

You are going to get shifting between business and individuals, you are also going to get deductions at high levels and taxation of income at lower levels, and you are going to get a lot of the leakage in the current system.

So I think what has happened is, if you go to two or three rates, what you find is, all that complexity everybody does not like—which I think is partly responsible for the attractiveness of tax simplification—creeps back in very, very rapidly.

So, there are more than just economic reasons to a low flat rate, there are administrative reasons. The elegance of a tax system is directly proportional to the fact that you have one rate. Complexity rises at the square cube, the fourth power, of two or more rates.

Mr. GRAETZ. Mr. Chairman, could I just add two quick sentences to this? First, if the base is wages, progressive rates do not solve this distributional problem that you are worried about, which turns on the individual tax base. I mean, they do not solve it with respect to capital income, they solve it only with respect to people who have a lot of wages.

If you want to tax consumption at a progressive rate, you have to move in the direction of the Nunn-Domenici kind of proposal, which has a lot of complexity in it. I will not go into that.

Senator BRADLEY. You mean, more complexity than we have had this morning? [Laughter.]

Mr. GRAETZ. I believe it is more complicated.

The CHAIRMAN. I will say, Nunn-Domenici, I like the concept. It is not a simple tax, it is a complicated tax.

Let me conclude, because both Bill and I have to run. For what it is worth, I sat through, within the last month, a focus group on the subject of the flat tax, about 20 people, particularly selected with incomes of $30,000 to $70,000. We excluded below that on the assumption that most people under $30,000 were not going to pay any taxes anyway, in terms of one form or another of the deductions.

I was intrigued with the fact that they thought the flat tax was progressive. If you make $1 million—and they were using 19 percent as a figure—you pay $190,000; you make $100,000, you pay $19,000. Therefore, the rich person paid more than the poor person and it struck them as fair. They were not arguing for higher progressive rates, which was interesting considering the income brackets they were in.

Fellows, we have got to stop. Thank you very, very much for spending this much time with us.

[The prepared statement of Dr. Rabushka appears in the appendix.]

[Whereupon, at 12:07 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF CONGRESSMAN DICK ARMEY

[APRIL 5, 1995]

Mr. Chairman and Members of the Committee, thank you for this opportunity to discuss the issue of tax reform. As we complete our work on the Contract with America this week, it is a good time to begin looking beyond the first hundred days to the even more exciting and sweeping changes that lie ahead.

I believe the flat tax is in America's future. It is an idea that is catching fire. My office is piled high with supportive letters and postcards with exclamations like "Wow!" "Hallelujah!" and "It's about time." What is it about the flat tax that people find so exciting? I think the answer can be summarized in three words: trust, freedom, and fairness. The flat tax trusts ordinary Americans to arrange their own economic affairs. It expands their personal freedom. And it is fair. It treats everyone the same. But my purpose today is not to make the populist case for the flat tax. My purpose is to make the economic case for the flat tax.

WHY A FLAT TAX?

Before I explain the virtues of the flat tax, allow me to explain why we need tax reform at all. Simply put, we need tax reform because today's tax code is artificially and unnecessarily suppressing American living standards.

The first problem with today's code is also the worst feature: the discriminatory treatment of savings. Consider how the present tax code treats saving and investment. Today, we double tax business earnings, which places a strong bias against saving and investment. For example, we tax business earnings through the corporate income tax and then tax dividends—which are, in fact, after-tax payments. This double taxation of the same stream of income creates a strong bias against saving and investing. Obviously, this makes saving and investing much less attractive relative to consumption. And the nation is poorer as a result.

Mr. Chairman, capital is the lifeblood of an economy. Without capital, workers cannot enhance their productivity and their wages stagnate. Today's double and even triple taxation of income discourages savings, reduces the pool of capital available to entrepreneurs and workers, slows productivity and wage growth, lowers living standards, and, as a side effect, reduces revenue to the Treasury. I believe we must fix this counterproductive policy. As I shall explain momentarily, my flat tax is designed to do just that.

A second problem with today's tax code is its high marginal rates. Any professional economist will tell you that as marginal tax rates rise, people tend to work less. The higher the marginal rate, the lower the work effort. Where only the very wealthy faced high marginal tax rates few decades ago, today millions of Americans do. According to IRS data, in 1965, fewer than three percent of families filing joint returns faced a federal marginal tax rate of 28 percent or more. In 1991, 36 percent of families—more than ten times as many—filing joint returns faced these high marginal rates. With state and local income taxes included, millions of middle class Americans confront a combined marginal tax rate of 48 percent.

Naturally, many Americans ask themselves why they should work longer hours when government is going to take away half of their earnings. A study by Robert Genetski has found that high marginal tax rates are inversely related to productivity growth, which is to say, workers and entrepreneurs spend less time trying to build the proverbial "better mousetrap" when the government is going to take most of the rewards for doing so anyway. The net result, again, is a poorer nation.

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The third major problem with today's tax code is its maddening complexity and unfairness. After seven decades of amendments, revisions, exceptions, loopholes, extenders, and the occasional overhaul, today's code is, frankly, a wasteful, complicated mess. The tax code contains hundreds of sections and thousands of pages of regulations. The Internal Revenue Service sends out eight billion pages of forms and instructions every year, which if you laid them end to end, would stretch 28 times the circumference of the earth.

The code is so complicated, even IRS agents cannot give accurate advice on it. Rates are high, loopholes abound, and noncompliance is rife because taxpayers feel the code is written not for them, but for well-organized special interests. And perhaps most disturbing, the complexity and unfairness of the code lead people to take an excessively jaded and cynical view of their government.

Fourth, I believe the overall level of taxes is too high, especially on families with children. The average family now pays more in taxes than it spends on food, clothing and shelter combined.

In sum, today's tax code is complicated, frustrating, and economically counterproductive. It is lowering our standard of living, and that is why it must be replaced. The question is, what do we replace it with?

HOW WILL THE ARMEY FLAT TAX WORK?

My plan, which is based on a 1981 proposal by Hoover Institution fellows Robert Hall and Alvin Rabushka, would scrap the existing tax code entirely. Instead, *all income would be taxed once and only once at the single low rate of 17 percent.* To minimize revenue loss, the rate would initially be set at 20 percent, then drop to 17 percent in year three. Income is defined as the total of wages, salary, and pensions. There would be no credits or deductions, although each taxpayer would receive a generous family allowance. Beginning in year three of the plan, this allowance, which is indexed for inflation, would be $13,100 for an individual, $26,200 for a married couple, and $5,300 for each child. A family of four would have to earn $36,800 before it owed a penny of federal income tax.

Business income would be handled with equal simplicity. A corporation would simply subtract expenses from revenues and pay 17 percent rate on the remainder. Revenues are defined as corporate, partnership, professional, farm, and rental income. The base is gross revenue less purchases of goods and services, capital equipment, structures, land, and wage and pension contributions to employees.

VIRTUE NO. 1—SIMPLICITY

One low rate for all income, no targeted tax breaks—this is as simple as an income-tax gets. No longer will Americans spend anything like 5.4 billion man-hours figuring their taxes each year, which is more man-hours than it takes to produce every car, van, and truck built in the United States. No longer will the IRS have to send out 480 tax forms and another 280 forms which explain how to fill out the 480 forms.

All income taxes could be filed on just two forms; one for wage income and another for business income. Most taxpayers, those with just wage income, will be able to pay their taxes on a simple, ten-line form the size of a postcard, a sample of which I have appended to this statement. Taxpayers with business income would need only file a second ten line postcard.

VIRTUE NO. 2—FAIRNESS

The Armey flat tax is also fair, because everyone pays the same rate, with no special breaks going to politically favored groups. The plan I have proposed is true to the idea of fairness we all learned in grade school: Everyone should be treated the same.

At the same time, it is progressive, thanks to the generous family allowance. The plan is progressive because the family allowance is worth more, the less you make. For example, a family making $36,000 would pay zero percent of its income in income tax, a family making $50,000 would pay 5 percent of its income, and a family making $200,000 would pay 14 percent of its income. I estimate the plan takes about ten million low-income taxpayers off the rolls entirely. This is the definition of progressive.

Additionally, the bill broadens the tax base by closing loopholes and capturing business income which escapes taxation today. The base broadening measures will collect revenue primarily from those at the upper end of the income spectrum. I might add that if experience is any guide, the richest Americans will likely end up paying more taxes when the rates come down, which is exactly what happened after

the Coolidge tax cuts of the 1920s, the Kennedy tax cuts of the 1960s, and the Reagan tax cuts of the 1980s.

VIRTUE NO. 3—DEFICIT NEUTRALITY

I have drafted my legislation to produce no net increase in the deficit. Although the rate and family allowance levels are set so as to give Americans a tax cut, the bill pays for these revenue losses with comprehensive spending reforms. As I mentioned earlier, however, the rate is set at 20 percent in the first year, and then drops to 17 percent only in year three, when the windfall revenue produced by spending cuts and economic growth will make it possible to lower the rate.

Let me be clear about one thing. I would like my bill to be debated on its merits, not on the issue of revenue loss. If the Joint Committee on Taxation predicts a greater revenue loss than my figures indicate, the legislation can simply be adjusted by raising the rate, trimming back the family allowance, adding further spending reforms as offsets, or some combination of these. The revenue-loss argument is a red herring.

VIRTUE NO. 4—ECONOMIC GROWTH

The flat tax would produce a higher economic growth rate and raise living standards. It would liberate the economy to be more efficient, replacing today's maze of politically targeted tax breaks with a system that is perfectly neutral as between types and sizes of business, between economic sectors, and between types of investment. Resources would be allowed to seek out their most efficient use.

In other words, the flat tax would relieve the economy from what economists call "dead weight" or social welfare loss. According to James L. Payne, just the compliance costs of today's tax code add up to $232 billion. When other costs of the current system—such as tax distortions which shift resources away from their most efficient use, thus lowering output—are included, the cost to the economy is well into the hundreds of billions of dollars. These costs are pure waste and directly lower the standard of living of the American people. The flat tax would eliminate the vast majority of these costs and dramatically improve the performance of the economy.

The flat tax would also lower the burden currently placed on work, savings, and investment. It rewards work by lowering the top marginal income-tax rate from 40 percent to 17 percent. It rewards saving by ending the current double taxation of savings, sweeping away the estate tax, the capital gains tax, and the tax on interest and dividends. And it rewards investment by permitting businesses to immediately deduct all expenses, plant, and equipment. Thus, the flat tax would produce higher productivity and economic growth, leading to higher employment and wages.

VIRTUE NO. 5— VISIBILITY

By ending the discriminatory treatment of savings, the flat tax functions as a kind of consumption tax, much favored by economists. In this sense, the Domenici-Nunn proposal for a consumed income tax and my flat tax are trying to accomplish the same thing. They are blood brothers in spirit. This goal would be achieved, as well, by my colleague Bill Archer's proposed national retail sales tax, or even a European-style value-added tax. All of these plans can lay claim to the title of "consumption tax." So the question becomes, which plan is best? Naturally, I favor the flat tax. Allow me to explain why.

First, the flat tax is much more visible than either a retail sales tax or a value-added tax, both of which have justifiably been dubbed "stealth" taxes because they are more or less hidden in the price of goods and services. A VAT is especially insidious because it is built into the price of goods and services, making it virtually invisible to the final consumer.

The flat tax, on the other hand, is highly visible. It permits taxpayers to see right on their tax form clearly how much they're paying for the costs of government. In Europe, where VATs are the norm, citizens have no clear idea of how much they pay for government. In fact, Europeans are notorious for greatly under-estimating their actual tax payments, because they never see the bill. While a retail sales tax is more visible than a VAT—you can see it on your register tape—it has a tendency to evolve into a VAT. This is what has happened in Europe. Compliance problems and other considerations have caused governments slowly but surely to transform their sales taxes into VAT. The same thing would likely happen here.

On the visibility issue, the consumed income tax is much superior to either a retail sales tax or a VAT. I am concerned that a consumed income tax retains the complexity and high marginal rates of the current system.

VIRTUE NO. 6—HIGHER COMPLIANCE

The final virtue of the plan is that it would lead to higher compliance with our tax laws. This may strike some as an odd statement, since the plan eliminates income-tax withholding. Employers would no longer be required to take federal taxes out of their employee's paychecks. Instead, we would all have to sit down and right out a check to the federal government once a month, just as we do with all of our other bills.

I regard income withholding as the crucial, deceptive tool that has made today's oversized government possible. If America had not accepted withholding as a "temporary" wartime measure in 1943, and if taxpayers had continued paying their taxes the same way they've always made rent or car payments, the government could never have grown as large as it has. Only by taking people's money before they ever see it has the government been able to raise taxes to their current high level without sparking a revolt.

The question arises: Would people still pay their taxes? I am confident they would because the Armey flat tax eliminates the three primary excuses for noncompliance. These are, first, the current system's maddening complexity; second, the low likelihood of getting caught; and third, the feeling that today's system is somehow rigged to favor special interests "at my expense"—which, for the most part, it is. Stripped of these rationales for noncompliance, the great majority of taxpayers will find it much easier to pay their taxes, and much harder to elude detection were they to cheat. The underground economy will actually shrink. After all, if you give the American people a tax system that is honest, direct, simple, low, and fair—something they have not had in decades—does it not stand to reason they would be more inclined to pay their fair share?

CONCLUSION

Mr. Chairman, America's current tax code is broken and must be replaced. I assume you agree that any new tax system must meet the tests of fairness, simplicity, visibility, economic neutrality, deficit neutrality, and low marginal rates. I am proud to say that the Armey flat tax plan meets each of these criteria. It would raise revenue efficiently. It would give Americans an honest bill for their share of the cost of government. It would shrink the underground economy. It would expand economic growth and increase wages. And it is neutral—it would treat everyone the same.

To quote one of those thousands of letters I've received over the past eight months, from a gentleman named "Al" in San Jose, California: "If this proposal can be enacted, it will do much to restore faith and confidence in our government."

For all of these reasons, Mr. Chairman, I hope you will give the flat tax the close and thoughtful examination this increasingly popular idea deserves.

Form 1 DICK ARMEY FLAT TAX FORM 1997

Your first name and initial	Last name	Your social security number
Present home address		Spouse's social security number
City, Town or Post Office Box, State and ZIP code		Your occupation
		Spouse's occupation

	Line	Amount
1. Wages, Salary, and Pensions	1	
2. Personal Allowance		
a. $26,200 for married filing jointly	2(a)	
b. $13,100 for single	2(b)	
c. $17,200 for single head of household	2(c)	
3 Number of dependants, not including spouse	3	
4 Personal allowances for dependants(line 3 multiplied by $5300).	4	
5. Total personal allowances (line 2 plus line 4)	5	
6. Taxable wages (line 1 less line 5, if positive, otherwise zero)	6	
7. Tax (17% of line 6)	7	
8. Tax already paid	8	
9. Tax due (line 7 less line 8, if positive)	9	
10. Refund due (line 8 less line 7, if positive)	10	

PREPARED STATEMENT OF CONGRESSMAN DICK ARMEY

[MAY 18, 1995]

Mr. Chairman and Members of the Committee:

I want to begin by expressing my deep appreciation to you Mr. Chairman for holding this hearing today on the flat tax. Unfortunately, I was not able to attend the hearing on April 5th because we in the House were completing our work on our contract with America.

While the flat tax has struck a responsive chord in America because of its inherent fairness, I also believe that the American people appreciate the fact that a flat tax would improve the incentives to work, save, and invest, and raise living standards. I want to focus my comments today on the powerful growth effects of the flat tax.

As I'm sure Members of the Committee are well aware, wage growth in the past 25 years has slowed to half the rate of the preceding 25 years. The purpose of any economic policy should be to promote wage growth, but unfortunately, the current tax system is failing us. Before I discuss how my flat tax would reverse this discouraging trend of slow wage growth, I want to outline the shortcomings of today's burdensome, complex tax code.

CURRENT SYSTEM REDUCES WAGES

Let's begin with the sheer waste associated with unnecessary compliance costs due to the complexity of the income tax. The compliance burden of our complex tax code is truly mind boggling. Americans spend 5.4 billion man hours figuring out the tax law. That is the equivalent of nearly three million people working full time, year round. The Internal Revenue Service sends out eight billion pages of forms and instructions every year, which if you laid them end to end, would stretch 28 times the circumference of the earth. Just the compliance cost of today's tax code adds up to $232 billion, according to James L. Payne,

The code is complex because of the endless credits, deductions, and loopholes designed to grant special preferences. These biases throughout the tax code distort economic decisions and divert resources from their most productive use, thus placing a heavy toll on economic output, wages and living standards.

The code is so complicated that even IRS agents cannot give accurate advice on it. Rates are high, loopholes abound, and noncompliance is rife because taxpayers

feel the code is written not for them, but for well-organized special interests. And perhaps most disturbing, the complexity and unfairness of the code lead people to take an excessively jaded and cynical view of their government.

But the current tax code does much more than impose staggering compliance costs and efficiency losses. Perhaps the worst feature of today's code is the discriminatory treatment of savings. Consider how the present tax code treats saving and investment. Today, we double tax business earnings, which places a strong bias against saving and investment. For example, we tax business earnings through the corporate income tax and then we tax dividends—which are, in fact, after-tax payments. This double taxation of the same stream of income makes saving and investing much less attractive relative to consumption. And the nation is poorer as a result.

Mr. Chairman, capital is the lifeblood of an economy. Without capital, workers cannot enhance their productivity and their wages stagnate. Today's double and even triple taxation of income discourages saving, reduces the pool of capital available to entrepreneurs and workers, slows productivity and wage growth, lowers living standards, and, as a side effect, reduces revenue to the Treasury. I believe we must fix this counterproductive policy. As I shall explain momentarily, my flat tax is designed to do just that.

Another problem with today's tax code is its high marginal rates. Any professional economist will tell you that as marginal tax rates rise, people tend to work less. The higher the marginal rate, the lower the work effort. Where only the very wealthy faced high marginal tax rates a few decades ago, today millions of Americans do. According to IRS data, in 1965, fewer than three percent of families filing joint returns faced a federal marginal tax rate of 28 percent or more. In 1991, 36 percent of families—more than ten times as many—filing joint returns faced these high marginal rates. With state and local income taxes included, millions of middle class Americans confront a combined marginal tax rate of 48 percent.

Naturally, many Americans ask themselves why they should work longer hours when the government is going to take away half of their earnings. A study by Robert Genetski has found that high marginal tax rates are inversely related to productivity growth, which is to say, workers and entrepreneurs spend less time trying to build the proverbial "better mousetrap" when the government is going to take most of the rewards for doing so anyway. The net result, again, is a poorer nation.

While not a tax issue, I would be remiss if I did not also mention that the growth of federal regulations has also played a very important role in slowing labor productivity and wage growth—a fact which is often overlooked. The geometric growth in federal red tape has reduced the return to investment, diverted resources from their most efficient use, raised the cost of labor, and sapped entrepreneurial energy. Federal regulations have had a particularly adverse effect on wage growth for two reasons. Higher payroll taxes and government mandates such as family leave directly raise the cost of labor and thus lower wages. Other regulations, such as environmental mandates, have indirectly lowered wages by diverting resources away from investment which would raise the productivity of labor.

HOW WILL THE ARMEY FLAT TAX WORK?

My plan, which is based on a 1981 proposal by Hoover Institution fellows Robert Hall and Alvin Rabushka would scrap the existing tax code entirely. Instead, all income would be taxed once and only once at the single low rate of 17 percent. To minimize revenue loss, the rate would initially be set at 20 percent, then drop to 17 percent in year three. Income is defined as the total of wages, salary, and pensions. There would be no credits or deductions, although each taxpayer would receive a generous family allowance. Beginning in year three of the plan, this allowance, which is indexed for inflation, would be $13,100 for an individual, $26,200 for a married couple, and $5,300 for each child. A family of four would have to earn $36,800 before it owed a penny of federal income tax.

Business income would be handled with equal simplicity. A corporation would simply subtract expenses from revenues and pay 17 percent on the remainder. Revenues are defined as corporate, partnership, professional, farm, and rental income. The base is gross revenue less purchases of goods and services, capital equipment, structures, land, and wage and pension contributions to employees.

FLAT TAX PROMOTES ECONOMIC GROWTH

The flat tax would produce a higher economic growth rate and raise living standards. It would liberate the economy to be more efficient, replacing today's maze of politically targeted tax breaks with a system that is perfectly neutral as between

types and sizes of business, between economic sectors, and between types of investment. Resources would be allowed to seek out their most efficient use.

In other words, the flat tax would relieve the economy from what economists call "dead weight" or social welfare loss. As I noted earlier, just the compliance costs of today's tax code add up to $232 billion—or about $900 for every American. When other costs of the current system—such as tax distortions which shift resources away from their most efficient use, thus lowering output—are included, the cost to the economy is well into the hundreds of billions of dollars. These costs are pure waste and directly lower the standard of living of the American people. The flat tax would eliminate the vast majority of these costs and dramatically improve the performance of the economy.

The flat tax would also lower the burden currently placed on work, savings, and investment. It rewards work by lowering the top marginal income-tax rate from 40 percent to 17 percent. It rewards saving by ending the current taxation of savings, sweeping away the estate tax, the capital gains tax, and the double tax on interest and dividends. And it rewards investment by permitting businesses to immediately deduct all expenses, plant, and equipment. Thus, the flat tax would produce higher productivity and economic growth, leading to higher employment and wages.

WHAT THE ECONOMISTS SAY

Professor Dale Jorgenson estimates that the loss in efficiency imposed on the economy by the current tax system equals 18 percent of government revenue. As he puts it, "Each dollar of tax revenue costs the private sector a dollar in foregone investment or consumption and an additional loss in growth opportunities of eighteen cents." In other words, the distortions in the current income tax code cost the American economy $242 billion in lost output. If we replaced the current system with a nondistortive one, that alone would be the equivalent of writing every American a check for nearly $1,000 every year.

By taxing all income only once, the neutral treatment of savings would create a powerful new incentive to save and invest. Professors Alan Auerbach and Larry Kotlikoff estimate that just ending the double taxation of savings would increase the growth rate in the economy by nearly a percentage point. While that may seem trivial, a one percentage point increase in economic growth would add $65 billion to the national output this year.

By lowering marginal tax rates, the bill would unleash the creative energies of America's entrepreneurs and workers. After reviewing the economic literature, Hoover fellows Hall and Rabushka estimate in their book, The Flat Tax, that work effort would increase four percent. I believe Professor Kotlikoff, who will appear later today with Professor Rabushka, has a similar estimate. That translates into a 3 percent increase in output or nearly $750 in additional income for each American.

When adding the effects of more work effort, a higher capital stock, and improved incentives for entrepreneurial effort, Professors Hall and Rabushka estimate that a flat tax would increase per capita income by $1,900 by the year 2002. In other words, a typical family of four in America would see its income increase $7,600 more than if we preserve the tax system we have today. Let me emphasize that while this is a truly astonishing number, it is based on the consensus of the economic literature and is a mainstream estimate. Many studies suggest the number would be even higher.

AMERICANS WANT THE FLAT TAX

For those who are suspicious of economic models and the figures which economists generate from them, let me share an observation. Last year when campaigning for the candidates who would be come the new Republican majority, I stopped in Washington State. At one of the events there, the speaker related how several small businessmen and women had decided, because of high taxes and burdensome regulations, to let all of their employees go. I have heard similar stories from people who decided against starting a business at all because of high, complex taxes and red tape. I've heard countless other examples of small businessmen, often a husband and wife team, that refuse to expand their business and hire employees because of the hassle associated with it.

While we debate national economic policy based on GDP data and employment statistics, we often times overlook the fact that these statistics fail to account for the businesses not started and the jobs not created. The decisions people make not to start a business or not to hire employees will never show up in any Commerce or Labor Department data, but the economic loss is very real, nevertheless. Cumulatively they represent a national tragedy. The loss is millions of jobs never created,

thousands of new businesses never initiated, billions in output never generated. And, incidentally, billions in taxes never sent to Washington.

Since introducing the flat tax, I have received thousands of letters from average Americans from across the entire nation. Many of these people explain in their letters how difficult the government makes it for them to run their businesses and make a living. Let me give you just two examples.

James and Nancy of Carabelle, Florida write, "Because of government regulations, and complicated laws regarding employees, withholding, payroll, etc., we have continuously avoided hiring people in favor of keeping small and simple. I know a lot of intelligent people who feel and do likewise. It's a shame that our laws/lawmakers continue to pile-it-on business, killing the entrepreneurial spirit within so many of us. We strongly support the Dick Armey flat tax proposal and all of its features. Let's make an indelible mark on the future of this country!"

Then there is John from Evergreen, Colorado. He writes, "I once started with $1,500, a second-had kitchen table, and a donated typewriter and—in ten years—built a $20,000,000 a-year-business. But I walked away from all that about 14 years ago . . . too many taxes, too many rules and regulations, too many bureaucrats. Get your plan passed intact and hundreds of thousands of people like me will come out of the woodwork and create a prosperity that the world only sees now in some Asian countries!"

The flat tax plan I have proposed, together with the spending restraint and regulatory relief included in my bill, will free the economy and encourage the American people to work hard, save, invest, create jobs and grow the economy. The flat tax would tap the latent entrepreneurial energy and talent that is now smothered by the invisible foot of government.

PREPARED STATEMENT OF ALAN J. AUERBACH

Mr. Chairman and Members of the Committee: I am pleased to appear today to discuss "flat" taxes, a particular class of tax systems that many in Congress support as an alternative to the current federal income tax. My purpose is not to argue either for or against such a tax reform, but rather to comment on several of the issues, including those identified in your letter of invitation, that should be considered in any serious debate about the merits of flat taxes. Because flat taxes are a relatively new concept, I will begin by discussing what they are and how they are imposed. I will then turn to an analysis of their effects on economic growth and welfare, and the options available when considering their adoption. My conclusions are the following:

1. As typically conceived, the flat tax is equivalent to a consumption-based national sales or value-added tax that is rebated below a tax-paying threshold. This equivalence is sometimes obscured by differences in the method of tax collection, such as whether taxes are remitted by businesses or individuals. These differences are superficial, however, and do not alter the effects of the flat tax on progressivity, incentives or the price level, and should be given little weight in evaluating the tax's merits.
2. As consumption taxes, flat taxes encourage private saving and investment by exempting capital income from tax. However, the full effect of the flat tax on national saving depends on several factors, including the magnitude of windfalls during transition and the extent to which government revenues change. It is impossible to say whether adoption of a flat tax will increase national saving without considering its provisions in detail.
3. Although flat taxes may be made progressive at low income levels, the restriction to a single marginal tax rate limits their progressivity at higher income levels. This problem may be addressed while preserving the basic flat tax structure by allowing the business and individual income components of the tax base to face different rates of tax and by introducing one or more additional tax brackets at the individual level.
4. A broad-based flat tax would be far less distortionary and much simpler than the present income tax. However, most of its benefits could be achieved through reforms of the current system, without the adoption of a single marginal tax rate or the switch to a consumption tax base.

WHAT ARE FLAT TAXES?

While flat tax proposals vary, all have certain key elements in common:

—a single marginal tax rate considerably below the top marginal rates of today's income tax;

—few deductions and exclusions from the tax base; and

—high exemption thresholds, below which individuals would not be subject to tax.

There are several advantages to this general approach. The low marginal tax rate reduces tax distortions, thereby encouraging labor supply and discouraging unproductive tax avoidance activities. The single marginal tax rate reduces the scope for avoidance through income shifting. The broad tax base, which makes the low rate feasible from a revenue standpoint, greatly simplifies tax filing and further reduces the tax system's interference in economic decisions by eliminating a range of tax expenditures present under the current income tax. The high exemption threshold makes the flat tax progressive, and further simplifies tax compliance by eliminating the need for a large segment of the population to file a tax return.

WHAT DO FLAT TAXES TAX?

Flat tax proposals typically are phrased in terms of taxes on "households" and "businesses," but these distinctions relate primarily to the method of tax collection, rather than the incentives and burdens that the taxes impose. All taxes ultimately are borne by individuals, as much as we might wish them to be borne by disembodied "businesses." Of primary importance in determining the economic effects of a tax is the base of that tax. Although it is usually left unclear in the proposals themselves, flat taxes are consumption taxes. That is, rather than having income as a tax base, they tax that portion of income that is not saved, i.e., consumption. There is nothing about the logic of flat taxes that requires this; just as easily, one could design a flat tax with an income base. However, one of the additional advantages to flat taxes is intended to be their elimination of the tax on saving present in the income tax.

As a consumption tax with a single marginal tax rate, the flat tax is, then, basically a value-added tax combined with a rebate for low-income households. It may differ from more traditional value-added taxes in the method of collection, but this is not of significance. For example, the Hall-Rabushka flat tax, which forms the basis of several current proposals, including those of Representative Armey and Senator Specter, would consist of two components, a business cash-flow tax and an individual wage income tax[1], with the two taxes imposed at the same rate. In combination, the business cash-flow tax and the individual wage tax would cover all domestic income less business investment. Except for the trivial distinction that the wage taxes are being remitted by individuals, rather than withheld by their employers, this is precisely a subtraction-method, origin-based value added tax. It is neither more nor less progressive than the traditional, European-style VAT, or a subtraction-method VAT (also known as a business transfer tax) because a portion of the taxes are remitted by individuals. It will have the same incentive effects as the VAT, and the same impact on the Consumer Price Index. Its most substantive difference from the destination-based VAT is that it does not tax imports or give a rebate for exports.

This last distinction, and others like it, involve the treatment of different forms of saving. A true consumption tax would provide a deduction for all forms of private saving. The origin- based VAT included in the Hall-Rabushka flat tax permits a deduction only for saving that takes the form of domestic business capital. A destination-based VAT effectively adds to this a deduction for U.S. capital investment abroad, while taxing income earned abroad.[2]

Some have suggested that its treatment of foreign trade and investment makes the destination-based VAT foster exports and competitiveness, but this argument is without economic foundation. Though investments abroad receive a deduction, the tax benefit of this deduction is equal in present value to the taxes that will be paid in the future on the cash flows that the investment generates. As a result, it is not particularly important whether foreign investments are made under an origin-based or destination-based value added-tax.[3] However, the differences in treatment do matter during the transition, because of investments made before the new tax scheme's adoption. For a country that is a net debtor, as the United States has be-

[1] The individual tax would also include certain non-wage income, such as pension benefits. However, it would exclude capital income.

[2] According to the economic identity relating the current and capital accounts, net foreign source income less net foreign investment equals imports minus exports. Thus, by taxing imports and rebating tax on exports, the destination-based VAT taxes net cash flow from abroad.

[3] The comparison is analogous to that between traditional individual retirement accounts, under which investors receive a deduction for invested funds and are taxed on withdrawals, and so-called "back-end" IRAs, under which investors receive no deduction for contributions but are not taxed on subsequent withdrawals. In each case, there is no net tax burden imposed on the investment.

come in recent years, an origin-based VAT will raise more revenue in the long run by denying a deduction for the future trade surpluses needed to service this debt.[4]

HOW BROAD SHOULD THE FLAT TAX BE?

As discussed, a broad tax base permits the flat tax to be imposed at a low rate, and lessens the distortions associated with selective tax expenditures. Some of these tax expenditures, such as saving incentives and capital gains exclusions, would disappear automatically with the shift to a tax base that excludes saving. However, a comprehensive consumption tax would include in its base two important items excluded by most flat tax proposals, the imputed rent on owner- occupied housing and purchases financed by government transfer payments. These exclusions narrow the tax base, requiring a higher tax rate.

In order to treat owner-occupied housing like other forms of investment, it would be necessary to provide a deduction for new housing construction, and to tax the imputed rent from new and existing housing. This is difficult to accomplish because of the problem of measuring each taxpayer's imputed rent. One simple alternative, adopted by the Hall-Rabushka plan, is simply to ignore housing altogether, offering no deduction for construction and no tax on imputed rent. This has the effect of taxing the imputed rental flows from new housing only. Excluding housing from the tax base has no net impact on tax revenues from new housing, because the relief from taxes on imputed rent is offset by the loss of the initial investment deduction; however, excluding existing dwellings, which would not qualify for an investment deduction, anyway, simply relieves the tax on all their future imputed rent.

In principle, one could recoup this lost revenue by imposing a one-time tax on the value of all existing homes. However, even if this extra levy is not imposed, the flat tax is broader in its treatment of housing than the present income tax, which does not tax any of the imputed rent on owner-occupied housing. Furthermore, by implicitly taxing the consumption of new housing, the flat tax would remove the present income tax distortion of the allocation of new investment funds between business and residential uses. Thus, the flat tax is less distortionary than the present income tax in its treatment of owner-occupied housing.

It is, of course, possible to treat housing more generously under a flat tax. For example, Senator Specter's recently introduced version of the flat tax (S. 488, "The Flat Tax Act of 1995") would provide an interest deduction on mortgages up to $100,000 per taxpayer. This deduction would represent a tax cut for all taxpayers with mortgages, and an incentive to acquire more housing for those with mortgages below $100,000. Ultimately, such a provision makes sense only if it is desirable to maintain the relative tax subsidy to owner-occupied housing. As with many other tax expenditures, this is a question that does not disappear with the shift to a flat tax.

The treatment of government transfer payments, particularly social security benefits, presents another challenge in the design of flat taxes. In the past, it was sometimes argued that transfer payments would bear consumption taxes indirectly through induced increases in the price level. Now, however, to whatever extent the price level responds to the imposition of a flat tax, social security benefits will be insulated; they are indexed to the Consumer Price Index. Thus, to tax the consumption financed by social security benefits, it will be necessary to include these benefits explicitly in the tax base. The easiest way to do so is to add them to wages. Presumably, the high tax-paying threshold would protect the elderly poor, just as it would protect the nonelderly poor.

Most remaining tax expenditures are eliminated under the flat tax, although Senator Specter's version would also provide a limited deduction for charitable contributions. What other tax expenditures might be kept under a flat tax? It is hard to answer this question without knowing why certain tax expenditures exist now. While some are intended to encourage saving, and would be obviated by adoption of the flat tax, others, such as the exclusion of employee health benefits, are no more justified now than they would be under a flat consumption tax. Logically, the merits of eliminating such tax expenditures should be distinguished from the merits of adopting a flat tax; you will still have to make the difficult choices about which tax expenditures to keep.

PROGRESSIVITY

The progressivity of flat taxes relates to three issues that can be considered separately: the rate structure (a low, single rate), the long-run tax base (consumption

[4] For further discussion, see Alan J. Auerbach and Laurence J. Kotlikoff, *Macroeconomics: An Integrated Approach* (Cincinnati: South-Western College Publishing, 1995), Chapter 6.

rather than income), and the treatment of existing assets during the transition to the new tax system.

RATE STRUCTURE

While flat taxes can provide tax progressivity at the low end of the income distribution, they cannot do so at the high end. Because a taxpayer's average tax rate can rise no higher than the single marginal rate, virtually any flat tax would reduce the tax burden on very high-income individuals. If the poor also benefit relative to the current system, through the high exemption threshold, and tax revenues remain the same, then even in today's magical world of budget analysis this means that the middle class will face a tax increase. Perhaps the easiest way to lessen this problem is to introduce one or more additional tax rates under the individual component of the flat tax and raise the top individual rate and the single rate on business cash flow. While this revised tax system could no longer officially be called a "flat" tax (Professor David Bradford of Princeton University, who originally proposed the idea, has called it the "x-tax"), it would preserve most of the simplicity of the flat tax. The main economic cost compared to the flat tax would be the greater distortion of household labor supply occasioned by the higher marginal tax rates. A much more ambitious approach would be to adopt a personal consumption tax with a progressive rate structure, sometimes called a "consumed income" tax, such as has been proposed by Senators Domenici and Nunn as part of their "USA Tax System."

LONG-RUN TAX BASE

Proponents of the flat tax may shy away from referring to it by its "real" name—a consumption tax—to avoid the perception that, as a consumption tax, it must be more regressive than an income tax. But one cannot analyze a tax properly without understanding its basic characteristics. As I have already stressed, the name of a tax or its method of collection is of little economic importance. In particular, you should be highly suspicious of any analysis claiming that the distributional burden of a flat tax is materially different from that of an equal-revenue combination of a VAT with a comparable low-income rebate.

As I have just discussed, regressivity of the basic flat tax can be addressed by adding tax rates. If taxing consumption, in itself, makes the tax system more regressive, this can be offset by further rate-structure adjustments. However, perceptions of the underlying regressivity of consumption taxes are overstated by our tendency to look at consumption and income on an annual basis, rather than over longer periods of time. In any given year, consumption as a share of income falls as income rises. However, much of this pattern is due to the fact that, for each individual, income fluctuates more over time than does consumption. Hence, when we observe any particular individual with a relatively high annual income, perhaps during a peak earning year, his consumption will appear relatively low. When we observe the same individual with relatively low annual income, say, as the result of retirement or temporary unemployment, his consumption will appear relatively high. This pattern is much less pronounced if one takes a multi-year or lifetime perspective, as the life-cycle and year to year fluctuations in income are averaged out.[5]

EXISTING ASSETS AND THE TRANSITION

While the rate structure and the tax base determine the long-run progressivity of any tax, transition policies are important when we consider short-run distributional effects and the relative burden imposed on current and future generations. One example already discussed is that of previously built owner-occupied housing. By failing to tax the imputed rent on such housing, the flat tax improves the well-being of existing homeowners in relation to others who will have to make up the lost tax revenue: non-homeowners now alive, who are likely to be less well-off on average, and members of future generations. As I indicated above, this transfer could be undone by a one-time levy on existing owner-occupied housing.

A similar analysis applies to existing corporate assets. In replacing the corporate and individual income taxes with a single-level business cash-flow tax, the flat tax would eliminate one level of tax on corporate cash flows. While there is no compelling economic logic to having a separate-level corporate tax in the long run, its re-

[5] See Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden? (Washington: Brookings, 1993), Chapter 7 and Joint Committee on Taxation, Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993.

moval conveys windfalls to the owners of existing shares.[6] As with housing, these windfalls benefit current asset holders at the expense of others, now and in the future. In the same way, they can be alleviated, either through the same sort of one-time levy or, to be more realistic, through a separate tax on corporate cash flows or a higher level of tax on the business cash-flow component of the flat tax. That is, if the household component is taxed at a rate of, say, 20%, the business tax rate could be set higher to offset the windfalls produced by eliminating the corporate tax.[7] Raising the business tax in this way would have no impact on the incentive to save or invest.

SAVING

In addition to simplicity, one of the best arguments for adopting a flat tax is that it would encourage saving, a goal about which there is little argument. The flat tax would encourage saving and investment by eliminating the tax wedge on capital income. In itself, this should encourage saving and investment, although there remains considerable uncertainty as to how much. The total impact on saving and investment also depends on the level of government revenues, and how the burden of these revenues is distributed during the transition to the new tax. The higher the level of government revenues, assuming government spending is fixed, the higher the level of government saving, and hence national saving. Even if aggregate revenues do not change, shifts in the tax burden among households with different propensities to save will also influence the aggregate level of saving.

Given the empirical uncertainty about how much tax incentives encourage saving, the most direct way to increase saving would be to reduce government dissaving—to raise taxes, reduce spending, or both. Yet, most discussions of the flat tax appear to presume that the tax should be revenue-neutral (though some of the initial proposals appear to fail even that test). I know of no compelling reason why adoption of the flat tax cannot be used as an opportunity to raise revenues as well. Indeed, the need for more revenue is, in itself, an argument in favor of the flat tax: it makes more sense to raise revenues if the tax being used has a broad base and relatively low rates, so that the increase in rates is not terribly distortionary.

Even if aggregate revenues remain the same as under current law, the level of private saving may be affected by how their burden is distributed among households with different propensities to save.[8] The greater the windfalls to existing assets, the lower the tax burden on existing asset holders, and the higher the burdens on others, including future generations. This shift in the burden is likely to have offsetting effects on saving, as current asset holders are more likely than others to be high lifetime savers, but also more likely to be older, with less need to save for the future, than others. Ultimately, the net impact of transition provisions on saving is an empirical question that depends on the specific proposal.

SUMMING UP

The flat tax would provide a much simpler tax system, with fewer economic distortions. Depending on its precise structure, it might also increase national saving. However, in its purest form, it lacks the progressivity of the current income tax. Overcoming this lack of progressivity would require a departure from the pure flat tax to a tax system with multiple rates and/or different rates on business and individual tax bases. As an alternative, one could achieve most of the benefits of the flat tax under the current system by eliminating many tax expenditures and reducing marginal tax rates. Whether one modifies the present tax system or the flat tax, the eventual outcome would represent an improvement over the current tax system and, it is important to note, a return to the basic principles that underlay the Tax Reform Act of 1986.

PREPARED STATEMENT OF BRUCE R. BARTLETT

Mr. Chairman, thank you for the opportunity to testify today on the issue of the flat rate income tax. This is an issue I have been interested in for many years. In

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[6] The exact size of these windfalls would depend on a number of transition provisions. For example, they would rise to the extent that depreciation deductions were still permitted for assets purchased under prior law.

[7] Of course, using a higher business tax rate to offset corporate windfalls would also raise taxes on the cash flows of unincorporated businesses that had not received the windfalls.

[8] See Alan J. Auerbach, "Options for Increasing Private Saving," paper prepared for the Competitiveness Policy Council, December 1994.

fact, as staff director for the Joint Economic Committee I organized the first congressional hearing ever held on this subject in 1982.

Today I would like to specifically address my comments toward the proposal put forward by Professors Robert Hall and Alvin Rabushka of the Hoover Institution at Stanford University, since neither of them could attend this hearing.

The Hall-Rabushka proposal was first put forward in a Wall Street Journal article on December 10, 1981, and has since been elaborated in three editions of their book, *The Flat Tax*. The most recent edition has just been published by the Hoover Institution Press.

Although they have always referred to their proposal as a flat tax, I prefer to think of it as a single rate tax plan. This is because the central element of the Hall-Rabushka plan is to tax all income only once. Moreover, their plan is not truly a flat tax because those with higher incomes will pay higher effective tax rates, although the marginal rate will be the same for all.

The importance of this distinction gets at what I believe is the major problem with our current tax system, which is that some forms of income are taxed two, three or more times while others are not taxed at all. Thus we have close to confiscatory rates on some forms of capital income, while a considerable portion of labor income—in the form of fringe benefits—is entirely free of tax.

In the aggregate, we tax less than half of all personal income. In 1992, personal income as defined by the Commerce Department came to $5.2 trillion, yet taxable income as defined by the IRS came to just $2.4 trillion. This means that in theory a 9.2% tax rate on all personal income would raise the same revenue that the individual income tax raises today at an effective rate of 19.2%, with marginal rates between 15% and 39.6%.

However, the effective tax rate on capital income can go far higher than 39.6%. Consider a dollar of increased corporate profit. Looking only at federal taxes, we first take off 35% corporate income tax. Then whatever is paid out to the corporation's owners, the shareholders, is taxed again up to a 39.6% rate. This adds up to better than a 60% tax on the original dollar of profit. But we aren't finished yet, because if the higher profit lead to a higher stock price, we tax that profit again when the stockholder sells his shares, even though the stock price merely reflects the discounted present value of the future profits that are already going to be taxed twice. The capital gains tax, therefore, in effect is a third layer of taxation, going up to 28%, on the same dollar of profit. If we factor in state and local taxes and inflation, it is not at all difficult to get tax rates on capital up over 100%. This, I believe, is at the root of our economic malaise.

This excessively heavy taxation of capital, combined with widely different tax rates on different forms of income, has created enormous inefficiency. It means that we are collecting less revenue for the government at a far higher cost than necessary. As this Committee is well aware, the compliance cost of the income tax runs into the tens of billions of dollars a year.

However, the compliance cost is only a small part of the cost we pay for our current tax system. A much larger cost is what economists call the "excess burden" of the tax system. The excess burden is the cost to the economy of reduced work, saving and investment that is over and above the amount of tax collected. Estimates of the excess burden run into the hundreds of billions of dollars per year.

I believe that the Hall-Rabushka plan, which has been sponsored by Congressman Dick Armey and Senators Richard Shelby, Larry Craig and Arlen Specter, is the best plan that has ever been put forward for dealing with the problems I have just described.

In brief, the Hall-Rabushka plan would establish a single tax rate of 19% on all personal and business income. Businesses would be taxed on their gross revenue less cash wages, salaries and pensions paid; purchases of goods, services and materials used in business; and all capital equipment, structures and land. Individuals would be taxed on their wages, salaries and pensions received less a large family allowance. A family of four would have to earn $25,500 per year before it paid any income tax. Note that individuals would pay no tax whatsoever on interest, dividends or capital gains received.

At first glance, it appears that there is no way such a tax system could possibly raise the same $740 billion that the federal government expects to raise in individual and corporate income taxes in 1995. It also appears to be an enormous giveaway to the rich, who now pay rates as high as 39.6% on all of their income except capital gains, which is taxed at a maximum of 28%.

In fact, the numbers in the Hall-Rabushka plan do add up. And it is not quite the giveaway to the rich that it appears. The reason is because in return for gaining the ability to expense capital investment, businesses would lose the ability to deduct the cost of fringe benefits and interest. Hall-Rabushka would also sweep away a

long list of business tax incentives currently in law. On the individual side, taxpayers would lose the ability to deduct mortgage interest, charitable contributions, and state and local taxes, among other things. Also, keep in mind that while interest and capital gains are not taxable for individuals, they are taxable at the business level.

The result of all this is to roughly triple current federal revenues from taxing businesses, while halving individual income tax revenues. Since business income largely accrues to the wealthy, the effect of the Hall-Rabushka plan is to raise the actual amount of taxes paid by rich people even as their tax rate falls. And this result does not in any way depend on any "supply-side" effects on economic behavior, although it is clear that there will be a significant impact on saving, investment and work effort. Professor Dale Jorgenson of Harvard, for example, recently predicted that if something like the Hall-Rabushka plan were enacted by Congress it would lead to an immediate $1 trillion increase in national wealth.

Unlike the Tax Reform Act of 1986, however, the Hall-Rabushka plan is not a simple trade-off between higher corporate taxes and lower individual taxes. Rather, Hall-Rabushka must be viewed as a fully integrated tax system, of which the business tax and the wage tax are simply two sides of the same coin.

In addition, it should be noted that Hall-Rabushka is by definition a pure consumption tax, because capital investment is fully expensed and because individuals pay no taxes on their investment income. Thus it is unnecessary to institute any sort of specialized saving incentive, such as that proposed by Senators Sam Nunn and Pete Domenici. Their plan, in effect, would force people to save before they received any tax benefit, whereas Hall-Rabushka simply abolishes taxes on saving altogether.

As noted earlier, the Hall-Rabushka plan is not the pure flat rate tax it appears to be. That would require a single rate on gross income, with no deductions at all. The effect of having a large personal and family allowance is to create effective progressivity. Under Hall-Rabushka the effective tax rate on wage, salary and pension income would rise from zero on low income families, to a rate between 3% and 12% on moderate income families, to 16% on a family earning $200,000. Rates continue to rise as income rises, although no one would ever pay more than 19%.

At this point I should mention that the Armey-Shelby-Craig plan is not identical to the one I have described thus far. They would set the personal allowance at a higher level and begin with a 20% tax rate, which would fall to 17% after two years. Thus the Armey-Shelby plan is not revenue-neutral, as the Hall-Rabushka plan is. The loss in revenue would be paid for with spending cuts enforced with spending caps and a sequester mechanism.

Moreover, I should also mention that the proposal introduced by Senator Arlen Specter also is not identical to Hall-Rabushka. It is the same in every respect except that he retains the deduction for mortgage interest on loans up to $100,000 and the deduction for charitable contributions up to $2,500. In order to pay for these deductions, Senator Specter would set his tax rate at 20%. The Specter plan would be revenue-neutral.

Since mortgage interest and charitable contributions are two of the biggest political objections to Hall-Rabushka, I will just discuss them briefly.

The biggest problem with retaining these two deductions, and deviating from the pure Hall-Rabushka tax base, is that it establishes a precedent that could easily undermine the whole plan. If we make an exception for these two items—as popular as they are—it makes it far more difficult to resist the efforts of various lobbies and special interests to retain other deductions as well. It becomes almost inevitable that Congress will want to restore the deduction for state and local taxes and other politically popular, easily justifiable deductions. This creates a slippery slope that will quickly undermine the virtues of tax reform. The Members of this Committee know this process well from 1986. By the time the House got finished with tax reform it bore no resemblance to the Reagan Administration's proposal for this very reason.

Therefore, it is essential that if serious consideration is given to the Hall-Rabushka plan, it be kept intact. No exceptions should be made, even for mortgage interest and charitable contributions. Thus I believe that the Specter plan is much inferior to the Armey-Shelby-Craig approach, although I would prefer if they had maintained the revenue-neutrality of the Hall-Rabushka plan. I believe it is undesirable to confuse the issues of tax reform and tax cuts. They should be debated separately.

In any case, it is really not necessary to keep either the charitable contribution deduction or the mortgage interest deduction, as Senator Specter proposes. The vast bulk of charitable contributions are not motivated by a tax deduction, but by religious conviction. Most of the money that is thrown into the collection plate on Sun-

day is not deducted from taxable income. According to "Giving USA," individuals contributed $102 billion to charity in 1992, but according to the IRS only $54 billion was deducted on income tax returns.

Of course, some high income taxpayers do make contributions expressly for the tax deduction. However, the $2,500 cap in the Specter proposal would do nothing for such people. Thus, the Specter plan really rewards those most likely to make charitable contributions without a deduction, while doing nothing to motivate giving by those who are mainly influenced by a tax deduction. And remember that with the increase in the family allowance, large numbers of people would be unable to deduct their contributions anyway, because their income would not be high enough to pay any taxes to begin with.

As to the mortgage interest deduction, retaining the deduction for loans under $100,000 really does little to help the middle class. The median price for new homes is already 25% higher than that and will rise over time. Eventually, the $100,000 limit will be so low as to be almost worthless, thus putting pressure on Congress to raise it periodically. It would be better to treat this matter as a transition rule and let people continue to deduct interest on existing loans on primary residences, losing the deduction if they sell or refinance. The tax rate could temporarily be set at a slightly higher rate, falling as homes are sold or refinanced. This way people can transition into the new tax system without undermining its integrity and opening the door to retaining other politically popular deductions.

In any case, reducing the top rate from 39.6% to 19% means that for many taxpayers the value of their charitable contributions and mortgage interest deductions would fall by more than half anyway. Thus retaining these deductions really accomplishes little, but at the steep price of undermining the integrity of the Hall-Rabushka plan. Moreover, rather than improving the political prospects for passage, I believe it undermines them.

Another area where I would urge the Committee to resist any compromise is on the full integration of the corporate and individual income taxes. I believe that the Hall-Rabushka plan does this in exactly the right way. The corporate income tax as we know it would disappear completely. Business income would be taxed much more comprehensively than at present, but only once.

While in principle the idea of tax integration is not controversial, it does create an important problem that I want to bring to the Committee's attention. That is the problem of distribution.

As the Committee is well aware, existing tax distribution tables to not attribute to individuals any portion of the corporate income tax. The standard reason given for not doing so is that economic theory does not clearly indicate who bears the burden of the corporate tax. Although I would argue that it is borne entirely by shareholders, others argue that it is partially borne by workers and consumers, in the form of lower wages and higher prices.

This failure to include the burden of the corporate tax in the distribution tables inevitably makes our tax system appear far less progressive than it really is. It also means that any distribution tables attempting to allocate the burden of the Hall-Rabushka system and compare it to the current system are likely to be incomplete.

Since the Hall-Rabushka plan fully attributes all business income to the owners of the business, and because the business side of the Hall-Rabushka plan goes far beyond the existing corporate income tax, it is simply not possible to compare the distribution of the current income tax only to the wage tax portion of Hall-Rabushka. Nor is it correct to look at the business side and compare it to the existing corporate income tax. To have any real idea of the distributional implications of switching from the current system to Hall-Rabushka, we have to look at the individual and corporate tax systems as an integrated whole. While, as I said, this is a very difficult thing to do, I do not believe that this is an excuse to ignore the problem, as is presently done. Otherwise, the distributional tables will make it too easy for the opponents of tax reform to characterize any flat tax plan as unfair.

Incidentally, on the issue of fairness, I would call the Committee's attention to some poll results. A poll by Fabrizio-McLaughlin last fall found a clear majority of all income groups supporting a 17% flat tax rate for everyone. Although support for the idea increased with incomes, even among those making $20,000 per year or less 51.5% of those surveyed favored the idea while only 23.8% opposed it.

Focus groups organized by Frank Luntz have also shown that the flat tax is viewed as fair by all income groups. Interestingly, those with lower incomes were adamant in their belief that a pure flat tax system was the best way to get the rich to pay their fair share. Apparently, it is widely believed that vast numbers of wealthy Americans are avoiding taxes altogether and that only by eliminating all deductions can such people be forced to pay up.

Finally, I would urge the Committee to avoid tinkering with the existing system. There are any number of reforms that would improve it. However, I believe that the time for tinkering is past. Nothing short of a wholesale rewrite of the Tax Code will do.

While there are many other comprehensive reform ideas out there—such as the Treasury Department's "Blueprints" proposal—I believe that the Hall-Rabushka plan is the best one that has been put forward in terms of fairness and simplicity. Moreover, it is not a new proposal, but one that has been around for almost 15 years. It has been the subject of previous hearings in this Committee and the House Ways and Means Committee, and been discussed in numerous studies and articles. Consequently, it is a plan that is familiar and well vetted. Thus, rather than reinvent the wheel and try to come up with an entirely new reform proposal of your own, I recommend that the Committee simply adopt the Hall-Rabushka plan as is.

APPENDIX—HALL-RABUSHKA TAX FORMS

Form 1	Individual Wage Tax	1995
Your first name and initial (if joint return, also give spouse's name and initial)	Last name	Your social security number
Present home address (number and street including apartment number or rural route)		Spouse's social security no.
City, town, or post office, state, and ZIP code	Your occupation ▶	
	Spouse's occupation ▶	

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

Form 1	Business Tax	1995
Business Name		Employer Identification Number
Street Address		County
City, State, and ZIP Code		Principal Product

1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2(a)	
	(b) Wages, salaries, and pensions	2(b)	
	(c) Purchases of capital equipment, structures, and land	2(c)	
3	Total allowable costs *(sum of lines 2(a), 2(b), 2(c))*	3	
4	Taxable income *(line 1 less line 3)*	4	
5	Tax *(19% of line 4)*	5	
6	Carry-forward from 1994	6	
7	Interest on carry-forward *(6% of line 6)*	7	
8	Carry-forward into 1995 *(line 6 plus line 7)*	8	
9	Tax due *(line 5 less line 8, if positive)*	9	
10	Carry-forward to 1996 *(line 8 less line 5, if positive)*	10	

PREPARED STATEMENT OF MICHAEL J. GRAETZ

Mr. Chairman and Members of the Committee: It is a great pleasure to appear before this Committee to discuss flat tax proposals. The flat tax proposals introduced in this Congress contemplate the most dramatic changes in the United States tax system since the income tax was extended to the masses during the Second World War. Such extensive change raises many questions—including the critical question of transition: how do we get there from here? I shall highlight only a few of the important issues in this brief statement at this early stage of your deliberations.

1. THERE IS NOTHING NOVEL ABOUT A FLAT TAX RATE

While a progressive rate income tax has been a feature of the U.S. income tax for more than eighty years and a progressive rate estate tax has been in place for seven decades, flat rate taxes are common in this nation's tax system. Most state sales taxes are leveled at a flat rate, although the tax rates differ from state to state. Both the federal wage tax that funds old age, survivors' and disability insurance, and the separate federal wage tax imposed to fund hospital insurance under Part A of Medicare are flat rate taxes. The corporate income tax is basically a flat rate tax. Until 1993, the alternative minimum income tax on individuals was a flat rate tax and now has only two rates, 26 and 28 percent, with the second rate undoubtedly added to satisfy someone's revenue and distributional tables.

Multiple tax rates generally serve one of two purposes: (1) they enable the legislature to favor certain types of investment or consumption, or (2) they reflect a belief that fairness demands some progressive rates in a tax system. The latter point recently has been put well by the New York Times columnist William Safire: "Most of us accept as 'fair' this principle: the poor should pay nothing, the middlers something, the rich the highest percentage."[1] The 1986 Tax Reform Act demonstrated that a desired level of progressivity can be achieved with very few different tax rates. In Europe, value-added taxes are often imposed with multiple rates, in an effort to eliminate regressivity and perhaps even introduce some progressivity into the tax, and also to favor or disfavor certain forms of consumption.

Contrary to many popular beliefs, however, multiple tax rates are not now a source of very much complexity in the federal income tax. Thus, flat rate taxes are neither radical in concept nor necessarily simple in design or compliance.

The major simplification achieved by a flat tax rate system is the elimination of the need to worry about the attribution of income, deductions, and losses among family members, but the 1986 enactment of the so-called kiddie tax and changes in the tax rates relating to the income of trusts have minimized this problem under the current income tax. A single flat rate does allow the Congress greater flexibility in choosing whether to collect taxes from businesses or individuals, as the Armey-Spector proposal demonstrates, but much of that flexibility can be achieved so long as the rates are kept relatively low and the corporate or business rate is not substantially different from the highest individual rate.

Moreover, even a flat rate tax typically has multiple rates. For example, many entities will be tax-exempt, including not only various levels of government, but also a variety of nonprofit organizations, including charities, such as the Red Cross, schools and universities, churches, arts and health organizations, etc. In addition, business entities which do not have income in the current year, but are instead experiencing losses will face a zero marginal tax rate on additional dollars of income, and businesses that operate abroad will typically face multiple foreign tax rates. Finally, under most flat tax proposals, a large exemption—or zero bracket—is typically provided that may enable some tax savings if items of income or deduction are shifted among family members.

These kinds of variations in tax rates are inevitable, even in a flat rate system, and they will tend to create opportunities for tax reduction through shifting of income and deductions through a variety of legal arrangements. The members of this Committee may well remember "safe harbor leasing" under the 1981 Tax Act as a troublesome recent manifestation of the kinds of tax shifting problems that flat rates cannot solve. Some of you no doubt even recall sales and leasebacks by tax exempt entities, such as the city of Atlanta's lease of its civic center and the Department of Defense's sale and leasebacks of navy aircraft carriers; complex legislation was enacted to inhibit such transactions. Even though these particular avenues for transferring income, deductions or losses have specifically been cut off, businesses today engage in a variety of transactions, including lease arrangements, to shift in-

[1] William Safire, "The 25% Solution," New York Times, April 20, 1995, p. A23.

come, utilize losses and take advantage of lower foreign tax rates. Efforts by taxpayers to shift items of income and deduction are inevitable even in a flat rate system. Likewise, flat tax rates do not eliminate the advantages of tax deferral where postponing payment of taxes is advantageous to taxpayers.

2. THE REAL ISSUE IS DEFINING THE TAX BASE

Indeed the principal sources of complexity in the income tax can be found in the provisions that define the tax base. What is included in income subject to tax? What deductions and credits are allowable and what conditions must be satisfied to obtain them? When are items of income includable or deductions or credits allowable?

Broad tax bases with low rates cause fewer economic distortions and can be made much simpler to comply with and administer than narrow tax bases with high rates, regardless of which tax base—income, wages, or consumption—we are talking about. Most of the flat tax proposals make significant efforts to eliminate deductions. The Armey proposal, for example, does away with all itemized deductions, including those for charitable contributions, home mortgage interest, and state and local taxes, although Senator Spector's variation does not go quite that far, retaining some deduction for both charitable contributions and home mortgage interest.

Both Congressman Armey and Senator Spector avoid the complexities of taxing income from capital by having individuals include only wages in their tax base. Even this dramatic shift in policy retains some significant complexities, however. To know the amount of wages, rules must be specified for fringe benefits and deferred compensation, for example, and employees must be distinguished from independent contractors. As you know, Mr. Chairman, all three of these issues have been very troublesome under the income tax. Additional complexities may occur at the business level.

But the essential point is this: If Congress has the political will to make such major changes in the tax base and to maintain them over time, much simplification can be achieved and tax rates can be lowered substantially. Whether the tax is imposed at one flat rate or a few multiple rates is of little consequence in terms of costs of compliance or economic efficiency, although it may be important in determining how the tax is distributed among the populace.

3. MOST FLAT TAX PROPOSALS INTRODUCED IN THE CURRENT CONGRESS ARE IN FACT CONSUMPTION TAXES

The key common features of consumption taxes are that the tax base is generally sales, and that the tax does not reduce the pre-tax rate of return on savings and investment. The most common consumption taxes are retail sales and value-added taxes. The principal distinction between retail sales and value-added taxes is that the former taxes sales directly, while the latter taxes only the excess of sales over purchases and thereby collects a portion of the tax at each level of production.

Consumption taxes, including value-added taxes, can take a variety of forms. Typically businesses are taxed directly either on sales as Senator Lugar has proposed, or on valued added (sales minus purchases). Value-added taxes can themselves take a variety of forms. Most European value-added taxes are of the credit-invoice type, as Congressman Gribbons has proposed, but subtraction method value-added proposals seem to be enjoying greater favor among current proposals; for example, this was the form of value-added tax advanced by Senators Boren and Danforth in the last Congress and is an important aspect of the current Domenici-Nunn proposal. However, as Senator Spector and Congressman Armey have demonstrated in their flat tax proposals, it is possible to split the collection of a subtraction-method value-added tax between businesses and individuals. As Congressman Armey, Senator Spector, and the parents of this proposal, Professors Hall and Robushka, have all emphasized, this division of the tax enables the exemption of a certain amount of wages from tax, and it even would permit the imposition of progressive rates on wages.

Another method of taxing consumption—advanced by Senators Domenici and Nunn—is to tax individuals directly by measuring their annual consumption. In broad terms, this calculation requires subtracting amounts saved from amounts received to determine the amount consumed. The only reason to prefer this kind of consumption tax—typically labeled an expenditure tax—to a sales or value-added tax is to impose progressive rates on consumption at the individual level. The Domenici-Nunn proposals combine their individual level expenditure tax with a subtraction-method value-added tax at the corporate level, presumably to constrain the tax rates necessary at the individual level to produce the revenues required.

The common feature in each of these proposals is that the total tax base is sales. It is a bit curious that most of these proposals avoid the most common forms of con-

sumption taxes—retail sales taxes, which are imposed by the states in this country, and credit-method value-added taxes, which are common in Europe—and instead propose consumption taxes in a form which resembles income taxes. The Domenici-Nunn subtraction method value-added tax at the business level, and individual level "consumed income" or expenditure tax both have this feature, as does the Spector-Armey flat tax. There are certain substantive advantages to these forms; a subtraction-method value-added tax makes exemptions and multiple rates more difficult and the Spector-Armey flat tax permits exemption of a certain level of wages. But proponents of these taxes also resist referring to them as value-added taxes or consumption taxes and have instead embraced such labels as "flat-rate taxes," "consumed income taxes," or even "USA taxes."

4. WHY DO CONSUMPTION TAX PROPONENTS AVOID COMMON SALES OR VALUE-ADDED TAXES?

In a recent editorial in the New York Times discussing the Armey-Spector flat tax, Professors Hall and Robushka noted that there are many "economically equivalent ways to impose consumption taxes." Apparently, however, all methods are not politically equivalent; avoiding a sales or value-added tax label and achieving close association with the income tax apparently are regarded as desirable political attributes for federal consumption taxes.

This, I think, is principally because neither a wage tax nor a consumption tax will impose significant burdens on a wealthy person who lives frugally off of interest, dividends, rents or royalties, but has no wages. By all accounts, Sam Walton would have paid very little consumption tax.

In effect, both wage and consumption taxes effectively exempt from taxation capital accumulations and the income from capital; therefore, taxes on consumption or wages alone omit from account any ability to pay based upon the accumulation of capital or income derived from capital. Since the adoption of the Sixteenth Amendment in 1913, this nation has regarded income as the best measure of people's relative abilities to pay taxes. This is because income is a more comprehensive measure of a person's ability to pay than either wages or consumption. In terms of sources, an income tax base includes both income from labor and income from capital; in terms of uses, an income tax base includes savings as well as consumption. A person who consumes more may have a greater ability to pay than a person who consumes less and a person who earns higher wages may have greater ability to pay taxes than a person who earns lower wages. But in the United States, the tax system has not regarded either of these measures in isolation as an adequate index of overall economic well-being.

In addition, avoiding typical value-added and sales tax structures and labels in favor of income tax-like computations and collection may be intended by consumption tax proponents to blunt potential opposition from governors and mayors. The nation's state and local executives have historically viewed consumption taxes as the exclusive domain of state and local governments and have vigorously opposed federal sales or value-added taxes. Indeed, the uniform opposition of governors and mayors was an important—perhaps decisive—factor in dissuading President Nixon from proposing a value-added tax as a partial substitute for social security and corporate income taxes in the early 1970s. I will offer no prediction here today about the likely position of the governors and mayors on these alternative consumption tax proposals, but I do want to emphasize a point made by Senator Lugar.

One of the greatest sources of complexity in this nation's tax system is the limited coordination between federal and state taxes and among the states. These differences impose substantial costs on individuals and businesses alike in complying with the various government's tax requirements. Multiple state income tax filings are common and a retail business operating nationwide may be required to file as many as 150 different state and local sales tax returns as frequently as monthly. The longstanding failure of the Congress to demand greater conformity of income tax bases has been extremely costly to the public. If the Congress is now to move into the consumption tax business, there is much to be said in favor of aligning federal and state tax bases. While I do not share Senator Lugar's optimism that introducing a federal sales tax collected by the states would permit the instantaneous dissolution of the Internal Revenue Service, his plea for federal-state conformity merits this Committee's serious attention.

By raising these questions however, I do not mean to call into question the critical role of economic growth. To be sure, economic growth is the engine that produces federal revenues, and is also the path to improved well-being of the populace. The question is not whether economic growth is important, the question is how best to achieve growth in a manner that is fair to all segments of the American public.

5. THE CASE FOR CONSUMPTION TAXES

There are valid reasons to consider federal consumption taxes for the United States, I emphasize here three in particular. First, the strengthening of the income tax in the 1986 Tax Act was incomplete. In particular, the 1986 Act's complexities reflecting many political compromises failed to abate the accelerating costs of income tax compliance that are so wasteful to our economy. Its failure to address the fundamental problem of income taxation in an inflationary economy no doubt will continue to haunt taxpayers and government alike in future years. Its low rates have been pushed upwards and although the 1986 Act enhanced tax neutrality among different types of investment or savings vehicles, many important differentials remain.

Second, the globalization of capital markets, with their rapid transfers of capital across borders, along with movement toward greater European unification, has made it more difficult for any one country to impose substantial taxes on capital income and also has increased the likelihood that the tax systems of the developed countries will tend to converge. The rush of many of our trading partners to imitate the income tax base-broadenings and rate reductions of the 1986 Tax Act offer striking evidence of this tendency.

When one compares this nation's tax system to those of our trading partners, the greatest disparity is their greater reliance on taxes on consumption. The OECD countries, on average, collect about 30% of their tax revenues from consumption taxes; and only the United States, Japan and Switzerland collect less than one quarter of their total revenues from such taxes. In the United States, consumption taxes account for only about 17% of total federal, state and local revenues, and the federal government's share of that is quite small. Less than 5% of federal revenues come from excise taxes, and the federal government has no broad-based tax on consumption.

Third, the United States rates of savings and investment are low compared to those of our international competitors. The net rate of national savings as a percentage of GDP in the United States is currently below the savings rates of virtually all OECD countries, and our average 3.6% net savings rate in the decade of the 1980s compares quite unfavorably with the 10.2% rate of West Germany and the 17.8% rate of Japan during that same decade. Likewise, the United States investment rate has long been lower than that of other countries, and during the past three decades, the Japanese net private investment rate has averaged 2½ times greater than that of the United States, while that of Germany has been two-thirds greater. Moreover, a far greater proportion of our private investment goes into housing relative to the corporate sector, when compared to our international competitors. Indeed, in recent years, the Untied States has had the lowest corporate investment per dollar of housing investment and the lowest ratio of corporate to non-corporate investment when compared to the United Kingdom, Australia, Germany and Japan.

Much support for consumption taxation is grounded in the view that taxing consumption rather than income would contribute to this country's rates of savings and investment and thereby promote long-term economic growth.

But the empirical evidence of the effects of the choice between consumption and income taxation on national rates of savings and investment remains controversial. Although, under a consumption tax, each dollar a person saves will allow her to consume more at a future point in time than would be true under an income tax, some people may decide to save less because under a consumption tax, smaller current savings would permit them to accumulate to a specific desired level of savings to be spent at some future time. To put the point more precisely, an income tax will encourage so-called "target savers" to save more, and a consumption tax will encourage additional savings by people whose level of savings depends on its rates of return. Both kinds of people no doubt exist, but despite the application of great amounts of data and time, massive computer power, and considerable talent, economists simply do not agree on the likely amount of additional savings that would occur if the federal government were financed solely through wage and consumption taxes rather than income taxes. Indeed, there is considerable economic evidence that both the social security and Medicare systems have had a substantial adverse impact on aggregate domestic private savings in this country even though both are financed by flat rate taxes on wages.

Moreover, the globalization of capital markets adds uncertainty to the potential impact of additional savings on the nation's economic growth. Today, global mutual funds allow even unsophisticated U.S. residents to invest their savings abroad rather than in the United States. Moreover, when an individual contributes to the capital of a U.S. multinational corporation, say, by purchasing newly issued shares, these funds may be used to finance the company's investments abroad. On the other

hand, reduction or elimination of taxes on capital income may serve to attract capital from abroad. The effects of the globalization of capital markets are not yet well understood, but a minimum, they have made it more difficult for this nation to increase domestic investment—domestic capital formation—simply by increasing domestic savings, even if we could be confident that a shift in tax policy would have the desired effect on the overall level of domestic savings.

Unfortunately, even the most fundamental factual questions about the effects of taxes or tax changes often lack definitive answers. The effects of a variety of taxes including both the income tax and social security on work, on aggregate savings and domestic investment remain controversial. Despite 80 years of experience, we still do not know for sure who pays the corporate income tax: shareholders, consumers, employees, all owners of capital, or some combination thereof. The abuse and misuse of facts, the masking of ideology and self-interest as non-controversial factual assumptions, are standard features of tax reform debates.

6. ONE AND ONE-HALF TAXES MAY BE BETTER THAN ONE

My reservations about the current legislative proposals for consumption taxes are grounded in the fact that they would completely eliminate both corporate and individual income taxes. I simply do not think that would be a stable situation. I remember well the outrage generated in 1969 by Treasury Secretary Joe Barr's revelation that 154 people that year had more than $200,000 in adjusted gross income and paid no taxes, the beating taken by Mrs. Dodge, in particular, who had $1 million of tax-exempt interest and no tax liability. Recall as well the expressions of outrage generated in 1986 when the laborers on General Electric's assembly line paid more taxes than the company. One need not defend the widespread complaints these circumstances generated, only recognize their political appeal. Although these complaints may have been based on important misconceptions, they had had enormous political force. The Congress should avoid repeating Margaret Thatcher's disastrous error of replacing an extremely unpopular property tax with an even more unpopular "community charge."

As recently as the elections if 1990 and 1992, political hay has been harvested by complaints about undertaxation of the "rich." The Untaxed Midas anecdotes that will inevitably flow from the elimination of taxes on capital and capital income and the wide disparities in taxes of people with similar levels of income, but very different consumption, will, I think, inevitably create a backlash against a consumption-based tax system. Indeed, I believe that the fear of such backlashes is at least part of the reason why consumption tax proponents in the Congress have attempted to cloak their proposals in income tax garb. But you cannot fool all the people for all time. In my opinion, complete elimination of the income tax and substitution of consumption taxes is an unstable outcome, even in the unlikely event that such a plan could be enacted into law.

This suggests taking a hard look at other alternatives. In 1992 outgoing Treasury Secretary Nicholas Brady offered one such plan—a revenue and distributionally neutral substitution of a 5 percent value-added tax for income taxes for all taxpayers with incomes below $30,000 or so. The value-added tax proposal of this Committee's recently retired former members, Senators Danforth and Boren, also combined a subtraction-method value-added tax with a more narrowly targeted income tax. I believe these proposals and variations on this theme merit serious attention in the Congress. A few basic facts reveal their potential.[2] A 10 percent value-added or sales tax is estimated by CBO to raise about $360 billion of revenues in 1998, about one-half the total $700 billion CBO expects to be raised that year by the individual income tax. Thus, without any revenues from base-broadening or spending cuts, such a tax would allow the income tax could be cut to half its current size.

Because the flat-rate value-added tax is not distributed similarly to the current income tax, a simple halving of income tax rates may not be appropriate. But consider these additional facts. Based on preliminary IRS data for tax returns for 1993, tax returns with adjusted gross income ("AGI") above $75,000 paid one-half of all the income taxes for that year although they accounted for only 7½ million of the 107 million returns filed, or less than 7 percent of the total.[3] This implies that, in principle, without any changes in the current income tax, a 10 percent value-added tax would allow elimination from the income tax rolls of the 100 million tax returns with adjusted gross income of less than $75,000. Moreover, the tax filers with incomes above $75,000 paid taxes at an average rate of just under 21% of AGI, so that—in principle at least—a 10% value-added tax would allow exemption of all tax

[2] These are back of the envelope calculations, but they reveal some of the possibilities.
[3] These returns accounted for 31% of total adjusted gross income.

returns below $75,000 of adjusted gross income and a flat rate 21% tax on the total adjusted gross income of returns above$75,000. Alternatively, to keep in place deductions for charitable contributions, medical expenses and home mortgage interest, the regular income tax could be repealed and the current alternative minimum tax applied to these taxpayers.

If one thinks a bit about lowering the income tax threshold, say to $50,000, additional possibilities occur. Again based on the data for 1993, a 10 percent tax on the adjusted gross income of tax filers with adjusted gross income between $50,000 and $100,000, coupled with a 20 percent tax on the adjusted gross income of filers with AGI above $100,000 would raise more than 110% of the revenues necessary to replace one-half the individual income tax. If the new value-added tax were coupled with income tax base broadening additional flexibility appears.

In practice, of course, things are not so simple. For example, an exemption of returns at $75,000 and below, with either the current regular tax, a 21% flat tax rate or the current alternative minimum tax applicable to people above that level, would produce unacceptably high marginal rate cliffs that would need to be ameliorated through phase-outs, and some mechanisms would be necessary to provide equivalent relief to the nearly 6 million people who claimed earned income tax credits in 1993.

I have offered these simple illustrations to demonstrate that introducing a value-added tax into the federal tax system offers enormous potential to simplify the income tax, perhaps removing 100 million people from the income tax rolls in the process,[4] and to make the federal tax system much more economically efficient and friendlier to savings and capital formation, without introducing the inherent unfairness of completely substituting a consumption tax for income taxation. The changes of the sort I am suggesting here would return the income tax to its pre-World War II status, when it supplied progressivity to the United States tax system by limited application to people at the top of the income tax scale. If I were a politician I might label this the "Half-Tax" or "Going Back to the Future Tax." Perhaps this is why I am not.

Interestingly, it is this very Committee that is largely responsible for the U.S. tax system being based principally on income rather than consumption. In 1921, when the income tax was only eight years old and a fraction of its current size, Chester Jordan, a public accountant from Portland, Maine, told this Committee that he could reduce the size of his accounting firm from eight to three members if Congress only would substitute "a tax on spendings" for the income tax. That proposal was strongly seconded by Ogden Mills, then a congressman from New York, who later served as Herbert Hoover's Secretary of Treasury. But this Committee and ultimately the Congress refused to go along.

Also, more than fifty years ago Franklin Roosevelt's Treasury Secretary Henry Morgenthau called for a progressive graduated rate tax on spendings, but once again, the Senate Finance Committee rejected the proposal for a consumption tax and instead, in the Revenue Act of 1942, began the conversion of the income tax into a tax on the masses. Had this piece of history turned out differently, the income tax might have remained a narrow tax on high income people and a consumption tax might have entered our fiscal system as the broad-based mainstay revenue-raiser that the income tax became.

Even though the public may feel as if everything but the air they breathe—and sometimes even that—is taxed by some level of government, in fact the expenditures of the governments of the world, including those of the United States—are generally financed by only four kinds of taxes: taxes on income, wages, consumption and wealth. This is no accident. These are the four general tax bases that are both sufficiently robust to produce the amount of revenues a modern government requires, and have any claim to be fair, to be connected in some way to a person's ability to pay.

Ultimately, the fundamental question raised by consumption tax proposals—whatever their form—is whether exempting capital or capital income from tax in an effort to simplify tax compliance and promote economic efficiency and growth comports with a goal of fair taxation tied to people's ability to pay. The challenge to this Committee and to other tax policymakers today is to forge a modern reconciliation between the competing claims of equity and economic efficiency. Surely it is possible to enact an income tax that distorts savings and investments far less than the present system and that imposes far smaller costs of compliance on the American people and businesses, while still imposing a rate of taxation on capital or capital income that exceeds zero, the consumption tax rate. The key question is how to improve the nation's current mix of taxes. Any tax law inherently demands a

[4] The number of people is greater than the number of tax returns because of the many returns, particularly joint returns of married people, that include more than one person's income.

compromise among competing values. If one single tax perfectly satisfied all the criteria of fairness, economic growth and neutrality, and simplicity of administration and compliance, we would not be sitting here today.

7. THE DEVIL IS IN THE DETAILS

Mr. Chairman, as you and your colleagues on this committee know well, when the tax law is significantly changed, the details of the legislation will determine its likely impact. I have not yet studied in depth the specifics of the various flat tax and other consumption tax legislative proposals that have been introduced in this Congress, but I do want to bring to the Committee's attention two troubling features of the proposals that I have noticed, one of the Armey-Specter proposal and one of the Domenici-Nunn proposal:

The Armey-Specter Proposal—one of the major differences between Majority Leader Armey and Senator Specter's flat-rate consumption tax proposal and the consumption taxes prevalent throughout the world is its treatment of imports and exports. Typically, when sales or value-added taxes are imposed by a country, they are imposed on a destination basis. In practice, this means that goods that are produced in the country but exported for consumption elsewhere are not taxed, while goods imported into the country are subject to the nation's value-added tax. In contrast, the Armey-Specter proposed tax would be imposed on an "origin" basis. This means that imports would not be subject to tax but exports would be taxed. Thus, for example, whenever a U.S. automobile dealer sells cars manufactured in the United States for use in the United States, the full retail sales value of that automobile would be included in the flat tax base. Likewise, whenever a U.S. automobile manufacturer sells automobiles to a foreign dealer for export and use abroad, the manufacturer's sales price of each car would be subject to the U.S. flat tax. But, in contrast, a U.S. dealer in foreign cars would be required to pay tax only on the excess of that dealer's sales prices over its purchase prices of the cars from the foreign manufacturer. Therefore, the costs of manufacturing the cars abroad would not be included in the U.S. consumption tax base, and only the dealer's markup would be subject to U.S. taxation.

Economists typically claim that we should be indifferent whether a consumption tax is levied on a destination or origin basis because exchange rates will adjust to compensate for any differences. But U.S. automobile manufacturers and other U.S. companies will be skeptical that exchange rates will adjust quite so perfectly, and will no doubt regard the imposition of U.S. sales tax on the full retail price of cars manufactured in the United States coupled with U.S. taxation of only the dealer markup of automobiles manufactured abroad as fundamentally unfair and as producing a competitive disadvantage to U.S. manufacturers. One need only recall the serious concerns of U.S. manufacturers with the possible effects of President Clinton's 1993 proposed energy tax on domestic vs. foreign manufacturing to recognize this as an important, perhaps decisive, issue. Indeed, as currently structured, the flat tax may create incentives for automobile manufacturers headquartered in Japan or Germany, for example, to reverse their recent policies of manufacturing cars for U.S. use in U.S. plants and instead to return to their prior policy of exporting automobiles to the United States.

The Domenici-Nunn Proposal. Under the Domenici-Nunn "consumed income" tax, purchases of investment assets generally are immediately deductible. The tax policy literature makes clear that such cash flow treatment can be viewed as equivalent to an exemption of yield from these assets so that, in effect, there generally would be no tax on investment income.[5] This means that in order to favor particular kinds of investments by creating tax advantages for them, a negative rate of tax is required. But negative tax rates have occurred under the current income tax—indeed they were present in most tax shelters of the 1970s and 1980s—and tax preferences for particular investments are easy to implement under a consumption tax as a technical matter.

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[5] "Assume a taxpayer with $1,000, who faces a tax rate of 50 percent, could invest the $1,000 in a tax-exempt savings account that yielded 10 percent annually and have $100 to consume each year after taxes. If that taxpayer could instead invest $2,000 in a deductible asset or account (by virtue of $1,000 in tax savings from the deduction) that yielded a fully taxable return of 10 percent, this also would leave the investor $100 to consume each year after taxes. Withdrawal of the balances from the accounts would leave the taxpayer with $1,000 after taxes in both cases, because the $2,000 amount would be fully taxable as a result of the previous deduction of that amount." This example is from American Bar Association, Section of Taxation, Simplification Committee, "Report on the Bradley-Gephardt and Kemp-Kasten Bills," 38 Tax Law. 381 (1985).

Indeed, in an effort to maintain a tax advantage for borrowing by state and local governments, the Domenici-Nunn cash-flow tax both allows a deduction purchase of state and local bonds and also exempts interest on such bonds from inclusion in the tax base (in a manner similar to how such interest is exempt under the current income tax). I do not wish to discuss here the difficult and important question of the wisdom of a federal tax advantage for borrowing by state and local governments as a matter of policy, but I remark on this particular provision simply to raise a flag about the political realities of attempting to enact either a consumption tax or an income tax that does not favor particular forms of investment or consumption or otherwise endeavor to direct taxpayers' behavior. As an American Bar Association report on consumption taxation observed more than a decade ago:

> "The forces that have led to differential treatment that is avoidable under the income tax are unlikely to disappear with the adoption of a consumption tax . . . We do not agree that there would necessarily be less differential treatment under one tax than the other. . . . [D]eliberate differences would seem as possible under one tax as the other. . . We see no reason to believe that those interested in preferential treatment would be less effective in the lawmaking process if the standard of equal treatment became consumption rather than income, nor are we convinced that zero is a natural lower bound on effective tax rates below which those seeking preferential treatment would necessarily be unsuccessful."[6]

Indeed, many of the priorities for broadening the tax base are the same under a consumption tax as under the income tax. Examples include current income tax rules that permit certain taxpayers to enjoy tax-free personal consumption, either by excluding fringe benefits such as employer-provided meals, lodging, parking and mass transport and perhaps even health insurance, or deducting consumption-laden business expenses. Likewise, the treatment of medical expenses, state and local taxes, owner-occupied housing, and charitable contributions raise similar questions under a Domenici-Nunn consumption tax as under the current income tax. It is far from obvious why the political and administrative difficulties of including such items in the tax base would necessarily be diminished under a consumption tax.

8. BEWARE SELLERS BEARING IVORY

The essential point is this: comparisons between the real income tax forged through decades of accumulated political compromises with an ideal consumption tax imagined in the solitude of the Ivory Tower will inevitably favor the latter. But such comparisons should be avoided; they are unrealistic and deny all experience with the legislative process.

9. MARRYING SHORT-TERM LEGISLATION AND LONG-TERM GOALS

Mr. Chairman, I would feel remiss if I did not raise one final issue. There seems to be a genuine prospect that during this year the Congress may enact tax reductions that would return to the public somewhere between 150 and 350 billion dollars as a result of anticipated spending savings over the next seven years. This, I think, presents both a dilemma and a genuine opportunity for the Committee. It is surprising that so far, at least, this tax reduction effort has been totally disconnected from the more fundamental tax reform and restructuring movement. Why should current tax reductions , if they prove possible, not be targeted to simplify the existing income tax, to reduce the massive costs of compliance currently imposed on taxpayers, and to improve the economic efficiency and the growth-enhancing potential of the income tax. Whatever the merits of an additional per child tax credit, for example, it cannot be said to satisfy these criteria. Let me mention a few options that I hope this committee will consider.

The Committee should reexamine the potential of eliminating the tax return filing requirements for individuals who have only wage income and small amounts of dividend or interest income. The IRS had considered allowing a return-free system for such people in connection with consideration of the 1986 Tax Reform Act, but unfortunately abandoned the idea. This might spare many millions of people the costs and agony of filing tax returns.

There also exists considerable potential to increase conformity between state and federal income taxes. Congress should consider allowing state income tax deductions only if the state piggybacks the federal income tax base and enables its citizens to calculate their state liability as a percentage of their federal taxable or adjusted gross income. Then state income tax returns would not even require a postcard.

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[6] American Bar Association, Section on Taxation, Committee on Simplification, "Complexity and the Personal Consumption Tax," *Tax Lawyer*, Vol. 35, p. 415, pp. 433-434. (Winter, 1981-1982.)

Third, the Congress should take seriously the elimination of the double tax on corporate income and consider integration of corporate and individual income taxes. No one knows better than I the tepid response of corporate managers to this idea, but their lack of enthusiasm does not diminish its importance. In combination, our overtaxation of corporate income coupled with basically no income taxation of housing investments has greatly affected the allocation of capital in the United States. As I have indicated, the U.S. is extreme in the division of our national investments in favor of housing relative to corporate investments. Building a house creates jobs while the house is being built; corporate investments create jobs that may last. Simplifying and restructuring the corporate minimum tax might well also move in the right direction.

Fourth, the Committee should consider targeting family tax relief in a manner to improve people's potential to earn income. Child care might merit a high priority in this connection, and opportunities for great simplification reside in those provisions. Congress might also expand deductions for people who take educational courses to improve their productivity, whether in the form of formal higher education or vocational training or simply through enrolling in specific courses to improve job performance, such as learning computer skills.

Finally, the old standby of tax simplification efforts, increasing the standard deduction, perhaps coupled with floors or ceilings on itemized deductions, always simplifies tax compliance for large numbers of individuals and reduces their compliance costs. The interest deduction provision screams for simplification. Taking a hard look at ways to simplify tax compliance for small business also should be a priority.

My personal list of today's suggestions is of no particular moment here. I have not attempted to be particularly innovative or comprehensive in listing these ideas. In the short time since I agreed to testify here today, I have not even attempted to prioritize the changes I would advance.

The key point is that revenues that might buy some simplification have long been scarce. This year may provide an opportunity for the first tax reduction legislation since 1981 and may well be the last such opportunity in some time, if we are to get on and stay on a path toward a balanced budget. In these circumstances, the Committee should try to merge its long-term vision and its short-term legislative agenda. Thank you.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, I am pleased that we are holding this hearing today on the concept of the flat tax.

As I have had it described to me by some of its proponents, a flat tax has the power to fix practically everything that's wrong with our current tax system. Where we now have mind-numbing complexity, we would have simplicity. Where we now have wide-scale tax evasion, we would have ease of compliance. Where we now have a huge drain on the national economy because of the countless hours and tremendous effort that taxpayers invest into trying to reduce their tax burden, we would have economic growth. This sounds great. I'm all for reforms that would address these problems in our current system.

There is no doubt that our current tax system needs to be changed. Like all of our colleagues, I have received numerous complaints from my constituents about the perceived abuses of the Internal Revenue Service and the burdens of dealing with a tax system that makes taxpayers confused and resentful. I believe that the greatest nation in the history of the world can and should be able to put together a far better system than the one we have. It is especially critical that we do so as we enter the next century. I have serious doubts that our current system can successfully be adapted to our constantly changing and increasingly technologically oriented economy.

Having said this, Mr. Chairman, I am somewhat skeptical that the answer is going to be as easy as enacting a flat-rate tax. I am somewhat skeptical that American taxpayers are willing to give up dearly beloved deductions, such as those for charitable contributions, state and local taxes, and mortgage interest. And, I am somewhat skeptical that we in Congress can keep our hands off a flat tax once it were enacted. I need not mention that we already went through this exercise in 1986.

Nevertheless, we owe it to ourselves, our children, and our grandchildren to find a way to create a better tax system. A flat tax or some variation of it should be fully explored. With this in mind, I look forward to the testimony of our distinguished witnesses.

PREPARED STATEMENT OF HON. JESSE HELMS

[APRIL 5, 1995]

Mr. Helms: Mr. Chairman, thank you for holding these hearings today on the flat tax. The concept of a flat tax is an idea whose tim has come—in fact, in my judgment, if its time had come 20 or 30 years ago, the American people would not be in such a mess today.

The concept of a flat tax is fair and it is simple; and, in contrast to the existing system, it will save billions of dollars in terms of time and paperwork. And, of course, it will spur massive economic growth.

The idea of a flat tax is not new. As a matter of fact, the first flat tax bill that I offered was S. 2200 which I introduced on March 15, 1982. S. 2200 called for a 10% flat tax. (I offered similar bills in the 100th, 101st and 102nd Congresses.)

I shall carefully review testimony presented by the experts appearing before the Committee today. Then, based on this testimony and the advice of other knowledgeable citizens, I plan to introduce a revised version of my own flat tax bill in the next few weeks.

I commend Representative Armey for putting forward a solid proposal. He has done the nation a great service and I plan to co-sponsor his version when it is introduced in the Senate. The only difference in my approach is that I believe we should go with a lower tax rate and provide more spending cuts.

I strongly belief that Congress must overhaul the Federal income tax system and at the same time we must overhaul the federal government. A flat tax must be based on two fundamental principles: equity and efficiency.

And a flat tax should accomplish three goals: 1) it must be simple and pure—there should be no exceptions or deductions other than a personal deduction, otherwise where do you draw the line; 2) it should provide Americans with a tax cut; and, 3) it should be coupled with drastic spending cuts.

On the first point, it is abundantly clear that the tax laws are too complex, unfair, and unworkable. Taxpayers spend billions of dollars trying to comply with or avoid the tax laws. The Tax Foundation estimates that $192 billion is spent every year by businesses and individuals trying to avoid taxes. A study by James Payne of Lytton Research estimates that the tax code cost America over $600 billion, which includes tax avoidance, tax compliance, paperwork, and lost production.

Second, we must cut taxes. Over the years, taxpayers have been taken to the cleaners by Uncle Sam. The Federal government keeps taking more and more money away from American workers. According to the Heritage Foundation, in 1948 the average family of four paid 2% of its income to the federal government. In 1992, a family of four pays 24.5% of its income to Uncle Sam. American workers need a break. Congress must reverse this trend of increasing taxation.

Third, we should slash the size of the federal government by eliminating all federal spending that is not absolutely necessary. Yes, we should terminate entire programs and abolish or reform as many federal agencies as possible.

A flat tax would have a profound effect on the economy in several ways:

- it will promote growth by increasing incentives for work, investment, and production.
- it will eliminate the double taxation of interest and dividends and the taxation of capital gains, which will increase savings and investments and will stimulate economic growth and create jobs.
- furthermore, increased savings will push interest rates down and thus reduce the cost of capital and the cost of homes for American families.
- a flat tax brings greater efficiency to the economy by eliminating preferences in the Tax Code that interfere in economic decisions.

Finally, the flat tax will simplify the income tax system and enhance its fairness and equity. If we can simplify the income tax system so that every American can fill out his or her income tax on the back of a post card, we would put an end to the huge and burdensome tax avoidance industry.

Our tax system has become so complex, economically counterproductive, outmoded, and riddled with exceptions that it's no wonder that the American people are losing faith in their Government.

We need a new tax system based on equity, efficiency, and simplicity. The flat tax will do just that.

PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF

Senator Packwood and Other Distinguished Members of The Senate Finance Committee:

I am honored by this opportunity to discuss with you the economics effects of a flat tax of the type originally proposed by Professors Robert Hall and Alvin Rabuska.

My testimony makes five points.

First, the flat tax, like other forms of consumption taxation, would be very good for the U.S. economy. Its adoption would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

Second, the predicted economic benefits from a flat tax are substantial. Generic simulations of shifting from income to consumption taxation in the standard neoclassical economic growth model—the life-cycle model—produce long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of a flat tax, although much more detailed simulation studies are needed.

Third, the flat tax, like other forms of consumption taxation, increases saving in large part by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young and unborn, the flat tax would offset to a small degree the enormous past and ongoing reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs and which is primarily responsible for the critically low level of U.S. saving.

Fourth, the flat tax is a much more progressive tax system than is generally believed to be the case. The reason is that consumption taxation, of which the flat tax is a form, represents the combination of wage taxation and wealth taxation. Since much of the inequality in living standards across members of each generation represents differences in the amounts of inherited wealth, the wealth tax component of the flat tax would enhance intragenerational equity.

Fifth, the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a flat tax, a retail sales tax, a personal consumption tax, an Electronic Consumption Tax,[1] or a value-added tax is a question that can provide hours of interesting debate. Each of the different methods of taxing consumption has it advantages and disadvantages. But it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in debate over which is the best one. In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

THE CRISIS IN U.S. SAVING

In 1950, the U.S. rate of net national saving was 12.3 percent. In 1994, it was only 3.5 percent. The difference in these saving rates is illustrative of a dramatic long-term decline in U.S. saving. The U.S. saving rate averaged 9.1 percent per year in the 1950s and 1960s, 8.5 percent in the 1970s, 4.7 percent in the 80s, and just 2.7 percent in the first five years of the 1990s.

The decline in U.S. saving has been associated with an equally dramatic decline in U.S. domestic investment. Since 1990, net domestic investment as a share of net national product has averaged 3.6 percent per year, compared with 8.2 percent in the 1950s, 7.9 percent in the 1960s and 1970s, and 6.1 percent in the 1980s.

The low rate of domestic investment has limited growth in labor productivity and, consequently, growth in real wages. Since 1980, labor productivity has grown at less than half the rate observed between 1950 and 1979, and total real compensation (wages plus fringe benefits) per hour has grown at only one-eighth its previously observed rate.

UNDERSTANDING THE DECLINE IN SAVING

Table 1 reports average values of the net national saving rate for the 1950s, 1960s, 1970s, and 1980s as well as the first five years of the 1990s. The table also reports rates of government and household consumption out of output. In addition, the table reports my preferred measure of private-sector saving, the *household saving rate*, which equals the share saved of the output left over to the household sector after the government has consumed.

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[1] Under the Electronic Consumption Tax (the ECT), proposed in Kotlikoff (1995), households pass their ECT card through a card reader when they purchase goods and services. Monthly purchases (but not the composition of purchases) are tallied and transmitted to the IRS, which withholds taxes. On April 15th, the IRS calculates consumption over the previous calender year, assesses taxes based on a progressive rate structure, and makes tax refunds or withholds additional taxes depending on whether total monthly withholdings in the prior calender year exceeds or falls short of the household's annual tax liability. Since the IRS' withholding of taxes and refunds of overpayments can be made electronically, the ECT entails no use of tax forms.

As Table 1 indicates, government spending is not responsible for reducing the rate of national saving. Indeed, government spending in the 1990s has averaged just 21.0 percent of output—as low a rate as any observed in the five periods. The rate of household consumption spending, on the other hand, rose from 69.9 percent of output in the 1950s to 76.6 percent in the early 1990s. This increased rate of household consumption was associated with a decline in the household saving rate from 11.5 percent in the 1950s to 3.2 percent in the 1990s.

WHOSE CONSUMPTION HAS RISEN?

If the driving force behind the decline in U.S. saving is an increase in the rate of household consumption, it's natural to ask whose consumption within the household sector has risen so rapidly? The answer is the elderly's. Tables 2 and 3 document this fact.[2] They show a remarkable increase in the relative consumption of the elderly over four periods for which Consumer Expenditure Survey data are available. This increase is more pronounced if medical care is included in the measure of consumption, but the increase in the relative consumption of non medical goods and services is also striking.

As shown in Table 4, the striking increase in the relative consumption of the elderly has coincided with an equally remarkable increase in their relative resources.[3] Indeed, as described in Gokhale, Kotlikoff, and Sabelhaus (1995), the postwar decline in U.S. saving can be traced to two factors: (a) this redistribution of resources toward older generations, with high propensities to consume, from younger ones (including those not yet born), with low or zero propensities to consume and (b) increases in the propensity of the elderly to consume.

Much of the redistribution to the elderly reflects the growth in Social Security, Medicare, and Medicaid benefits. The increase in the elderly's consumption propensities may also reflect government policy, namely the fact that government transfers to the elderly come in the form of annuities. In providing these annuities, which are, of course, indexed for inflation, the government has, in effect, told the elderly they needn't worry as much about over-consuming and running out of income.[4]

IMPLICATIONS OF THE U.S. SAVING DECLINE FOR EVALUATING THE FLAT TAX

The fact that the government's past and ongoing intergenerational redistribution appears to be the chief culprit for the decline in U.S. saving is worth bearing in mind in considering switching from the income tax to the flat tax. Such a switch would partially offset this process of taking from the young and unborn and giving to the old. It would do so by placing a somewhat higher tax burden on the initial elderly and a somewhat lower tax burden on younger and future generations. In switching tax structures (and thus redistributing from the elderly with high propensities to consume to the young and unborn with low or zero propensities to consume), the government can engineer a reduction in aggregate consumption and a concomitant rise in national saving. This redistributional or "income" effects is the key reason that consumption taxation, in general, and the flat tax, in particular, raises national saving.

UNDERSTANDING WHY THE FLAT TAX TAXES CONSUMPTION

To understand why the flat tax taxes consumption and to place it in perspective, it may help to consider briefly the different tax bases available to the government and how their taxation affects saving decisions. Let's start by considering a government that wants to tax all of output (national income) at a fixed rate τ. To do so, it can levy a tax at rate τ on output as it is sold by firms to the private sector. Alternatively, it can levy a tax at rate τ on the factors of production—labor and capital—as they receive the proceeds from the sale of output in the form of wage income and capital income. A third possibility is to tax income recipients when they use their income to purchase consumption goods or acquire assets, i.e., when they save. Since what is saved is invested (i.e., saving equals investment), our hypothetical government can also tax income by taxing consumption plus investment.

A little algebra helps clarify the equivalency of these four different ways of taxing output. If we let Y stand for aggregate output or income, Yl for aggregate labor in-

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[2] These tables come from Gokhale, Kotlikoff, and Sabelhaus (1995).

[3] The term "resources" refers to a generation's net worth plus the present values its future labor income, pension income, and Social Security, Medicare, and other transfer payments, less the present value of its future taxes.

[4] In addition, the medical care annuities that the government provides through Medicare and Medicaid come in the form of in-kind consumption of medical goods and services which the elderly cannot help but consume.

come, Yk for aggregate capital income, C for aggregate consumption (including government consumption), S for aggregate saving, and I for aggregate investment, we have the following identities: Y = Yl+Yk = C+S = C+I. So taxing output Y at a flat rate, say τ, is equivalent to taxing both Yl and Yk at the rate τ, and both, in turn, are equivalent to taxing C plus S or C plus I at the rate τ.

But there is no requirement that governments tax all of output either directly, by taxing it when it is produced and sold, or indirectly, by taxing it when it is received as income or when it is used to purchase consumption or acquire assets (finance investment). Governments can, instead, choose to tax only a component of income. For example, they can choose to tax labor income, but not capital income. Or they can choose to tax only one use of income, say consumption, but not investment.

If a government chooses to tax consumption it can do so directly by taxing the purchase of consumption goods, or indirectly, either by 1) taxing income when it is received by individuals in the form of wage income and capital income, but allowing a deduction (or subtraction) for the saving these individuals do or by 2) taxing wage income at the personal level, taxing capital income at the business level (before it is paid out), but allowing a deduction at the business level for investment.

The equivalence of these ways of taxing consumption can be seen from our simple identity; Consumption C equals income Y minus investment S, but it also equals Yl plus the difference between Yk and I. This last point, that consumption equals Yl plus (Yk—I) indicates that flat tax is a consumption tax. Why? Because a flat tax taxes Yl by means of a personal wage tax, and it taxes Yk-I by means of a tax on business profits (revenues less the cost of intermediate inputs and wage payments, which is Yk) and a deduction for new investment (which is I).

WHY TAX CONSUMPTION?

Given that governments can tax consumption directly or indirectly and that they can do so either with progressive or proportional tax rates, why would they want to tax only output that is consumed and exempt from taxation output that is save (invested)? The answer is that a consumption tax provides more incentive to save (invest) than does an income tax. As our identity Y = C+S indicates, taxing output can be viewed as taxing saving as well as consumption. Now economists view saving, not as an end in itself, but as a means to finance future consumption. So by taxing consumption and saving, an income tax effectively taxes future consumption twice, once when households save funds for future consumption and once when they engage in that future consumption. Since current consumption is taxed only once (ignoring past taxes on saving because bygones are bygones), in deciding between consuming more now and saving for future consumption, an income tax provides an incentive, at any point in time, to consume more now and save less for the future.

In addition to providing better saving incentives, moving from an income to a consumption tax produces, as previously mentioned, an intergenerational redistribution away from older generations toward younger and future generations that also lowers aggregate consumption and raises national saving.

The reason this intergenerational redistribution occurs is that older generations pay a larger share of consumption taxes than they do of income taxes. Under an income tax, elderly retirees pay tax on only their capital income, whereas under a consumption tax, they pay tax on all their consumption purchases. Since elderly retirees finance their consumption by spending not just capital income earned on their net worth, but also the net worth itself (the principal) as well as private and social security pension benefits, the consumption of the elderly, taken together, exceeds their capital income. Moreover, the consumption of the elderly is a larger share of aggregate consumption, than their capital income is as a share of aggregate taxable income. Consequently, a shift from taxing income (including the capital income of the elderly), to taxing consumption (including that of the elderly), places a relatively higher tax burden on the elderly.

Economists refer to the change in economic behavior, such as saving, that arise from a change in one's resource position as income effects. They refer to changes in economic behavior due to changes in incentives, holding resources constant, as substitution effects. The above discussion indicates that the substitution and income effects of moving from income taxation to consumption taxation reinforce one another. Both work in favor of lowering aggregate consumption and raising national saving.

WHY CONSUMPTION TAXATION REPRESENTS A COMBINATION OF WAGE AND WEALTH TAXATION

The income effects from consumption taxation arise, in large part, because the consumption tax represents a combination of a tax on wages and a tax on wealth.[5] The reason is that the consumption goods and services that households purchase over time are ultimately financed by the wages they earn plus their initial wealth. Consider, for example, a millionaire who doesn't work, but spends his wealth on consumption. In the case of a direct consumption tax, such as a retail sales tax, the millionaire pays tax as he spends down his wealth; hence, the consumption tax effectively taxes his wealth. Now suppose the millionaire also works. Then when he spends his wage earnings, he also pays consumption taxes, so the consumption tax also effectively taxes wage earnings. If the millionaire chooses not to consume and passes his wealth to his heirs, they will be taxed when they spend their inherited wealth.

Since, as just mentioned, the elderly have a disproportionately large share of wealth, a switch from income to consumption taxation places a relatively large share of the tax burden on them. Although the consumption tax also, in effect, taxes wage income, which is also taxed under the income tax, it does so at a lower rate than under the income tax because the consumption tax gets more revenue from the wealth tax component. Hence, the young, who are disproportionately larger earners of labor income, benefit from the shift from income to consumption taxation because their effective rate of wage taxation is reduced.

The reduction in the effective rate of wage taxation stimulates labor supply, thereby raising output and further increasing aggregate saving. This stimulus to labor supply will be even greater if the switch in tax structures is from a progressive income tax to a consumption tax. Why? Because the incentive to work depends on the marginal rate of taxation of labor supply, not the average rate. Under progressive income taxation, the marginal effective rate of taxation of labor supply is higher than under a proportional income tax, which is higher still than under a consumption tax.

UNDERSTANDING HOW THE FLAT TAX TAXES WEALTH

The flat tax, at least the one originally designed by Hall and Rabushka, encompasses a one time effective tax on real wealth. Under the flat tax, as under our current income tax structure, the sale, by businesses (really, by the owners of businesses), of their real assets (their plant, equipment, and inventories) is included in the calculation of business revenues and is subject to tax. But, unlike the current tax structure, the flat tax permits no deduction of the basis of the asset when it is sold. If the basis of the asset could be deducted, the flat tax, like our current income taxation of businesses, would be taxing simply the capital gains realized by businesses on the sale of their real assets. Why? Because capital gains are calculated as the difference between the sale price of the asset and its depreciated tax basis.

Can owners of real assets avoid the additional tax arising from not being able to deduct basis by simply not selling their asset, but instead, continue to use them to produce business income? The answer is no. The market value of real assets will fall to the point that the owners of the assets will be indifferent between retaining and selling their assets. This decline in the market value of existing real wealth (which will be registered on the stock market) represents an effective tax on real wealth.

To understand why the market value of real business assets must fall, consider an investor, ABC Co., which is considering purchasing a newly produced real asset, say a drill press, for $1000 or buying an existing business, DEF Co., with, for simplicity, a single asset—an identical drill press which it had purchased prior to the switch to the flat tax and which has a basis of $1000. Assume, for simplicity, that drill presses do not physically depreciate, so the two machines are physically identical. If ABC purchases the new drill press, it can immediately expense it (deduct

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[5] To see this algebraically, note that at time t, $C_t = Yl_t + Yk_t - S_t$. But, if we let W_t stand for wealth at time t, then $Yk_t = r_t W_t$, where r_t is the rate of return earned on wealth (i.e., $r_t W_t$ equals capital income). Also, $S_t = W_{t+1} - W_t$. Hence, $C_t = Yl_t + r_t W_t - W_{t+1} + W_t$. Write this equation out for time t+1, t+2, etc., and then use the t+1 equation to substitute out for W_{t+1} in the time t equation, to get a new time t equation that will depend on W_{t+2}. Next use the time t+2 equation to substitute out for W_{t+2} in the new time t equation. Proceding in this manner leads to an equation in which the present value of consumption equals the present value of current plus future labor earnings plus initial wealth. Multiplying each side of this present value budget constraint by the tax rate t shows that taxing consumption through time at rate τ is equivalent to taxing earnings through time at rate τ plus taxing initial (time t) wealth at rate τ.

its purchase price from its business income). If the flat tax rate is 20 percent, the value of the write off is $200. If ABC purchases DEF, it acquires the same machine, but can't expense it. Consequently, the market value of DEF must fall until ABC and other potential investors are indifferent between purchasing DEF directly and purchasing the same real asset owned by DEF, but expensing it. Hence, the market value of DEF will be $800.

Now, if ABC purchases and then liquidates DEF, it will be to sell DEF's drill press on the market for $1000, because the new owner can treat the press as a new asset and expense it. But in selling the drill press, ABC will produce $1000 in sales revenues for its subsidiary, DEF, and, thus, a $200 tax liability. Hence, in liquidating DEF, ABC will end up with $800. So whether ABC buys DEF to hold it or to liquidate it, the most it will pay is $800. If it tries to buy DEF for less than $800, the owners of DEF will refuse, because they will be able to find other buyers willing to pay $800. Hence, the market price of DEF will be $800.

THE IMPORTANCE OF IMPLICIT WEALTH TAXATION

Note that if the flat tax is modified from the original Hall/Rabuskha proposal, which taxed, at the business level, all sale proceeds (including sale of old capital) less purchases from firms (including purchases of new capita) and wages, to one which allows firms to deduct the basis in their old capital when it is sold, the outcome will be quite different. Now the sale of old capital will engender a tax on the sale proceeds, but be accompanied by a deduction of the basis of equal value, so that, in effect, only the capital gain on the old capital is being taxed. In this case, in which there is a very strong incentive to sell old capital to new owners who can deduct it, the market value of old capital doesn't fall and, consequently, the effective taxation of wealth does not arise. Without this effective taxation of wealth, the flat tax produces a much smaller reduction of consumption and, consequently, a much small increase in aggregate saving.

Indeed, devoid of its effective taxation of wealth, a flat tax or any other "consumption tax" simply ends up taxing wages. Note that the switch from income to wage taxation redistributes from the young to the old, since the elderly have relatively little wage income, but benefit from the elimination of capital income taxation. Although a wage tax structure provides better incentives to save, its income effects work to reduce saving. Indeed, the net impact, according to simulation studies (see Auerbach and Kotlikoff, 1987) of a switch from income to wage taxation is a relatively modest increase in aggregate saving, investment, and output. It follows that permitting firms to deduct the basis of their old capital at the time it is sold greatly undermines the case for the flat tax.

THE SIZE OF IMPLICIT WEALTH TAXES AND THE IMPACT ON INTEREST RATES

The precise extent to which the market value of old capital may decline as the result of implementing the original Hall-Rabushka flat tax proposal depends on a number of factors. One of these is the size of the current basis of the asset. Since the deduction of basis is being precluded, the larger an asset's basis, the larger will be the decline in its market value. A second factor is the rate of taxation that will prevail under the flat tax. The lower this rate, the smaller will be the advantage of expensing new capital and, consequently, the smaller will be the market discount of old capital. A third factor is the extent of costs of adjusting the level of business capital stocks. If these costs are high and investment is positive, old capital will, other things equal, sell at a premium, relative to new capital for the simple reason that it is already installed; i.e., business do not need to install old capital (and incur adjustment costs) in order to use it in production.

In addition to lowering the market value of old capital and, thus, the market value of equity (the price of stocks), the flat tax may reduce the market value of existing debt (the price of bonds). The depends, in part, on monetary policy and, in part, on what happens to interest rates. If the money supply is not increased beyond what would otherwise have been the case, we should see no additional rise in the price level associated with the introduction of the flat tax and, consequently, no watering down of the real value of outstanding nominal debts.

In the case of interest rates, a rise in which would lower bond prices, there are at least four important factors at play. First, the increase in investment induced by the shift to the flat tax would, over time, raise the stock of capital above levels that would otherwise prevail. These higher levels of capital will raise the productivity of labor, but lower that of capital. This factor will depress interest rates, primarily medium and long-term interest rates. The second factor is the reduction in the rate of business taxation which means that companies will be able to pay a higher return to their lenders. This factor will serve to raise short- as well as medium- and long-

term interest rates. The third factor is the elimination of business' ability to deduct interest payments. This factor will reduce short-, medium-, and long-term interest rates because it will limit the amount of after-tax income firms can pay their lenders. The fourth factor is the ability of firms to expense their investment. This tax saving represents another source of after-tax income that firms can pay their lenders (and will be forced, by competition, to pay their lenders). This factor will serve to raise short-, medium-, and long-term interest rates.

What will be the net impact of these four factors on interest rates? It's hard to give a precise answer without some more detailed analysis, but my sense is that interest rates will, on balance, rise as the result of introducing the flat tax, although probably not by more than 100 basis points.

The flat tax is also likely to produce a decline in the market value of housing. The reason is that, under the flat tax, the consumption of housing services will no longer be tax-favored as it is under the income tax. Under the income tax, the implicit rental income that homeowners earn by living in their homes escapes taxation because the government does not impute and add this income to homeowners' adjusted gross incomes prior to assessing their income taxes (i.e., this form of capital income escapes income taxation). Under the flat tax, personal capital income taxation is eliminated, so the receipt of imputed rent on owner-occupied housing is no longer tax-favored relative to the receipt of other forms of capital income. Although the flat tax will not alter the market value of newly built versus old homes, it will make home ownership relatively less advantageous than other forms of consumption. Consequently, the demand for homes will decline and this will, in the short run, put downward pressure on house values given that the existing supply of homes cannot costly be reduced, at least in the short run.

EFFICIENCY GAINS FROM CONSUMPTION TAXATION

The current tax system contains a number of distortions which also could be eliminated by switching to the flat tax or other forms of consumption taxation. One of these distortions is the differential tax treatment of corporate and noncorporate business that distort business ownership and control decisions. A second is the differential tax treatment of capital gains and dividends that distort firms' decisions about retaining earnings and that lock investors in from selling shares of stock which have accrued capital gains. A third is the aforementioned implicit subsidy to home ownership, as well as automobiles, and other durable goods that arises from our failure to tax, under the income tax, the rental income we implicitly earn from the services on these durables.[6] A fourth is the subsidization of current relative to future consumption (the tax on saving) associated with the taxation of capital income. A fifth is the differential tax treatment of investment in equipment, structures, and inventories. A sixth is the distortion in corporate financial structure due to the deductibility of interest payments, but the nondeductibility of dividends. And an seventh is the subsidization of health insurance premia and other fringe benefits that are currently exempt from income taxation, but would be treated like wage compensation under most consumption tax proposals.

The distortion of labor supply incentives associated with income taxation would also be eliminated by the proposed tax shift. But a consumption tax would distort this margin of choice as well, so one needs to compare the efficiency gains from eliminating the income tax's distortion of labor supply with the efficiency loss from adding the consumption tax's distortion of labor supply. There is good reason, however, to expect the tax shift to result in a net reduction in the distortion of labor supply. The reason, as mentioned above, is that consumption taxation will extract a larger share of its revenues from older generations, many of whom are retired. As a result, the total tax that needs to be collected from working generations is smaller under a consumption tax than it is under the income tax.

The distortion of labor supply will also be substantially reduced if our progressive income tax rate is replaced by the flat tax because the flat tax will leave most workers facing significantly lower total effective marginal tax rates on their labor supply than is currently the case. The size of economic distortions of particular economic activities rises with the square of the total effective marginal tax rate on that activity. In the case of labor supply, most Americans face marginal taxes above 50 per-

[6] To see this, suppose homeowners, owners of automobiles, and owners of other durables were forced to pay rent to themselves for their use of their homes, cars, furniture, etc. At one level, this would be a wash, since the person writing the check would also be the recipient of the check. But this requirement would raise households' taxable income, leading them to pay more income taxes. Does it make sense to think of, say, a home owner as renting her house to herself? The answer is yes since in occupying her house, the home owner is effectively earning the rent on the house and then spending it on herself.

cent on their earnings once one adds together the effects of all the different tax and transfer programs at the federal, state, and local government levels. This is an extremely high level of marginal taxation, which is highly distortive. The flat tax's reduction in this rate of taxation, like that of other proportional consumption taxes, represents a very strong argument for its adoption, indeed.

THE AUERBACH-KOTLIKOFF DYNAMIC LIFE CYCLE SIMULATION MODEL[7]

The Auerbach-Kotlikoff Model (henceforth, the AK model) can provide some sense of the potential saving, investment, and growth effects of shifting to a proportional consumption tax, such as the flat tax.[8] The AK model calculates the time-path of all economic variables in its economy over a 150 year period. The model has 55 overlapping generations. Each adult agent in the model lives for 55 years (from age 20 to age 75).

There are three sectors in the model: households, firms, and the government. Households (adult agents) make decisions concerning how much to work and how much to save based on the after-tax wages and after-tax rates of return they can earn in the present and the future on their labor supply and saving, respectively. The work decision involves not only deciding how much to work in those years that one is working, but also when to retire. The AK model's particular form of consumption and leisure preferences that agents use in making their labor supply and saving decisions were chosen in light of evidence on actual labor supply and saving behavior.

As agents age in the model, they experience a realistic profile of increases in wages. This age-wage profile is separate from the general level of wages, the time-path of which is determined in solving the model. Fiscal policies affect households by altering their after-tax wages, their after-tax rates of return, and, in the case of consumption taxes, their after-tax prices of goods and services. The model is equipped to deal with income taxes, wage taxes, capital income taxes, and consumption taxes. It is also able to handle progressive as well as proportional tax rates.

All agents are assumed to have the same preferences, so differences in behavior across agents arise solely from differences in economic opportunities. Since all agents within an age cohort are assumed to be identical, differences in economic opportunities are present only across cohorts. In this study, the model's population growth rate is set at a constant 1 percent rate, with the population of each new cohort being 1 percent larger than that of the previous cohort.

The AK Model's production sector is characterized by perfectly competitive firms that hire labor and capital to maximize their profits. The production relationships that underlie firms' hiring decisions and production of output are based on empirical findings for the U.S. The government sector consists of a treasury that collects resources from the private sector to finance government consumption and an unfunded, "pay as you go" Social Security system which levies payroll taxes to pay for contemporaneous retiree benefit payments. The model does not distinguish federal from state and local government. Hence, in simulating with the model the elimination of income taxation in favor of consumption taxation, we will, in effect, replace all state and local income taxes, as well as federal income taxes, with a federal consumption tax which can be thought of as a federal flat tax. There is no money in the model, and thus, no monetary policy. There is, however, government debt, and the model can handle deficit-financed tax cuts. It can also handle gradual phase-ins of one tax for the other.

While the model handles a great number of complex processes, its predictions need to be viewed cautiously for several reasons. First, the model does not deal with several of the real world distortions associated with the income tax that were mentioned above. For example, it doesn't distinguish corporate from noncorporate production, housing consumption from non housing consumption, different forms of corporate finance, different types of investment, or differences in capital gains and dividend tax rates. Nor does it permit the kind of tax arbitrage that is available to most tax-paying Americans through tax-subsidized saving accounts. Second, the model's agents are heterogeneous only with respect to their age. There are no welfare recipients or millionaires, whose saving and work behavior might differ dramatically from that of the model's agents. Third, the model does not include saving for purposes

[7] This section presents the results reported in Kotlikoff (1992) of simulations of a switch from federal income taxation to a retail sales tax. Because a retail sales tax is equivalent to a flat tax of the type originally proposed by Hall and Rabushka, the simulation findings apply to the flat tax as well. The simulations are highly stylized. They do not, for example, take into account proposed exemptions from taxation as well as a number of other features of the flat tax proposals recently advanced by Congressman Armey and Senator Specter.

[8] For a detailed description of the AK Model see Auerbach and Kotlikoff (1987).

other than retirement, such as bequests. Fourth, the model does not incorporate uncertainty either with respect to individual or macroeconomic outcomes. Fifth, the model ignores illegal tax avoidance, an issue that would certainly arise in implementing a flat tax or any other form of consumption taxation. While the model abstracts from a significant portion of reality, it can, nonetheless, suggest the degree to which a switch from consumption taxation to income taxation might raise U.S. national saving.

SIMULATING THE SWITCH FROM PROPORTIONAL INCOME TO PROPORTIONAL CONSUMPTION TAXATION

In simulating the switch from income taxation to a federal consumption tax, one needs to specify the economy's initial position as well as the way the tax change takes place. To begin, let's assume that the economy has a 15 percent proportional income tax and a 17 percent sales tax. The 15 income tax figure is based on the 1991 ratio of the sum of federal, state, and local personal and corporate income taxes to net national product. The 17 percent sales tax figure is based on the 1991 ratio of the sum of federal, state, and local sales and excise taxes to total personal consumption.6 These taxes are used to finance government consumption spending as well as pay interest on the government debt. The level of government debt is set at 50 percent of output.7 In addition to these features of fiscal policy, the economy is assumed to have a "pay-as-you-go" social security system with a 15 percent payroll tax rates.

FINDINGS

Table 5 shows the transition-path of the economy that results from replacing in year 0 the model's income tax with a proportional consumption tax. I set the new federal consumption tax rate (the flat tax rate) at the level needed, in conjunction with the pre-existing 17 percent sales tax, to continue to finance the same level of government spending as well as pay interest on the stock of government debt. The first row in the table indicates the economy's initial (year 0) position. With no change in tax policy the economy would remain in this position through time. I measure annual saving rates, annual interest rates, and tax rates in percentage points. In the case of our economy's other variables, the units of measurement are arbitrary, so I describe each of these variables in terms of an index which has an initial (base-year) value of 100.

The initial position of the economy features a 2.6 percent saving rate, a per capita capital stock of 100, a per capita labor supply of 100, a level of per capita output of 100, a real wage rate of 100, a real interest rate of 9.4 percent and, of course, a zero federal consumption tax rate. The 2.6 percent saving rate is close to the current U.S. rate of saving, and the 9.4 percent real interest rate is close to the annual real rate of return that has been earned, on average, on the U.S. capital stock in the postwar period.

The remaining rows in Table 5 show how each of these variables reacts to the introduction at time 0 of the federal consumption tax. As row 1 indicates, the tax change produces an immediate and dramatic increase in the economy's saving rate from 2.6 percent to 9.0 percent. While the saving rate gradually declines after year 1, it remains above 6 percent through the tenth year of the transition. The long-run (year 150) value of the saving rate is 3.2 percent—23 percent larger than the year 0 value.

The increased saving produces a concomitant increase in investment. As a result, the capital stock rises. Indeed, the switch in tax regimes leads, eventually (by year 150), to a 34 percent increase in the per capita capital stock. The increase in the capital stock is gradual; only about one quarter of the ultimate increase occurs in the first 10 years of the transition. The increase in the capital stock raises the productivity of workers and thus their real wage. The policy also lowers the return to capital. The real interest rate falls by almost 200 basis points in the course of the transition.

While the real wage ultimately ends up 7 percent higher than it would have been without the tax change, for the first few years of the transition the real wage actually falls. The reason is that agents respond to the prospect of higher real wages and higher short-term real interest rates by increasing their labor supply. In the short run, before the capital stock has had much of a chance to increase, there is an increase in the supply of labor relative to the supply of capital. As a result, labor in the first few years of the transition becomes relatively abundant, meaning that the price it receives in the market—the real wage—falls. Eventually, as interest rates fall, the incentive to work more in order to save more and receive higher rates of return on the additional savings diminishes. As a result, labor supply declines.

In the long run, the supply of labor is only one percent greater than it is in year 0.

The changes in the supplies of capital and labor alter the per capita level of output. Between year zero and year 1, there is a 4 percent increase in output. In the following 10 or so years the switch in the tax structure raises the economy's growth rate by two tenths of one percent per year. In the long-run, the level of per capita output is 8 percent larger than it is at time 0.

The final variable to discuss is the consumption tax rate. The year 1 value of this tax rate is 23.1 percent. But it declines through time, with its value in the long-run ending up at 16.7 percent. The reason the tax rate can decline is that the growth of the economy permits a higher level of consumption and thus produces a higher consumption tax base. In addition, the reduction in the interest rate lowers required interest payments on the government's debt.

To summarize the findings in Table 5, the simulation of a switch to a federal consumption tax produces a significant increase in saving, capital accumulation, the real wage, and the level of per capita income. While the dynamics are nonlinear (e.g., labor supply first rises and then falls), all of the results make intuitive sense.

MAINTAINING A CONSTANT CONSUMPTION TAX RATE

As an alternative to having the consumption tax rate decline through time, we might want to have a tax rate that is constant through time. I've used the model to simulate such a policy. I've found that if I set the tax rate equal to 19 percent, the model produces deficits in the short-run, since the additional tax revenue raised with the 19 percent tax falls short of the loss in revenue from eliminating the 15 percent income tax. But over time, the growth of output and the consumption tax base associated with the reform raises the amount of revenue collected by the 19 percent tax permitting the full retirement of the additional debt that is issued in the short-run. In this constant tax rate simulation the long-run capital stock and output levels are 32 percent and 7 percent higher than their respective year 0 values. These long-run percentage increases may be compared with the 34 percent and 8 percent increases of Table 5.

ARE THE RESULTS REASONABLE?

Given the size of the model's predicted response to a switch to a consumption tax, one might ask whether the results are really plausible or whether they simply reflect some extreme assumptions about labor supply and saving behavior. The answer is that the labor supply and saving responses assumed in the model are quite conservative. They are certainly well within the range of responses that have been estimated in the empirical economics literature. In addition, the life cycle model being simulated is the basic bread and butter model of neoclassical economics.

There is, however, one feature of the model which may make the transition occur faster in the model than it would in the real world. This is the model's assumption that new capital can be immediately added to the existing stock of capital without the incursion of installation costs. As discussed in Auerbach and Kotlikoff (1987), the addition of such installation costs would slow down the transition, but would not alter the size of the long-run change of any of the economy's variables.

Another issue, with which I have not yet dealt, is the progressivity of the income tax which is to be replaced. As mentioned, the AK model can handle progressive as well as proportional tax rates. In the case of a progressive income tax, whose degree of progressivity is roughly comparable to that now in the U.S., the year 0 position of the economy from which the transition begins is one featuring a 2.2 percent, rather than a 2.6 percent, saving rate, a per capita capital stock that is 18.1 percent smaller, a per capita labor supply that is 5.2 percent smaller, a per capita output level that is 8.6 percent smaller, a real wage that is 3.5 percent smaller, and an interest rate of 10.4 percent rather than 9.4 percent. Since the switch from this progressive income tax regime to a proportional consumption tax produces the same long-run outcome as indicated in the last row of Table 6, the saving, capital accumulation, and growth effects of the tax change are all magnified by assuming that the initial income tax is progressive. For example, the long-run increase in the per capita capital stock is 63.4 percent, and the long-run increase in per capita output is 18.3 percent.

THE IMPACT ON THE INITIAL ELDERLY

While switching to a consumption tax has a lot to recommend it, this does not include the treatment of the initially elderly who, as mentioned, end up paying much more in consumption taxes than they would have paid in income taxes. For example, in the simulation of Table 5, the oldest elderly in year 1, those who are

age 55, suffer a 23 percent decline in their final year's consumption. There are different ways to avoid, or at least mitigate, this redistribution away from those who are old at the time of the switch in tax structures. One is to make additional transfer payments to the initial elderly by, for example, raising social security benefits. The problem with making transfer payments to the initial elderly is that these transfer payments will lead them to consume more and this additional consumption will limit the increase in saving and capital accumulation.

Table 6 points this out. It shows the transition arising from an immediate switch to a retail sale tax, but one in which the government makes transfer payments to all generations alive at the time of the transition to ensure that none of these generations is made worse off from the tax switch. These transfer payments are, of course, largest for the oldest generations alive at the time of the tax switch, since they do not benefit as much from the elimination of income taxes as do younger generations. While the provision of this compensation to initial generations limits the additional saving generated by the consumption tax, there remains, nonetheless, a substantial saving response. According to Table 6, there is a 22 percent increase in the economy's long-run capital stock. While this is less than the 34 percent increase of Table 5, it is still quite substantial. With the compensation scheme in place, the long-run increase in per capita income is 6 percent (compared with 8 percent with no compensation). The fact that one can compensate initial generations in switching to a federal consumption tax and still make future generations significantly better off is reflective of the inefficiency of an income tax structure relative to a consumption tax structure.

SUMMARY AND CONCLUSION

Our nation is facing a grave crisis with respect to its rate of saving. We are saving at record low levels, and unless we start saving more, we will continue our slide toward second-class economic status. A shift to consumption taxation, be in the form of a flat tax, a retail sales tax, a value-added tax, the Electronic Consumption Tax, or a personal consumption tax, has the potential for dramatically increasing our saving rate. It would do so by improving incentives to save and redistributing from the elderly with high propensities to consume to young and future generations with low or zero propensities to consume.

In addition to raising saving and investment, consumption taxation would reduce many of the distortions of the current tax system. Indeed, the distortion of saving behavior alone is so great under our current system of income taxation that it appears we could switch to consumption taxation, fully compensate the initial elderly for their higher tax burden, and still end up with a much higher rate of saving, capital accumulation, and level of per capita income.

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Table 1.—Saving and Spending Rates

Period	Net National Saving Rate (Y-C-G)/Y	Government Spending Rate G/Y	Household Consumption Rate C/Y	Household Saving Rate (Y-G-C)/(Y-G)
1950–59	091	.210	.699	.115
1960–69	091	.221	.688	.117
1970–79	085	.214	.701	.108
1980–89	047	.213	.740	.059
1990–94	027	.207	.766	.031

Y stands for net national product, C stands for household consumption expenditure, and G stands for government purchases of goods and services.

Table 2.—Consumption of the Elderly Relative to the Young

Comparison	1960–61	1972–73	1984–86	1987–90
Age 60/Age 20	1.17	1.37	1.58	1.59
Age 70/Age 20	0.97	1.21	1.56	1.64
Age 80/Age 20	0.89	1.16	1.61	1.60
Age 60/Age 30	0.86	0.93	1.09	1.15
Age 70/Age 30	0.71	0.82	1.07	1.18
Age 80/Age 30	0.65	0.79	1.11	1.16
Age 60/Age 40	0.77	0.83	0.87	0.91
Age 70/Age 40	0.64	0.73	0.86	0.94
Age 80/Age 40	0.58	0.70	0.89	0.92

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 3.—Non Medical Consumption of the Elderly Relative to the Young

Comparison	1960–61	1972–73	1984–86	1987–90
Age 60/Age 20	1.11	1.28	1.43	1.42
Age 70/Age 20	0.86	1.04	1.22	1.28
Age 80/Age 20	0.75	0.91	1.16	1.11
Age 60/Age 30	0.81	0.86	0.97	1.02
Age 70/Age 30	0.63	0.70	0.83	0.91
Age 80/Age 30	0.55	0.61	0.78	0.80
Age 60/Age 40	0.73	0.78	0.77	0.80
Age 70/Age 40	0.57	0.63	0.66	0.72
Age 80/Age 40	0.49	0.55	0.62	0.63

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 4.—Resources[1] of the Elderly Relative to the Young

Comparison	1960–61	1972–73	1984–86	1987–90
Age 60/Age 20	1.10	1.41	1.72	1.81
Age 70/Age 20	0.85	1.14	1.49	1.58
Age 80/Age 20	0.63	0.71	0.76	0.83
Age 60/Age 30	0.92	1.07	1.26	1.31
Age 70/Age 30	0.72	0.86	1.09	1.15
Age 80/Age 30	0.53	0.54	0.56	0.60
Age 60/Age 40	0.82	0.95	1.05	1.10
Age 70/Age 40	0.64	0.77	0.91	0.96
Age 80/Age 40	0.47	0.48	0.47	0.51

[1] Resources refers to net worth plus the present values of future labor income, private and government pension benefits, and government transfer payments less the present value of government taxes.

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 5.—Simulating An Immediate Switch From Income Taxation to a Consumption Tax

Year	Saving Rate	Capital [1] Stock Index	Labor [1] Supply Index	Output [1] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	9.0	100	105	104	99	9.7	23.1
2	8.5	102	105	104	99	9.6	22.5
3	8.1	105	105	105	100	9.4	21.9
4	7.8	107	105	105	100	9.2	21.5
5	7.5	109	104	105	101	9.1	21.1
10	6.2	117	103	106	103	8.5	19.5
20	4.5	127	101	107	106	7.9	17.9
60	3.7	131	101	108	107	7.8	17.3
90	3.2	134	101	108	107	7.5	16.8
150 [2]	3.2	134	101	108	107	7.5	16.7

[1] The capital stock, labor supply, and output are per capita measures.
[2] Year 150 represents the economy's final steady state.

Table 6.—Simulating An Immediate Switch From Income Taxation to a Consumption Tax But Compensating Initial Elderly for their Increased Tax Burden

Year	Saving Rate	Capital [1] Stock Index	Labor [1] Supply Index	Output [1] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	6.6	100	104	103	99	9.7	22.1
2	6.4	101	104	104	99	9.5	21.8
3	6.3	103	104	104	100	9.4	21.5
4	6.1	104	104	104	100	9.3	21.2
5	5.9	106	104	104	100	9.2	21.0
10	5.1	111	103	105	102	8.8	19.9
20	4.1	118	102	106	104	8.4	18.7
60	3.0	122	101	106	105	8.1	17.8
90	3.0	122	101	106	105	8.1	17.8
150 [2]	3.0 122	101	106	105	8.1	....	17.8

[1] The capital stock, labor supply, and output are measured per capita.
[2] Year 150 represents the economy's steady state.

PREPARED STATEMENT OF HON. CONNIE MACK

Today, the Committee has heard from many distinguished thinkers about the need for a flat tax. They have made arguments about fairness, simplicity, cost, and class warfare. They are all right: the flat tax will improve today's tax system in too many ways to count. But the most important benefit the flat tax has to offer is unparalleled economic growth.

In the last 30 years, our economy has slowed to well below its historic growth rate of 4 percent, and that has hurt the standard of living for every American. This chart illustrates what the "growth gap" has meant. The numbers really do sound unbelievable, but compared to real growth of 4%, the economy is $2.5 trillion smaller than it would have been—which means $40,000 a year less in the pockets of a family of four.

The flat tax is such a fundamental change from the way government does business today that there are no economic models which accurately calculate its impact

on economic growth. Nobody—not CBO, not OMB, not the Treasury Department, not the Joint Committee on Taxation—has predicted the dynamic potential of the flat tax.

I am absolutely convinced that the facts are our allies in this struggle, and we will need all the information we can muster in our battle with the guardians of the status quo. As Chairman of the Joint Economic Committee I commit to the members of this Committee that I will use the resources at my disposal to give us better information on the effects of the flat tax on individual behavior, corporate behavior, and the economy in general. In short, the information we need to make an informed decision.

I applaud you, Mr. Chairman, for holding this important hearing. Under your guidance in 1986, we began to reform the tax system by lowering high marginal tax rates and broadening the tax base.

Unfortunately, the marginal income tax rates that were limited to 15 and 28 percent only a few years ago, now reach as high as 45 percent. Tax rates affect people's incentive to work and invest. The amount of after-tax income they get to keep determines whether they work overtime, seek out tax shelters, or simply stay home.

As Americans struggle to complete their tax returns by April 17, it is appropriate to consider the failings of today's tax system. It punishes work, savings and investment through high marginal tax rates and double taxation. It hinders the full productive potential of our economy and every American's efforts to achieve a higher standard of living. It is too complex. It is inefficient, inequitable, and costly for both individuals and government.

I believe we need a single, low-rate flat tax.

The flat tax would spur unprecedented economic growth by eliminating destructively high marginal tax rates and boosting investment, productivity, wage growth, and the standard of living. This is not idle speculation. When Presidents Kennedy and Reagan lowered marginal tax rates, the economy boomed.

The flat tax would radically reduce the cost of complying with the tax code, costs currently imposed on every individual and business. People would finally be able to easily calculate what they owe in taxes. The IRS would no longer publish 480 different tax forms. Taxpayers wouldn't have to wade through 1,378 pages of tax code and 6,439 additional pages of federal tax regulations.

The flat tax would end the economic damage caused by the current system. Today, the graduated income tax demands an increasing share of people's hard work and success. It's no wonder Americans feel they are working longer and harder with nothing to show for it—they are! Under a flat tax, class warfare would end. People would be treated equally under the law, and all taxpayers would be treated fairly.

No doubt, some will try to kill the flat tax to preserve the status quo. For eighty years, the tax code has grown to accommodate the demands of special interest groups. Over time, taxpayers have come to feel dependent on these tax credits and deductions for their economic survival. However, once marginal tax rates are drastically reduced, today's deductions will be unnecessary for everyday taxpayers.

A low-rate flat tax would allow people to keep more of their own hard-earned money, decide for themselves how to use it, and not grovel for lower taxes by conforming to a list of approved uses dictated in Washington. Under the flat tax, government would finally stop tinkering with people's lives through the tax code.

Americans are working longer and harder to improve their lives, but their efforts are being eroded by our outdated and punitive tax code. With the flat tax, we have the chance to free our economy and secure for our children and grandchildren a better standard of living. I embrace that goal, and will work to make that dream a reality.

JONES, DAY, REAVIS & POGUE

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April 12, 1994

Hon. Daniel Patrick Moynihan
Senate Office Building
Washington, D.C. 20510

Dear Pat,

I have just filed my tax returns for 1993, by mail. As I have mentioned in writing to you previously, it seems to me that our government makes unreasonable demands on its citizens -- not in terms of the aggregate amount of money which they are called upon to pay, but rather because of the enormous amount of paperwork which is required in the process.

My filings included nine separate returns, sent to six different addresses. These include Social Security returns and Unemployment Insurance returns (all on a quarterly basis) as well as the Federal and D.C. Income Tax Return, and the Federal and D.C. Estimated Tax Return for 1994. Since the Social Security and Unemployment taxes are all the result of my wife's disability, it seems to me that a case could be made that we should rather receive an appropriate credit for providing employment to others who need it.

Near my desk here, I have a federal tax file which is three inches thick, and (I estimate) contains more than six hundred pieces of paper. I will have to keep this for several years, in order to be able to respond to any questions which may arise. In addition to the federal tax itself, the booklet supplied to taxpayers contains not only Form 1040 with many schedules, and references to other schedules, which must be applied for, but there are forty-nine pages of "Instructions," which must be carefully examined. These forty-nine pages are mostly three columns each of small print. I estimate that there are at least 1,225 worlds per page. This brings the total of "Instructions" to a total of 50,000 words. But, in addition to the Instructions, there are over thirty-six pages relating to various schedules. The grand total of material accompanying the return is at least 94,000 words, the equivalent of a moderate-sized book.

These Instructions include a great number of "worksheets." I am enclosing Xerox copies of two of these, both of which must

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be virtually incomprehensible to the ordinary citizen. In particular, I call to your attention the Itemized Deductions Worksheets on page A-5, where you multiply a line by 80%, and then four lines farther along you multiple a line by 3%, all to get a figure which must be quite beyond the understanding of those taxpayers who have to use it, and of the many others who have to find their way through it to see if it is something they have to use in order to complete their returns.

The net result is an enormous task, at which I spent just short of a hundred hours. Among other things, if you find, on checking, that a mistake has been made somewhere in the process of filling out the return, then the whole thing has to be done over again, including all of the complicated computations.

I do not blame the Internal Revenue Service for this extreme complexity. They have no choice. They have to take the law as it is written by Congress. I do think that Congress has failed to meet its basic responsibility to enact legislation that is reasonably comprehensible, and then not to change the statute too often. This was a role which Wilbur Mills handled very carefully and skillfully, but it has been almost completely neglected in recent years. The key man on this is the Chairman of the Ways and Means Committee of the House of Representatives, but the Chairman of the Senate Finance Committee can also have a very considerable impact on it.

Much of the problem goes back to the "reorganization" of Congress which was carried out close to fifty years ago under the leadership of the younger Senator LaFollette from Wisconsin. He was trying to get away from the "Solid South," and the domination of the two Houses of Congress by a few Southern members, who, in effect, had life terms. The net result of the change then made, though, was to weaken the leadership so that there are now 535 different and essentially independent parties in Congress. Each member has his own responsibility for fund-raising, and the result is that there is very little party leadership in Congress. This of course makes it very difficult for Committee Chairmen.

For example, the problem with respect to the Itemized Deductions Worksheet arises because some members (or the Treasury) wanted to save some part of the tax involved by the deductions allowed by Schedule A without "raising rates." So we have this frightfully complex computation, which is quite unfathomable to most taxpayers. I mention Schedule A only as an illustration. There are many other places where the computations are incomprehensible to ordinary citizens. This Form, and the many other Forms that are required, create a bitter feeling among our citizenry.

For better or for worse, I am one of those who keep his own records and makes out his own tax return. Practically everyone else, whether of substantial or modest income, feels that he must use a "tax advisor" or consultant, at considerable aggregate cost -- which cost is deductible in determining the tax. The reason that I make out my own return is that I have been doing so for more than sixty years. I started when the tax could be comprehended, and have not been willing to stop. It is only in the past eight or ten years that the task has become _very_ burdensome. I could have my returns prepared by an accountant, but I figure that it would be nearly as much work for me to gather together the necessary factual material as it is for me to make out the returns. Moreover, I resent the fact that my government forces me to use an accountant for such a matter, particularly when my career in law has been largely in the tax field, and I taught federal taxation in law school for a third of a century, between 1934 and 1967 and published the first casebook devoted solely to Federal Taxation. Paying an accountant to do the work seems to me to be a little like the civil War practice of hiring a substitute in order to avoid the draft. That does not look very good today, and so it is with a system which forces many taxpayers to have their returns made out by people with the most sophisticated computers.

And now the Treasury, with reason, is about to require more paper in order to meet the new rule that there must be a signed receipt for a high proportion of charitable contributions, including a statement that no benefit is received. These receipts must then of course be retained for a number of years.

I venture to suggest that, somehow or other, a better solution to these problems must be found. A tax law can never be as precise as the drafters have been trying to make it over the past several years. It is my earnest hope that the Ways and Means Committee, and the Finance Committee, through the energetic enterprise of their respective chairmen, will take steps to simplify this whole operation, making it possible for the ordinary citizen to comply with his responsibilities, and understand what he is doing in the process.

Keep up the good work.

With best wishes,

Very truly yours,

Erwin N. Griswold

IRA Worksheet 2—Lines 24a and 24b (keep for your records)

1. If you checked Filing Status box: 1 or 4, enter $35,000; 2 or 5, enter $50,000; 3, enter $10,000 ($35,000 if you lived apart from your spouse for all of 1993)	1.	
2. Enter the amount from Form 1040, line 23	2.	
3. Add amounts on Form 1040, lines 25 through 29, and any amount you entered on the dotted line next to line 30	3.	
4. Subtract line 3 from line 2. If the result is equal to or more than the amount on line 1, none of your IRA contributions are deductible. Stop here. If you want to make a nondeductible IRA contribution, see Form 8606	4.	
5. Subtract line 4 from line 1. If the result is $10,000 or more, stop here and use Worksheet 1	5.	
6. Multiply line 5 above by 20% (.20). If the result is not a multiple of $10, round it up to the next multiple of $10 (for example, round $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200. Go to line 7	6.	

Deductible IRA contributions		(a) Your IRA	(b) Your working spouse's IRA
7. For each person, enter wages and other earned income from Form 1040, minus any deductions on Form 1040, lines 25 and 27. Do not reduce wages by any loss from self-employment	7.		
8. Enter IRA contributions you made, or will make by April 15, 1994, for 1993. But do not enter more than $2,000 in either column	8.		
9. Enter the smallest of line 6, 7, or 8. This is the most you can deduct. Enter on Form 1040, line 24a, the amount from line 9, column (a), you choose to deduct. Enter on Form 1040, line 24b, the amount, if any, from line 9, column (b), you choose to deduct. If line 8 is more than line 9, go to line 10	9.		
Nondeductible IRA contributions			
10. Subtract line 9 from the smaller of line 7 or line 8. Enter on line 1 of your Form 8606 the amount from line 10 you choose to make nondeductible	10.		

If filing a joint return and contributions were made to your nonworking spouse's IRA, go to line 11.

Deductible IRA contributions for nonworking spouse		
11. Enter the smaller of line 7, column (a), or $2,250	11.	
12. Add the amount on line 9, column (a), to the part of line 10, column (a), that you choose to make nondeductible	12.	
13. Subtract line 12 from line 11. If the result is zero or less, stop here. You cannot make deductible or nondeductible IRA contributions for your nonworking spouse	13.	
14. Enter the smallest of (a) IRA contributions made, or that will be made by April 15, 1994, for 1993 for your nonworking spouse; (b) $2,000; or (c) the amount on line 13	14.	
15. Multiply line 5 above by 22.5% (.225). If the result is not a multiple of $10, round it up to the next multiple of $10. If the result is $200 or more, enter the result. But if it is less than $200, enter $200	15.	
16. Enter the amount from line 9, column (a)	16.	
17. Subtract line 16 from line 15	17.	
18. Enter the smaller of line 14 or line 17	18.	
19. Enter the smallest of line 6, 7, or 18. This is the most you can deduct. Enter on Form 1040, line 24b, the amount from line 19 you choose to deduct. If line 14 is more than line 19, go to line 20	19.	
Nondeductible IRA contributions for nonworking spouse		
20. Subtract line 19 from line 14. Enter on line 1 of your spouse's Form 8606 the amount from line 20 that you choose to make nondeductible	20.	

Schedule SE. Then, enter on Form 1040, line 25, one-half of the self-employment tax shown on line 5 of Short Schedule SE or line 15 of Long Schedule SE, whichever applies.

Line 26

Self-Employed Health Insurance Deduction

If you were self-employed and had a net profit for the year, or if you received wages in 1993 from an S corporation in which you were a more than 2% shareholder, you may be able to deduct part of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. But if you were also eligible to participate in any subsidized health plan maintained by your or your spouse's employer for any month or part of a month in 1993, amounts paid for health insurance coverage for that month cannot be used to figure the deduction. For example, if you were eligible to participate in a subsidized health plan maintained by your spouse's employer from September 30 through December 31, you cannot use amounts paid for health insurance coverage for September through December to figure your deduction. For more details, get Pub. 535, Business Expenses.

If you qualify to take the deduction, use the worksheet on page 23 to figure the amount you can deduct. But if either of the following applies, do not use the worksheet. Instead, see Pub. 535 to find out how to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

Caution: *If you can file Schedule EIC, Earned Income Credit, you may also be able to claim the health insurance credit on that schedule. If you do claim that credit, do not use the worksheet on page 23. Instead, get Pub. 596, Earned Income Credit, to figure your self-employed health insurance deduction.*

Line 27

Keogh Retirement Plan and Self-Employed SEP Deduction

If you are self-employed or a partner, deduct payments to your Keogh (HR 10) plan or simplified employee pension (SEP) plan on line 27. Deduct payments for your employees on Schedule C or F.

Caution: *You must be self-employed to claim the Keogh deduction. There are two types of Keogh plans:*

- A defined-contribution plan has a separate account for each person. Benefits are based on the amount paid to each account.
- Payments to a defined-benefit plan are determined by the funds needed to give a specific benefit at retirement. If you deduct payments to this kind of plan, enter "DB" next to line 27.

Get Pub. 560, Retirement Plans for the Self-Employed, for more details, including limits on the amount you can deduct.

If either 1 or 2 applies to you, fill in Form 2106 for all your job expenses. Then, enter on line 19 the amount from Form 2106, line 11.

If you don't have to fill in Form 2106, list the type and amount of each expense on the dotted lines next to line 19. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 19.

Examples of expenses to include on line 19 are:

- Travel, transportation, meal, or entertainment expenses. Note: *If you have any of these expenses, you must use Form 2106 for all of your job expenses.*
- Union dues.
- Safety equipment, small tools, and supplies you needed for your job.
- Uniforms your employer said you must have, and which you may not usually wear away from work.
- Protective clothing required in your work, such as hard hats, safety shoes, and glasses.
- Physical examinations your employer said you must have.
- Dues to professional organizations and chambers of commerce.
- Subscriptions to professional journals.
- Fees to employment agencies and other costs to look for a new job in your present occupation, even if you do not get a new job.
- Business use of part of your home but only if you use that part exclusively and on a regular basis in your work and for the convenience of your employer. For details, including limits that apply, call Tele-Tax (see page 30) and listen to topic 509 or get Pub. 587, Business Use of Your Home.
- Educational expenses you paid that were required by your employer, or by law or regulation, to keep your salary or job. In general, you may also include the cost of keeping or improving skills you must have in your job. For more details, call Tele-Tax (see page 30) and listen to topic 513 or get Pub. 508, Educational Expenses. Some educational expenses are not deductible. See Examples of Expenses You May Not Deduct on page A-4.

Line 20

Other Expenses

Enter the total amount you paid to produce or collect taxable income, manage or protect property held for earning income, and for tax preparation fees. But do not include any expenses deducted elsewhere such as on Schedule C, C-EZ, E, or F. List the type and amount of each expense on the dotted lines next to line 20. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 20.

Examples of expenses to include on line 20 are:

- Tax return preparation fees, including fees paid for filing your return electronically.
- Safe deposit box rental.
- Certain legal and accounting fees.
- Clerical help and office rent.
- Custodial (e.g., trust account) fees.
- Your share of the investment expenses of a regulated investment company.
- Certain losses on nonfederally insured deposits in an insolvent or bankrupt financial institution. For details, including limits on the amount you may deduct, see Pub. 529.
- Deduction for repayment of amounts under a claim of right if $3,000 or less.
- Expenses related to an activity not engaged in for profit. These expenses are limited to the income from the activity that you reported on Form 1040, line 22. See Not-for-Profit Activities in Pub. 535, Business Expenses, for details on how to figure the amount to deduct.

Line 25

Other Miscellaneous Deductions

Enter your total miscellaneous deductions that are not subject to the 2% AGI limit. List the type and amount of each expense on the dotted lines next to line 25. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 25. Only the expenses listed below can be deducted on line 25:

- Gambling losses to the extent of gambling winnings. Report gambling winnings on Form 1040, line 22.
- Federal estate tax on income in respect of a decedent.
- Amortizable bond premium on bonds acquired before October 23, 1986.
- Deduction for repayment of amounts under a claim of right if more than $3,000. Get Pub. 525, Taxable and Nontaxable Income, for details.
- Certain unrecovered investment in a pension. Get Pub. 575, Pension and Annuity Income (Including Simplified General Rule), for details.
- Impairment-related work expenses of a disabled person.

For more details on these expenses, see Pub. 529.

Total Itemized Deductions

Line 26

People with higher incomes may not be able to deduct all of their itemized deductions. If the amount on Form 1040, line 32, is more than $108,450 (more than $54,225 if married filing separately), use the worksheet on this page to figure the amount you may deduct.

Itemized Deductions Worksheet—Line 26 (keep for your records)

1. Add the amounts on Schedule A, lines 4, 8, 12, 16, 17, 18, 24, and 25 [illegible]

[illegible]

BEST AVAILABLE COPY

PREPARED STATEMENT OF PROFESSOR SHELDON D. POLLACK

Mr. Chairman and Distinguished Members of the Senate Finance Committee: I am honored to have this opportunity to present my views on some of the proposals before the Congress to adopt a so-called "flat" income tax. The Honorable Richard K. Armey, House Majority Leader, and the Honorable Arlen Specter, Senator from Pennsylvania, have both offered serious and thoughtful legislative proposals for a flat tax. A considerable number of newspaper editorials, columnists, and former presidential speech-writers have also recently expressed interest in a flat tax. House Minority Leader Richard A. Gephardt even joined the chorus at one point and proposed his own version of a flat (or flatter) income tax. I would suggest that notwithstanding the great importance of the Senate giving consideration to the concept of a flat tax, several issues need to be clarified first. Conceptual clarity has been sacrificed in the rush to "tear the income system out by its roots" and replace it with a flat tax, or any one of a number of other alternatives floating about Capitol Hill.

I first would like to direct my comments today to two common assertions made by proponents of the flat tax—specifically, that a flat tax is a "fairer" tax and a "simpler" tax. The former claim is invariably put forth without argument or reason, as if the proposition is another of those truths which we hold as self-evident. Likewise, proponents praise the flat tax as much simpler than the current tax regime. Absent radical broadening of the income tax base—a very separate issue which unfortunately has become confused with the flat tax per se—there is no reason at all to presume that a flat tax will be any simpler than the present model. Adopting a broader tax base will be necessitated by the revenue shortfalls which, I am afraid, will follow inevitably in the wake of the enactment of any flat tax proposal which is attractive to the electorate and therefore, politically feasible. But it should be recognized that broadening the tax base, and not the flat tax, will be the source of any such reduction in tax complexity. Under the banner of the flat tax, a massive assault is being waged on the federal income tax laws. This campaign is ultimately directed at those interests which have been nurtured by the tax laws over the past eighty years. While probably justified, the inherent difficulty of the enterprise and the magnitude of the political obstacles have been grossly understated by those who would have us believe that the Tax Code can be reduced to three or four provisions by the mere stroke of a pen. Rather than wage this all-out political war on tax expenditures, deductions, credits, and preferences, a more selective approach is preferable. Congressional policymakers need to distinguish between the different sources of complexity in the tax laws; only those which cannot be justified from the perspective of national policy (i.e., the public interest) should be the target of reform efforts. Recent success in repealing former Section 1071 of the Internal Revenue Code, as well as the House's contribution to the demise of the alternative minimum tax, demonstrate the wisdom and possibilities of this approach.

FLAT TAX, FAIR TAX?

One of the central arguments of proponents of a flat tax is that it is "fairer" than the current graduated rate structure which rises from 15% to 39.6% on income in excess of $250,000. To a considerable extent, the case for a flat tax has been advanced under the standard of "fairness." Senator Specter's proposal for a flat tax (in essence, a consumption-based flat tax with deductions only for mortgage interest and charitable contributions, and limits on those as well) asserts that a flat tax would "provide for fairness among all taxpayers."[1] The clear implication is that some taxpayers are treated unfairly by the current progressive rate structure. Representative Armey too has justified his proposal for a flat tax (which apparently eliminates all deductions) on the grounds that: "The great virtue of a flat tax is its fundamental fairness."[2]

Claims that a flat tax represents the embodiment of fairness ought be treated with the same degree of skepticism as the assertion that the income tax must be progressive in order that all taxpayers pay their "fair share" of tax. Elsewhere, I have questioned the widespread faith in so-called principles of tax "equity" which allegedly demand that an income tax be progressive to satisfy some vague criteria of "fairness."[3] Academics in our law schools commonly assert that "horizontal equity" demands that all income (regardless of its source) be treated comparably (i.e., taxed), while "vertical equity" demands that those with greater income be taxed at

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[1] Congressional Record, 104th Cong., 1st Sess., Vol. 141, No. 39 (May 2, 1995), S3416.

[2] Richard K. Armey, explanation of H.R. 4585, The Freedom and Fairness Restoration Act, p. 31.

[3] Sheldon D. Pollack, "Tax Reform: The 1980's in Perspective," 46 Tax Law Review 489 (1991).

higher marginal rates. Underlying these propositions is a very specific theory of equality and justice, one which inevitably goes unstated by the advocates of redistributive tax policies. We almost never hear a justification these days for graduation of the income tax, notwithstanding that it is one of the defining characteristics of the American tax system. It is simply said to be "fair."

But fair-minded individuals of good faith can and do disagree about the justice and fairness of progressive rates. One can just as easily posit that equity and fairness dictate that all citizens ought to bear the burdens associated with citizenship equally, suggesting that a "head" tax is appropriate, or that political equality dictates that taxes ought to be imposed in direct proportion to ones "ability to pay"—supporting the argument in favor of a flat tax.[4] Likewise, there is a sustainable position that equity demands nothing more than that the tax laws be applied equally and uniformly to all taxpayers alike, with no special privileges (e.g., exclusions or exemptions) recognized for wealth, social standing, office, etc.[5] Such a notion of fairness or equity will be strictly confined to "process"—holding that tax outcomes are "fair" so long as the process by which they are made is unbiased and impartial.

Perceptive students of the income tax have always recognized and acknowledged the "perennial and unrelenting controversy" surrounding the concepts of horizontal and vertical equity.[6] While economics may indicate which tax system is most efficient, economic principles simply do not dictate that an income tax must redistribute income from wealthy taxpayers to those with less. But it also must be admitted that bold assertions that a flat tax is fairer than a progressive income tax are no more persuasive and only contribute to the confusion. The choice of a tax rate structure is a normative choice reflecting deep-rooted political values about the role of government and how the cost of government should be shared by the citizenry. In the end, one can hardly do better than economist Henry Simons, who long ago acknowledged that the answer lies in upon inherently normative propositions, and not upon economic theorems:

> The case for drastic progression in income taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly unlovely.[7]

Simons himself found income inequality to be "unlovely." Others may find the prevailing distribution of wealth and income to be less offensive to their aesthetic sensibilities, and even quite defensible in terms of the great economic wealth produced by individuals motivated by the drive to accumulate and keep the fruits of their labor and industry.

My point is that intellectual honesty requires that assertions such as that the income tax ought to be either flat or progressive need to be justified in terms of moral and ethical principles. And the very act of moving from any rate structure to another must be recognized as an inherently political act of the highest order as very specific economic and social interests will be helped, and others hurt, by such fundamental changes to our extant legal structures.

FLAT TAX, TAX SIMPLICITY?

Another claim commonly made for the flat tax is that it will significantly reduce the complexity of the tax system. The federal income tax has become ever more complicated through a process of gradual, evolutionary, and incremental adjustments to the original statute.[8] However, starting in the 1960s, the development of the federal income tax entered a new phase, and the level of complexity of the Tax Code and Treasury regulations increased more dramatically. Prior to World War II, the Tax Code and regulations were published in a single volume. Today, the same material

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[4] For a critique of early twentieth century theories holding that tax rates must be related to "ability to pay" (i.e., progressive), see John F. Witte, The Politics and Development of the Federal Income Tax (Madison: University of Wisconsin Press, 1985), p. 50.

[5] This echoes Michael Walzer's conception of equality and distributive justice in his classic, Spheres of Justice: A Defense of Pluralism and Equality (New York: Basic Books, 1983).

[6] See, e.g., George F. Break and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream? (Washington: The Brookings Institution, 1975), p. 3.

[7] Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy (Chicago: University of Chicago, 1938), p. 17-18. Simons himself scolded those who believe that such questions can be answered with slogans, such as that taxes must be determined by reference to the taxpayer's "ability to pay," arguing that such is little more than a statement that "the writer prefers the kind of taxation that he prefers," and such a principle amounts to no more than a "conjurer's hat" from which "anything may be drawn at will."

[8] I have considered some of the causes behind this increase in tax complexity in "Tax Complexity, Reform, and the Illusions of Tax Simplification," George Mason Independent Law Review, Volume 2, No. 2 (Summer 1994).

fills a total of twelve comparable volumes. The income tax provisions of the Internal Revenue Code of 1954 contained 103 sections, while the Internal Revenue Code of 1986, including 1993 amendments, contains 698 sections. One recent report estimates that the volume of the income tax regulations increased 730% during the same period from 1954-1994.[9] Most of us would agree with Messieurs Hall and Rabushka who concluded a decade ago that: "The current U.S. income tax system is a nightmare of complexity."[10]

In light of the increasingly excessive and oppressive complexity of the income tax laws, tax simplification has emerged as one of the perennial themes in the academic tax literature. The U.S. Treasury Department, the staffs of congressional tax committees, and the tax bar have also devoted considerable time and effort to the question of tax simplification. Indeed, there is a wide-spread tendency to equate tax reform per se with "simplification." Such a perspective fails to address the fundamental causes behind the rise in tax complexity. Few reformers demanding simplification recognize the inherent difficulties in their position. Excess complexity is rooted in the very process by which U.S. tax policy is made. Some of the complexity is attributable to efforts by policymakers to accomplish too much through the tax laws, using the Tax Code as the vehicle for implementing so much public policy. Likewise, much of the complexity is attributable to prior reforms enacted in the pursuit of greater purity and equity in the tax laws. As Senator Russell Long once quipped: "The complexity of our code in the main is not there because of some mischief. Most of it is there in the effort to do more perfect justice."[11] Complexity is not a result so much of malevolence as over-zealous reform efforts and excessive demands made on the tax laws by policymakers.

It is difficult to see how a flat tax would of itself contribute anything to solving the problem of excess tax complexity. Section 1 of the Internal Revenue Code (which prescribes the income tax rates for individuals) is not a very complicated provision. The computation of a taxpayer's liability under a flat tax will take no less time than under the current progressive tax—which requires that the taxpayer either look up his or her tax liability under the tax tables or (for those with higher incomes) make a very simple mathematical computation. Calculating 17% of one's taxable income will be no easier than this inoffensive computation. Obviously, eliminating all of the tax expenditures, preferences, credits, and mind-boggling economic computations allowed and required under the present income tax regime will result in a considerably simplified tax system. This is the stuff that economists at the Brookings Institution (with whom I am honored to be sharing office space this summer) have been dreaming of for decades. But the effort is not likely to succeed, nor is it clear that it should. The conclusive rebuff to those who relentlessly pursue the "Comprehensive Tax Base" was made over a quarter-century ago by Boris Bittker of Yale University Law School.[12] The best I can do is refer the esteemed Members of the Finance Committee to Professor Bittker's article. Beyond that, I suggest that the considerable political effort required to move the Tax Reform Act of 1986 through the tax committees and to a favorable vote of the floor of both Houses of Congress will look like a cakewalk compared to removing every single tax preference from the Tax Code (to say nothing of reducing the home mortgage deduction). All this will be required to achieve a tax return that fits on a postcard—the dubious goal of flat-taxers.

FLAT TAX, REVENUE SHORTFALLS?

Any discussion of the various equities and obstacles to the adoption of a flat tax must inevitably turn to the role of the income tax in providing revenue for the federal government. During World War I, the income tax became the single most important source of revenue for the federal government, supplanting the tariff and excise taxes as the "cornerstone of the federal revenue system."[13] Revenue derived from the federal income tax (corporate and individual combined) has increased from $28 million in 1913 (the first half-year of the tax), to $29 billion in 1945 during the height of World War II, to $587 billion in 1990, to a projected $739 billion for 1995.

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[9] Arthur P. Hall, Jr., "Growth of Federal Government Tax 'Industry' Parallels Growth of Federal Tax Code," Special Report, No. 39, Tax Foundation, September 1994.

[10] Alvin Rabushka and Robert E. Hall, The Flat Tax (Stanford: Hoover Institution Press, 1985), p. 5.

[11] Senator Russell B. Long, quoted in U.S. Senate, Finance Committee Hearings, Tax Reform Proposals, Vol. 3, 99th Cong., 2d Sess., p. 53.

[12] Boris I. Bittker, "A Comprehensive Tax Base as a Goal of Income Tax Reform," 80 Harv. L. Rev. 925 (1967).

[13] James L. Curtis, "Federal Deficits and the Boundaries of Democratic Politics," (unpublished paper, 1994 Meeting of the Am. Poli. Sci. Asso., New York, N.Y.), p. 11.

In 1914, the federal income tax provided 9.7% of total receipts of the federal government; by 1985, the figure was 55%. In 1950, revenue from the income tax constituted 45% of federal receipts from all taxes; by 1985, the figure had risen to nearly 73%.

Like it or not, the current federal income tax is an integral component of the federal system. For that reason, I am surprised by those proponents of the flat tax who rather cavalierly side-step the revenue issue. The questions of equity and eliminating tax preferences really concern how the burden of taxation shall be shared among the various social and economic groups which comprise our polity. But the political and economic reality is that we must be sure that any reform initiative raises at least as much revenue as the current income tax. While I personally would prefer to see the overall level and scope of activity of the federal government reduced significantly, fiscal responsibility suggests that until that becomes political reality, we should proceed on the assumption that we will need to raise much the same levels of revenue going forward and that any alternative tax must be capable of meeting this criteria. On this score, the flat tax proposals come up short. The Treasury Department and Joint Committee on Taxation have both estimated that the flat tax proposals of Senator Specter and Representative Armey would produce significantly less revenue than the current system. This problem can be solved relatively easily by increasing the tax rate—Treasury calculated that a 25.8% rate would be needed to make Representative Armey's proposal revenue neutral. I suspect that such an act of fiscal responsibility would not be very attractive politically to proponents of the flat tax.

We are caught in a bind. When imposed at a rate sufficient to be revenue neutral (to satisfy the great appetite of the electorate for public goods), the flat tax will not be very attractive politically. To satisfy those who believe the poor should either pay no tax at all, or only at a very low rate, a flat tax will need be too low to raise anywhere enough revenue.[14] The present system must be recognized as a compromise and accommodation of these and other moral principles and political demands. A tax system based on only one Big Idea (i.e., a flat tax rate) will fail to satisfy other important principles and goals—revenue being but one.

In conclusion, my own view is that an incrementalist approach is the more appropriate mode of policymaking for reasonable and responsible tax reform. While the income tax laws may strike non-tax lawyers as entirely impenetrable and unmanageable, there is an accumulated wisdom expressed in the tax laws (albeit with considerable excess baggage), cultivated over the course of the eighty-year history of the income tax. This accumulated wisdom will be swept away by the flat tax proposals now on the table. The preferable alternative is that of incrementalism—a strategy for limited, gradual tax policymaking. After a decade of instability and radical changes to the Tax Code, the propriety of marginal and gradual change should be all the more obvious. Those who urge radical policy proposals such as abandoning the present federal income tax in favor of a flat tax with a comprehensive tax base, or the adoption of some entirely new mode of taxation altogether (for example, a national sales tax or an expenditure consumption tax), would do well to heed the warning of Chairman Rostenkowski: "Fundamental reform almost always runs the risk of making things worse."[15] At risk is the $739 billion of federal revenue projected to be raised by the current income tax in 1995.

PREPARED STATEMENT OF ROBERT E. HALL AND ALVIN RABUSHKA

Tax forms really can fit on postcards. A cleanly designed tax system takes only a few elementary calculations, in contrast to the hopeless complexity of today's income taxes. We have developed a complete plan for a whole new tax system. Our system puts a low tax rate on a comprehensive definition of income. Because its base is so broad, the tax rate is an astonishingly low 19 percent but raises the same revenue as does the current tax system. The tax on families is fair and progressive—the poor pay no tax at all, and the fraction of income that a family pays rises with income. The system is simple and easy to understand. And the tax operates on the consumption-tax principle—families are taxed on what they take out of the economy, not what they put into it.

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[14] This is the problem with the Pennsylvania personal income tax. Required to be uniform under the state Constitution, the tax traditionally has been kept low (presently 2.8%) to avoid imposing undue hardships on low income citizens. The inevitable revenue shortfalls pushed the corporate income tax rate upward, eventually reaching a maximum of 12.25%—the highest in the nation. This in turn created its own problems, such as capital flight.

[15] Quoted in Daily Tax Report (BNA), No. 193, October 7, 1993, p. G-3.

Our system rests on a basic administrative principle: income should be taxed exactly once, as close as possible to its source. Today's tax system violates this principle in all kinds of ways. Some kinds of income—like fringe benefits—are never taxed at all. Other kinds, like dividends and capital gains, are taxed twice. And interest income, which is supposed to be taxed once, escapes taxation completely in all too many cases, where clever taxpayers arrange to receive interest beyond the reach of the IRS.

Under our plan, all income is taxed at the same rate. Equality of tax rates is a basic concept of the flat tax. Its logic is much more profound than just the simplicity of calculation with a single tax rate. Whenever different forms of income are taxed at different rates or different taxpayers face different rates, the public figures out how to take advantage of the differential.

PROGRESSIVITY, EFFICIENCY, AND SIMPLICITY

Limiting the burden of taxes on the poor is a central principle of tax reform. Some ideas for tax simplification and reform flout this principle—neither a federal sales tax nor a value-added tax is progressive. Instead, all citizens, rich and poor alike, pay essentially the same fraction of their spending in taxes. We reject sales and value-added taxes for this reason. The current federal tax system avoids taxing the poor, and we think it should stay that way.

Exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income taxpayers. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating important differences in tax rates. Graduated taxes automatically create differences in tax rates among taxpayers, with all the attendant opportunities for leakage. Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax-rate differentials, applying the same tax rate to these taxpayers for all of their income in all years is the most important goal of flat-rate taxation.

Our proposal is based squarely on the principle of consumption taxation. Saving is untaxed, thus solving the problem that has perplexed the designers of the current tax system, which contains an incredible hodgepodge of saving and investment incentives. As a general matter, the current system puts substantial taxes on the earnings from savings. On that account, the economy is biased toward too little saving and too much consumption. But Congress has inserted a number of special provisions to spur saving. Most importantly, saving for retirement is excused from current taxation. Workers are not taxed on the amount their employers contribute to pension funds, and the employers can deduct those contributions. The self-employed can take advantage of the same opportunity with Keogh, IRA, and SEP plans. The overall effect of the existing incentives is spotty—there are excessive incentives for some saving-investment channels and inadequate incentives for others. In our system, there is a single, coherent provision for taxing the return to saving. All income is taxed but the earnings from saved income are not taxed further.

We believe that the simplicity of our system is a central feature. Complex tax forms and tax laws do more harm that just deforesting America. Complicated taxes require expensive advisers for taxpayers and equally expensive reviews and audits by the government. A complex tax invites the taxpayer to search for a special feature to exploit to the disadvantage of the rest of us. And complex taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and the spread of outright evasion.

AN INTEGRATED FLAT TAX

Our flat tax applies to both businesses and individuals. Although our system has two separate tax forms—one for business income and the other for wages and salaries—it is an integrated system. When we speak of its virtues, such as its equal taxation of all types of income, we mean the system, not one of its two parts. As we will explain, the business tax is not just a replacement for the existing corporate income tax. It covers all businesses, not just corporations. And it covers interest income, which is currently taxed under the personal income tax.

In our system, all income is classified as either business income or wages (including salaries, and retirement benefits). The system is airtight. Taxes on both types of income are equal. The wage tax has features to make the overall system progressive. Both taxes have postcard forms. The low tax rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1993.

Here is the logic of our system, stripped to basics: We want to tax consumption. Families do one of two things with income—spend it or invest it. We can measure consumption as income minus investment. A really simple tax would just have each

firm pay tax on the total amount of income generated by the firm less that firm's investment in plant and equipment. The value-added tax works just that way. But the value-added tax is unfair because it is not progressive. That's why we break the tax in two. The firm pays tax on all of the income generated at the firm except the income paid to its workers. The workers themselves pay tax on what they earn, and the tax they pay is progressive.

To measure the total amount of income generated at a business, the best approach is to take the total receipts of the firm over the year and subtract the payments the firm has made to its workers and suppliers. This approach guarantees a comprehensive tax base. Value-added taxes in Europe work just this way. The base for the business tax is the following:

Total revenue from sales of goods and services
less
purchases of inputs from other firms
less
wages, salaries, and pensions paid
less
purchases of plant and equipment

The other piece is the wage tax. Each family pays 19 percent of its wages, salary, and pension income over a family allowance. The allowance makes the system progressive. The base for the compensation tax is total wages, salaries, and retirement benefits less the total amount of family allowances.

Table 1 shows how we calculate flat tax revenue from the U.S. National Income and Product Accounts for 1993. The first line shows gross domestic product (GDP), the most comprehensive measure of income throughout the economy. The next two lines are items that are included in GDP but would not be taxed under the flat tax, such as sales and excise taxes. Line 3, income included in GDP but not in the tax base, is mostly the value of the services of houses owned and lived in by families; this income does not go through the market. Wages, salaries, and pensions, line 4, would be reported by the firm's workers on their wage tax forms and would be deducted by businesses. Investment, line 5, is the amount spent by businesses on purchases of new plant and equipment (each business could also deduct its purchases of used plant and equipment, but these would be included in the taxable income of the selling business and would net out in the aggregate). Line 6 shows the taxable income of all businesses after they have deducted their wages and investment. The revenue from the business tax, line 7, is 19 percent of the tax base on line 6. Line 8 shows the amount of family allowances that would be deducted. The wage tax base on Line 9 shows the amount of wages, salaries, and pensions left after deducting all family allowances from the amount on line 4. The wage tax revenue on line 10 is 19 percent of the base. Total flat tax revenue on line 11 is $627 billion. Lines 12 and 13 show the actual revenue from the personal and corporate income tax. The total actual revenue on line 14 is also $627 billion. The flat tax revenue and the actual revenue are the same, by design. Our proposal is to reproduce the revenue of the actual income tax system, not to raise or lower it.

Table 1.—Flat Tax Revenues Compared to Current Revenues

Line	Income or Revenue	Billions of dollars
1	Gross domestic product	6,374
2	Indirect business tax	431
3	Income included in GDP but not in tax base	217
4	Wages, salaries, and pensions	3,100
5	Investment	723
6	Business tax base (line 1 minus lines 2 through 5)	1,903
7	Business tax revenue (19 percent of line 6)	362
8	Family allowances	1,705
9	Wage tax base (line 4 less line 8)	1,395
10	Wage tax revenue (19 percent of line 9)	265
11	Total flat tax revenue (line 7 plus line 10)	627
12	Actual personal income tax	510
13	Actual corporate income tax	118
14	Total actual revenue (line 12 plus line 13)	627

These computations show that in 1993 the revenue from the corporate income tax, with a tax rate of 34 percent, was $118 billion. The revenue from our business tax at a rate of only 19 percent would have been $362 billion, just over three times as

much, even though the tax rate is not much over half the current corporate rate. There are three main reasons that the flat business tax yields more revenue than does the existing corporate tax. First, slightly more than half of business income is from noncorporate businesses—professional partnerships, proprietorships, and the like. Second, the business tax puts a tax on fringe benefits, which escape taxation in the current system.

The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system. Because most business income goes to the rich, putting an airtight tax of 19 percent on that income permits tax rates on working people to be lowered.

The other side of the coin, of course, is that our wage tax would have yielded less revenue than does the current personal income tax—$265 billion in 1993 as against $510 billion. We are not proposing a massive shift in taxes from wages to capital income. Our wage tax applies just to wages, salaries, and private pensions, whereas today's personal income tax includes unincorporated business income, dividends, interest, rent, and many other kinds of income that we tax as part of business income. The switch to the more reliable principle of taxing business income at the source, rather than hoping to catch the income at the destination, is the main reason that the business tax yields so much more revenue than does the corporate tax.

THE INDIVIDUAL WAGE TAX

The individual wage tax has a single purpose—to tax the large fraction of total income that employers pay as cash to their workers. It is not a tax system by itself, but is one of the two major parts of the complete system. The base of the tax is defined narrowly and precisely as actual payments of wages, salaries, and pensions. Pension contributions (as opposed to benefits) and other fringe benefits paid by employers are not counted as part of wages. In other words, the tax on pension income is paid when the retired worker actually receives the pension, not when the employer sets aside the money to pay the future pension. This principle applies even if the employer pays into a completely separate pension fund, if the worker makes a voluntary contribution to a 401(K) program, or if the worker contributes to a Keogh, IRA, or SEP fund.

The tax form for our wage tax is self-explanatory. To make the tax system progressive, only earnings over a personal or family allowance are taxed. The allowance is $25,500 for a family of four in 1995, but would rise along with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort needed to satisfy the Internal Revenue Service. What a change from the many pages of schedules the typical frustrated taxpayer fills out today!

For the 80 percent of taxpayers who don't run businesses, the individual wage tax would be the only tax to worry about. Many features of current taxes would disappear, including charitable deductions, mortgage interest deductions, capital gains taxes, dividend taxes, and interest taxes. We will discuss these in detail later.

Anyone who is self-employed or pays expenses directly in connection with making a living will need to file the business tax in order to get the proper deduction for expenses. Fortunately, the business tax form is even simpler than the wage tax form.

Form 1 **Individual Wage Tax** **1995**

Your first name and initial (if joint return, also give spouse's name and initial) Last name	Your social security number
Home address (number and street including apartment number or rural route)	Spouse's social security number
City, town, or post office, state, and ZIP code	Your occupation Spouse's occupation

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

THE BUSINESS TAX

It's not the purpose of the business tax to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by the business. Collecting business income tax at the source of the income avoids one of the biggest causes of leakage in the tax system today: Interest can pass through many layers where it is invariably deducted when it is paid out, but not so frequently reported as income.

Airtight taxation of individual business income at the source is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system has graduated rates, taxation at the source becomes a problem. If each owner is to be taxed at that owner's rate, the business would have to find out the tax rate applicable to each owner, and apply that rate to the income produced in the business for that owner. But this is only the beginning of the problem. The IRS would have to audit a business and its owners together in order to see that the owners were reporting the correct tax rates to the business. Further, suppose one of the owners made a mistake, and later was discovered to be in a higher tax bracket. Then the business would have to refile its tax form to collect the right tax. Obviously this wouldn't work. Business taxes have to be collected at the destination, from the owners, if graduated rates are to be applied. Source taxation is only practical when a single rate is applied to all owners. Because source taxation is so much more reliable and inexpensive, there is a powerful practical argument for using a single flat rate for all business income.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages, but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm. The resulting simplification and improvement in the tax system is enormous. Today, the IRS receives over a billion Form 1099s, which keep track of interest and dividends, and must make an overwhelming effort to match these forms to the 1040s filed by the recipients. The only reason for a Form 1099 is to track income as it makes its way from the business

where it originates to the ultimate recipient. Not a single Form 1099 would be needed under a flat tax with business income taxed at the source.

The way that we have chosen to set up the business tax is not arbitrary—on the contrary, it is dictated by the principles we set forth at the beginning of this paper. The tax would be assessed on all the income originating in a business, but not on any income that originates in other businesses, nor would it tax the wages, salaries, and pensions paid to employees. The types of income taxed by the business tax would include:

- profits from the use of plant and equipment;
- profits from ideas embodied in copyrights, patents, trade secrets, and the like;
- profits from past organization-building, marketing and advertising efforts;
- earnings of key executives and others who are owners as well as employees, and who are paid less than they contribute to the business;
- earnings of doctors, lawyers, and other professionals who have businesses organized as proprietorships or partnerships;
- rent earned from apartments and other real estate;
- fringe benefits provided to workers.

All of a business's income derives from the sale of its products and services. On the top line of the business tax form (our Form 2) goes the gross sales of the business—its proceeds from the sale of all of its products. But some of the proceeds come from the resale of inputs and parts the firm purchased; the tax has already been paid on these items because the seller also has to pay the business tax. Thus, the firm can deduct the cost of all the goods, materials, and services it purchases for the purpose of making the product it sells. In addition, it can deduct its wages, salaries, and pensions, for, under our wage tax, the taxes on these will be paid by the workers receiving them. Finally, the business can deduct all its outlays for plant, equipment, and land. Later we will explain why this investment incentive is just the right one.

Everything left from this calculation is the income originating in the firm, and is taxed at the flat rate of 19 percent. In most businesses, a lot is left, so the prospective revenue from the business tax is the $362 billion we computed earlier. Many deductions allowed to businesses under current laws are eliminated in our plan, including interest payments and fringe benefits. But our exclusion of these deductions is not an arbitrary move to increase the tax base. In all cases, the elimination of deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate and to achieve a broad consumption tax.

Form 2 — Business Tax — 1995

Business name	Employer Identification Number
Street address	County
City, state, and ZIP code	Principal product

		Line	Amount
1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2a	
	(b) Wages, salaries, and retirement benefits	2b	
	(c) Purchases of capital equipment, structures, and land	2c	
3	Total allowable costs *(sum of lines 2(a), 2(b), and 2(c))*	3	
4	Taxable income *(line 1 less line 3)*	4	
5	Tax *(19% of line 4)*	5	
6	Carry-forward from 1994	6	
7	Interest on carry-forward *(6 percent of line 6)*	7	
8	Carry-forward into 1995 *(line 6 plus line 7)*	8	
9	Tax due *(line 5 less line 8, if positive))*	9	
10	Carry-forward to 1996 *(line 8 less line 5, if positive)*	10	

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax business income at the source. It makes sense because we propose not to tax interest received by individuals. The tax that the government now hopes (sometimes in vain) that individuals will pay will assuredly be paid by the business itself. We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, an

immediate 100 percent first-year tax write-off of all investment spending. Sometimes this approach is called expensing of investment; it is standard in the value-added approach to consumption taxation. In other words, we don't deny depreciation deductions, we enhance them. More on this shortly.

Fringe benefits are outside the current tax system entirely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of the fringes. Consequently, fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929, when income taxes were unimportant, but reached almost 18 percent in 1993. The explosion of fringes is strictly an artifact of taxation, and fringes are an economically inefficient way to pay workers. Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice. Further, failing to tax fringes means taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates.

Under our system, each business would file a simple form. Even the largest business—the General Motors Corporation in 1993, with $138 billion in sales—would fill out our simple postcard form. Every line on the form is a well-defined number obtained directly from the business's accounting records. Line 1, gross revenue from sales, is the actual number of dollars received from the sales of all the products and services sold by the business, plus the proceeds from the sale of plant, equipment, and land. Line 2a is the actual amount paid for all the inputs bought from other businesses necessary for the operation of the business (that is, not passed on to its workers or owners). The firm could report any purchase actually needed for the business's operations and not part of the compensation of workers or owners. Line 2b is the actual cash put in the hands of workers and former workers. All the dollars deducted on this line will have to be reported by the workers on their Form 1 wage tax returns. Line 2c reports purchases of new and used capital equipment, buildings, and land. Note that the firm won't have to agonize over whether a screwdriver is a capital investment or a current input—both are deductible, and the IRS won't care which line it will appear on. The taxable income computed on line 4 bears little resemblance to anyone's notion of profit. The business tax is not a profit tax.

When a firm is having an outstanding year in sales and profits but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated at the firm will be taxed at 19 percent.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the start-up period will have negative taxable income. But the government will not write a check for the negative tax on the negative income. Whenever the government has a policy of writing checks, clever people abuse the opportunity. Instead, the negative tax would be carried forward to future years, when the business should have positive taxable income. There is no limit to the number of years of carry-forward.

Moreover, balances carried forward will earn the market rate of interest (6 percent in 1995). Lines 6 through 10 show the mechanics of the carry-forward process.

INVESTMENT INCENTIVES

The high rates of the current tax system significantly impede capital formation. On this point almost all experts agrees. The government's solution to the problem has been to pile one special investment or saving incentive on top of another, creating a complex and unworkable maze of regulations and tax forms. Existing incentives are appallingly uneven. Capital projects taking full advantage of depreciation deductions and the deductibility of interest paid to organizations exempt from income tax may actually receive subsidies from the government, rather than being taxed. But equity-financed projects are taxed heavily. Investment incentives severely distort the flow of capital into projects eligible for debt finance.

Our idea is to start over—throwing away all of the present incentives and replacing them with a simple, uniform principle—treating the total amount of investment as an expense in the year it is made. The entire incentive for capital formation is on the investment side, instead of the badly fitting split in the current tax system between investment incentives and saving incentives. The first virtue of this reform is simplicity. Businesses and government need not quarrel, as they do now, over what is an investment and what is a current expense. The distinction doesn't matter for the tax. Complicated depreciation calculations, carrying over from one year to

the next, driving the small business owner to distraction, will vanish from the tax form. The even more complicated provisions for recapturing depreciation when a piece of equipment or a building is sold will vanish as well, to everyone's relief.

Expensing of investment has a much deeper rationale than simplicity. Every act of investment in the economy ultimately traces back to an act of saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving. Consumption is what people take out of the economy; income is what people contribute. A consumption tax is the exact embodiment of the principle that people should be taxed on what they take out, not what they put in. The flat tax, with expensing of investment, is precisely a consumption tax.

Expensing investment eliminates the double taxation of saving; this is another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save and again when the savings earn a return. With expensing, the first tax is abolished. Saving is, in effect, deducted in computing the tax. Later, the return to the saving is taxed through the business tax. Although economists have dreamt up a number of other ways to eliminate double taxation of saving (involving complicated record keeping and reporting by individuals), the technique exploited in our flat tax is by far the most straightforward.

The easiest case for showing that expensing of investment is a consumption tax arises when someone invests directly in a personally owned business. Suppose a taxpayer receives $1,000 in earnings and turns around and buys a piece of business equipment for $1,000. There is a tax of $190 on the earnings, but also a deduction worth $190 in reduced taxes for the equipment purchase. On net, there is no tax. The taxpayer has not consumed any of the original $1,000 either. Later, the taxpayer will receive business income representing the earnings of the machine. This income will be taxed at 19 percent. If the taxpayer chooses to consume rather than invest again, there will be a 19 percent tax on the consumption. So the overall effect is a 19 percent consumption tax. Most people don't invest directly by purchasing machines themselves. The U.S. economy has wonderfully developed financial markets for channeling savings from individual savers, on the one hand, and businesses who have good investment opportunities, on the other hand. Individuals invest in firms by purchasing shares or bonds, and then the firms purchase plant and equipment. The tax system we propose taxes the consumption of individuals in this environment as well. Suppose the same taxpayer pays the $190 tax on the same $1,000 and puts the remaining $810 into the stock market. For simplicity, suppose that the share pays out to its owner all of the after-tax earnings on equipment costing $1,000. That assumption makes sense, because the firm could buy $1,000 worth of equipment with the $810 from our taxpayer plus the tax write-off worth $190 that would come with the equipment purchase. Our taxpayer gets the advantage of the investment write-off even though there is no deduction for the purchase of the share. The market passes through the incentive from the firm to the individual investor. Another possibility for the taxpayer is to buy a bond for $810. Again, the firm issuing the bond can buy a $1,000 machine with the $810, after taking advantage of the tax deduction. In order to compete with the returns available in the stock market, however, the bond must pay the same returns as does a stock selling for the same price, which in turn is equal to the after-tax earnings of the machine. so it won't matter how the taxpayer invests the $810. In all cases, there is effectively no tax for saved income; the tax only is payable when the income is consumed. In our system, any investment, in effect, would have the same economic advantage that a 401(K), IRA, or Keogh account has in the current tax system. And we achieve this desirable goal by reducing the amount of record keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their Form 1040s and then they have to report the distributions from the funds as income when they retire. Moreover, proponents of the "cash-flow" consumption tax would extend these requirements to all forms of saving. Our system would accomplish the same goal without any forms or record keeping.

CAPITAL GAINS

Capital gains on rental property, plant, and equipment would be taxed under the business tax. The purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale. Every owner of rental real estate would be required to fill out the simple business tax return, Form 2.

Capital gains would be taxed exclusively at the business level and not at the personal level. In other words, our system would eliminate the double taxation of capital gains inherent in the current tax system. To see how this works, consider the

case of the common stock of a corporation. The market value of the stock is the capitalization of its future earnings. Because the owners of the stock will receive their earnings after the corporation has paid the business tax, the market capitalizes after-tax earnings. A capital gain occurs when the market perceives that prospective after-tax earnings have risen. When the higher earnings materialize in the future, they will be correspondingly taxed. In a tax system like the current one, with both an income tax and a capital gains tax, there is double taxation. To achieve the goal of taxing all income exactly once, the best answer is to place an airtight tax on the income at the source. With taxation at the source, it is inappropriate and inefficient to tax capital gains as they occur at the destination.

Another way to see that capital gains should not be taxed separately under the flat tax is to look at the national income accounts. Gross domestic product, the most comprehensive measure of the nation's command over resources, does not include capital gains. The base of the flat tax is GDP minus investment, that is, consumption. To include capital gains in the flat-tax base would depart from the principle that it is a tax on consumption.

Capital gains on owner-occupied houses are not taxed under our proposal. Very few capital gains on houses are actually taxed under the current system—gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death. Exclusion of capital gains on houses makes sense because state and local governments put substantial property taxes on houses in relation to their values. Adding a capital gains tax on top of property taxes is double taxation in the same way that adding a capital gains tax on top of an income tax is double taxation of business income.

IMPORTS, EXPORTS, AND MULTINATIONAL BUSINESS

With NAFTA and the growth of trade throughout the world, U.S. companies are doing more and more business in other countries, and foreign companies are increasingly active here. Should the U.S. government try to tax business operations in other countries owned by Americans? And should it tax foreign operations in the United States? These are increasingly controversial questions. Under the current tax system, foreign operations of U.S. companies are taxed in principle, but the taxpayer receives a credit against U.S. taxes for taxes paid to the country where the business operates. Because the current tax system is based on a confused combination of taxing some income at the origin and some at the destination, taxation of foreign operations is messy.

Under the consistent application of taxing all business income at the source, the flat tax embodies a clean solution to the problems of multinational operations. The flat tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from the sales of products within the United States plus the value of products as they are exported would be reported on line 1 of the business tax Form 2. Only the costs of labor, materials, and other inputs purchased in the united States or imported to the United States would be allowable on line 2 as deductions for the business tax. Physical presence in the United States is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the United States. Its costs would include the actual amount it paid for its imports, valued as they entered the country—this would generally be the actual amount paid for them in the country of their origin. Its revenue would be the actual receipts from sales in the United States.

Second, consider an exporter selling goods produced here to foreigners. Its costs would be all of the inputs and compensation paid in the United States, and its revenue would be the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the country. Third, consider a firm that sends parts to Mexico for assembly and brings back the final product for sale in the United States. The value of the parts as they leave here would count as part of the revenue of the firm, and the value of the assembled product was it returned would be an expense. The firm would not deduct the actual costs of its Mexican assembly plant.

Under the principle of taxing only domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the flat tax, all income throughout the world would be taxed once and only once. Because the basic principle of the flat tax is already in use in the many nations with value-added taxes, a U.S. flat tax would harmonize nicely with those foreign tax systems. Application of the wage tax, Form 1, in the world economy would follow the same principle. All earnings from work in the United States would be

taxed, irrespective of the worker's citizenship, but the tax would not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The United States, with a low tax rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the flat tax would not tax the overseas earnings of American workers and businesses, there is no reason to fear an exodus of economic activity. On the contrary, the favorable tax climate in the United States would draw in new business from everywhere in the world.

THE TRANSITION

In our advocacy of the flat tax, we are spending the bulk of our effort in laying out a good, practical tax system. We have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of the ideal we have in mind. One area where the political process is likely to complicate our simple proposal is the transition from the current tax to the flat tax. The transition issues that are likely to draw the most attention are depreciation and interest deductions. In both cases, taxpayers who made plans and commitments before the tax reform will cry loudly for special provisions to continue the deductions.

Congress will face a choice between denying taxpayers the deductions they expected before tax reform or granting the deductions and raising the tax rate to make up for the lost revenue. Fortunately, this is a temporary problem. Once existing capital is fully depreciated and existing borrowing paid off, any special transitions provisions can be taken off the books.

Depreciation Deductions

Existing law lets businesses deduct the cost of an investment on a declining schedule over many years. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year write-off prescribed in the flat tax. No business will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they though they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1992, total depreciation deductions under the personal and corporate income taxes came to $597 billion. At the 34 percent rate for most corporations (which is close to the rate paid by the individuals who are likely to take deductions as proprietors or partners), those deductions were worth $192 billion. At the 19 percent flat rate, the deductions would be worth only $108 billion.

If Congress chose to honor all unused depreciation from investment predating tax reform, it would take about $597 billion out of the tax base for 1995. In order to raise the same amount of revenue as our original 19 percent rate would, the tax rate would have to rise to about 20.1 percent.

Honoring past depreciation would mollify business interest, especially in industries with large amounts of unused depreciation for past investment but little prospect of large first-year write-offs for future investment. In addition, it would buttress the government's credibility in tax matters by carrying through on a past promise to give a tax incentive for investment. On the other had, the move would require a higher tax rate and a less efficient economy in the future.

If Congress did opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue temporary. Within five years, the bulk of the existing capital would be depreciated and the tax rate should be brought back to 19 percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

Interest Deductions

Loss of interest deductions and elimination of interest taxation are two of the most conspicuous features of our tax reform plan. Shortly, we will discuss the important economic changes that would take place once interest is put on an after-tax basis. During the transition, there will be winners and losers from the change, and Congress is sure to hear from the losers. Congress may well decide to adopt a temporary transitional measure to help them. Such a measure need not compromise the principles of the flat tax or lessen its contribution to improved efficiency.

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows the continuation of deductions for interest on outstanding debt, it should also require the continuation of taxation of that inter-

est as income of the lender. if all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition than are depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. 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 percent of the actual interest payment, while the lender's taxable income should include 100 percent of the interest receipts.

Under this transitional plan, borrowers would be protected for almost all of their existing deductions. Someone whose personal finances would become untenable if the mortgage-interest deduction were suddenly eliminated can surely get through with 90 percent of the earlier deduction. But the plan builds in an incentive for renegotiating the interest payments along the lines we discussed earlier. 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 percent tax rate, would be $8,290. The net income to the bank, after subtracting the 19 percent 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 (instead of $8,290 without the deal) and the bank's income will be $8,200 (instead of $8,100 without the deal). The family will come out $90 ahead and the bank will come out $100 ahead. The deal will be beneficial to both.

One of the nice features of this plan is that it does not have to make any distinctions between old borrowing, existing at the time of the tax reform, and new borrowing, arranged after the reform. Lenders would always require that new borrowers opt out of their deductions and thus would offer a correspondingly lower interest rate. Otherwise, the lender would be saddled with a tax bill larger than the tax deduction received by the borrower.

As far as revenue is concerned, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised the right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear, and we would be left with the pure flat tax.

VARIANTS OF THE FLAT TAX

In this paper, we have set forth what we think is the best flat tax. But our ideas are more general than this specific proposal. The same principles could be applied with different choices about the key trade-offs. The two most important trade-offs are:

- Progressivity versus tax rate. A higher personal allowance would put an even lower burden on low- and middle-income families. But it would require a higher tax rate.
- Investment incentives versus tax rate. If the business tax had less than full write-off for purchases of capital goods, the tax rate could be lower.

Here are some alternative combinations of allowances and tax rates that would all raise the same amount of revenue:

Allowance for family of four	*Tax rate*
$12,500	15%
22,500	19%
34,500	23%

The choice among these alternatives depends on beliefs about how the burden of taxes should be distributed and on the degree of inefficiency that will be brought into the economy by the corresponding tax rates. We will have more to say about the inefficiency issue shortly.

Here are some alternative combinations of investment write-offs and tax rates that would all raise the same amount of revenue:

Equipment write-off	*Structures write-off*	*Tax rate*
100%	100%	19%
75	50	18
50	25	17

The choice among these alternatives depends on the sensitivity of investment-saving to incentives and on the degree of inefficiency brought by the tax rate.

STIMULUS TO GROWTH

The flat tax at a low, uniform rate of 19 percent will improve the performance of the U.S. economy. Improved incentives to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxation of entrepreneurial effort will enhance this critical input to the economy.

Work Effort

About two-thirds of today's taxpayers enjoy the low income tax rate of 15 percent enacted in 1986. Under the flat tax, more than half of these taxpayers would face zero tax rates because their total family earnings would fall short of the exemption amount ($22,500 for a family of four). The other half would face a slight increase in their tax rates on the margin, from 15 percent to 19 percent. In 1991, the remaining third of taxpayers were taxed at rates of 28 and 31 percent, and the addition of the 39.6 percent bracket in 1992 worsened incentives further. Heavily taxed people earn a disproportionate share of income: In 1991, 58 percent of all earnings were taxed at rates of 28 percent or higher. The net effect of the flat tax, with marginal rates of 0 and 19 percent, would be to improve incentives dramatically for almost everyone who is economically active.

One point we need to emphasize is that a family's marginal tax rate determines its incentives for all types of economic activity. There is much confusion on this point. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of her earnings is the same as the marginal tax on the last dollar of her husband's earnings. It is true that incentives to work for a woman with a well-paid husband are seriously eroded by high tax rates. But so are her husband's incentives. What matters for both of their decisions is how much of any extra dollar of earnings they will keep after taxes. Under the U.S. income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

Sheer hours of work make up one of the most important dimensions of productive effort and one that is known to be sensitive to incentives. At first, it may seem difficult for people to alter the amount of work they supply to the economy. Aren't most jobs 40 hours a week, 52 weeks a year? It turns out that only a fraction of the work force is restricted in that way. Most of us face genuine decisions about how much to work. Teenagers and young adults—in effect anyone before the responsibilities of parenthood—typically work much less than full time for the full year. Improving their incentives could easily make them switch from part-time to full-time work or cause them to spend less time taking it easy between jobs.

Married women remain one of the largest underutilized resources in the U.S. economy, although a growing fraction enters the labor market each year. In 1993, only 58 percent of all women over 15 were at work or looking for work; the remaining 42 percent were spending their time at home or in school, but could be drawn into the market if the incentives were right. There is no doubt about the sensitivity of married women to economic incentives. Studies show a systematic tendency for women with low after-tax wages and high-income husbands to work little. Those with high after-tax wages and lower incomes work a lot. It is thus reasonable to infer that sharply reduced marginal tax rates on married women's earnings will further stimulate their interest in the market.

Another remarkable source of unused labor power in the United States is men who have taken early retirement. Although 92 percent of men aged 25 to 54 are in the labor force, only 65 percent of those from 55 to 64 are at work or looking for work—just 17 percent of those over 65. Again, retirement is very much a matter of incentives. High marginal taxation of earnings discourages many perfectly fit men from continuing to work. Because mature men are among the best paid in the economy, a great many of them face marginal tax rates of 28, 36, or even 40 percent. Reduction to a uniform 19 percent could significantly reduce early retirement and make better use of the skills of older men.

Economists have devoted a great deal of effort to measuring the potential stimulus to work from tax reform. The consensus is that all groups of workers would respond to the flat tax by raising their work effort. A few workers would reduce their hours either because the flat rate would exceed their current marginal rate or because reform would add so much to their incomes that they would feel that earning was less urgent. But the great majority would face much improved incentives. The smallest responses are from adult men and the largest from married women.

In the light of the research on labor supply, were we to switch from the current tax law to our proposed flat tax, a reasonable projection is an increase of about 4 percent in total hours of work in the U.S. economy. That increase would mean about 1.5 hours per week on the average, but would take the form of second jobs for some workers, more weeks of work per year for others, as well as more hours per week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 3 percent, or almost $200 billion. That is nearly $750 per person, an astonishing sum. Of course, it might take some time for the full influence of improved incentives to have their effect. But the bottom line is unambiguous: Tax reform would have an important favorable effect on total work effort.

Capital Formation

Economists are far from agreement on the impact of tax reform on investment. As we have stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. Generous but erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level, however, combine to limit the adverse impact. The current tax system subsidizes investment though tax-favored entities such as pension funds, while it taxes capital formation heavily if it takes the form of new businesses. The result has been to sustain capital formation at reasonably high levels but to channel the investment into inefficient uses.

The most important structural bias of the existing system is the double taxation of business income earned in corporations and paid out to shareholders. Double taxation dramatically reduces the incentive to create new businesses in risky lines where debt financing is not available. On the other side, the existing system places no current tax on investments that can be financed by debt and where the debt is held by pension funds or other nontaxed entities. The result is a huge twist in incentives, away from entrepreneurial activities and toward safe, debt-financed activities.

The flat tax would eliminate the harmful twist in the current tax system. The flat tax has a single, uniform incentive for investment of all types—businesses would treat all purchases of capital equipment and buildings as expenses. As we noted earlier, allowing immediate write-off of investment is the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Public finance economists Alan Auerbach and Laurence Kotlikoff estimate that the use of a flat-rate consumption tax in place of an income tax would raise the ratio of capital stock to GNP from 5.0 to 6.2. Other economists are less optimistic that the correction of the double taxation of saving would provide the resources for this large an increase in investment. But all would agree that there would be some favorable effect on capital formation.

In terms of added GDP, the increase in the capital stock projected by Auerbach and Kotlikoff would translate into 6 percent more goods and services. Not all of this extra growth would occur within the seven-year span we are looking at. But, even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict a 2 to 4 percent increase in GDP on account of added capital formation within seven years.

Tax reform would improve the productivity, of capital by directing investment to the most productive uses. Auerbach has demonstrated, in a paper published by the Brookings Institution, that the bias of the current tax system toward equipment and away from structures imposes a small but important burden on the economy. The

flat tax would correct this bias. Auerbach estimates that the correction would be equivalent to a 3.2 percent increase in the capital stock. GDP would rise on this account by 0.8 percent.

Entrepreneurial Incentives and Effort

U.S. economic growth has slowed in the past two decades, and surely one reason is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There aren't any scholarly, studies with quantitative conclusions on the overall benefits from a fundamental shift, but they could be large.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and those individuals who have figured out how to avoid paying income tax on their interest. These people don't like insecure loans to new businesses based on great new ideas. They do like lending secured to readily marketable assets by mortgages or similar arrangements. It's easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds won't lend money to entrepreneurs with new ideas, because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture-capital market operates for exactly this purpose. But the cost to the entrepreneur is high—the ownership given to the financial backers deprives the entrepreneur of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky, innovative business. Even with the best tax system, or no taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and thus capture the entire future profits of a new business. Equity participation by investors is a fact of life. But it is the perverse tax system that greatly worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments actually is close to confiscation. The owners of a successful new business are taxed first when the profits flow in, at 34 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 40 percent bracket for the personal income tax, making the combined effective tax rate close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners who put up the capital, and then surrenders well over half of the remainder to the government.

The prospective entrepreneur will likely be attracted to the easier life of the investor who uses borrowed money. How much easier it is to put up a shopping center, borrow from a pension fund or insurance company, deduct everything paid to the inactive investor.

Today's absurd system taxes entrepreneurial success at 60 percent while it actually subsidizes leveraged investment. Our simple tax would put the same low rate on both activities. A huge redirection of national effort would follow. And the redirection could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle, but tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, the areas where confiscatory taxation has discouraged investment. The contribution to income from new resources will be correspondingly high.

Total Potential Growth from Improved Incentives

We project a 3 percent increase in output from increased total work in the U.S. economy and an additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 6 percent is our best estimate of the improvement in real incomes after the economy has had seven years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative.

Even this limited claim for economic improvement represents enormous progress. By 2002, it would mean each American will have an income about $1,900 higher, in 1995 dollars, as a consequence of tax reform.

INTEREST RATES

The flat tax would pull down interest rates immediately. Today's high interest rates are sustained partly by the income-tax deduction for interest paid and the tax on interest earned. The tax benefit ameliorates much of the pain of high interest,

and the IRS takes part of the income from interest. Borrowers tolerate high interest rates and lenders require them. The simple tax would permit no deduction for interest paid and put no tax on interest received. Interest payments throughout the economy will be flows of after-tax income, thanks to taxation of business income at the source.

With the flat tax, borrowers will no longer be so tolerant of interest payments, and lenders will no longer be concerned about taxes. The meeting of minds in the credit market, where borrowing equals lending, will inevitably occur at a lower interest rate. Potentially, the fall could be spectacular. Much borrowing comes from corporations and wealthy individuals, who face marginal tax rates of 34 and 40 percent. The wealthy, however, almost by definition, are the big lenders in the economy. If every lender and every borrower were in the 40 percent bracket, a tax reform eliminating deduction and taxation of interest would cut interest rates by a factor of 0.4—for example, from 10 to 6 percent. But the leakage problem in the United States is so great that the actual drop in interest would be far short of this huge potential. So much lending comes through the devices by which the well-to-do get their interest income under low tax rates that a drop by a factor of 0.4 would be impossible. Lenders taxed at low rates would be worse off if taxation were eliminated but interest rates fell by half. In an economy with lenders enjoying low marginal rates before reform, the meeting of the minds would have to come at an interest rate well above 0.6 times the prereform level. But the decline would be at least a fifth—say from 10 percent to 8 percent. Reform would bring a noticeable drop in interest rates.

One direct piece of evidence is municipal bonds, which yield interest not taxed under the federal income tax. Tax reform would make all bonds like tax-free municipals, so the current rates on municipals gives a hint about the level of all interest rates after reform. In 1994, municipals yielded about one-sixth less interest than comparable taxable bonds. But this is a conservative measure of the likely fall in interest rates after reform. Today, tax-free rates are kept high because there are so many opportunities to own taxable bonds in low-tax ways. Why own a bond from the city of Los Angeles paying 6 percent tax-free when you can create a personal pension fund and hold a Pacific Telesis bond paying 7 percent? Interest rates could easily fall to three-quarters of their present levels after tax reform; rates on tax-free securities would then fall a little as well.

The decline in interest rates brought about by putting interest on an after-tax basis would not by itself change the economy very much. To Ford Motors, contemplating borrowing to finance a modern plant, the attraction of lower rates would be offset by the cost of lost interest deductions. But he flat tax will do much more than put interest on an after-tax basis. Tax rates on corporations will be slashed to a uniform 19 percent from the double taxation of a 34 percent corporate rate on top of a personal rate of up to 40 percent. And investment incentives will be improved through first-year write-off. All told, borrowing for investment purposes will become a better deal. As the likely investment boom develops, borrowing will rise and will tend to push up interest rates. In principle, interest rates could rise to their prereform levels, but only if the boom is vigorous. We can't be sure what will happen to interest rates after tax reform, but we can be sure that high-interest, low-investment stagnation will not occur. Either interest rates will fall or investment will take off.

As a safe working hypothesis, we will assume that interest rates fall in the year after tax reform by about a fifth, say from 10 to 8 percent. We assume a quiescent underlying economy, not perturbed by sudden shifts in monetary policy, government spending, or oil prices. Now, take a look at borrowing decisions made before and after reform. Suppose a prereform entrepreneur is considering an investment yielding $1 million a year in revenue and involving $800,000 in interest costs at 10 percent interest. Today the entrepreneur pays a 40 percent tax on the net income of $200,000, giving an after-tax flow of $120,000. After reform, the entrepreneur will earn the same $1 million, and pay $640,000 interest on the same principal at 8 percent. There will be a 19 percent tax on the earnings without deducting interest; the amount of the tax is $190,000. After-tax income is $1,000,000 −$615,000 −$190,000 = $170,000, well above the $120,000 before reform. Reform is to the entrepreneur's advantage and to the advantage of capital formation. Gains from the lower tax rate more than make up for losses from denial of the interest deduction.

How can it be that both the entrepreneur and the government come out ahead from the tax reform? They don't—there is one element missing from this accounting. Before the reform, the government collected some tax on the interest paid by the entrepreneur—potentially as much as 40 percent of the $800,000, but, as our stories about leakage make clear, the government is actually lucky to get a small fraction of that potential.

To summarize, the flat tax automatically lowers interest rates. Without an interest deduction, borrowers require lower costs. Without an interest tax, lenders are satisfied with lower payments. The simple flat tax will have an important effect on interest rates. Lower interest rates will also stimulate the housing market, a matter of great concern to almost everybody.

Housing

Everyone who hears about the flat tax, with no deductions for interest, worries about its effect on the housing market. Won't the elimination of the deduction depress the prices of existing houses and impoverish the homeowner who can only afford a house because of its interest deductions? Our answer to all of these questions is no, but we freely concede that there is a significant issue here.

In all but the long run, house prices are set by the demand for houses, because the supply can only change slowly. If tax reform increases the cost of carrying a house of given value, then demand will fall and house prices will fall correspondingly. For this reason, we are going to look pretty intensively at what happens to carrying costs before and after tax reform. If tax reform had no effects on interest rates, its adverse effect on carrying costs and house values would be a foregone conclusion. A $200,000 house with a $120,000 mortgage at 10 percent has interest costs of $12,000 per year before deductions and $8,640 after deductions (for someone in the 28 percent tax bracket). The monthly carrying cost is $720. Take away the deductions, and the carrying cost jumps to $12,000 per year or $1000 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.

As we stressed earlier, our tax reform will immediately lower interest rates. And lower rates bring higher house prices, a point dramatically impressed on homeowners in the early 1980s when big increases in interest severely dampened the housing market. The total effect of reform will depend on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest. We have already indicated that there are good reasons to think interest rates would fall by about 2 percentage points—say from 10 to 8 percent for mortgages. The value of the lost deduction, on the other hand, depends on just what fraction of a house a prospective purchaser intends to finance. First-time home buyers typically, but not always, finance three-quarters or more of the price of a house. Some of them have family money or other wealth and make larger down payments. Families moving up by selling existing houses generally plan much larger equity positions in their new houses. Perhaps a down payment of 50 percent is the average, so families are paving interest (and deducting) on $500 per thousand dollars of house.

A second determinant of the carrying cost is the value of the deduction, set by the marginal tax rate. Among homeowners, a marginal rate of 28 percent is typical, corresponding to a taxable income of $37,000 to $89,000. Interest-carrying costs per thousand dollars of house are $50 per year before taxes ($500 borrowed at 10 percent interest) and $36 per year after taxes. When tax reform comes, the interest rate will fall to 8 percent, and carrying costs will be $40 per year ($500 at 8 percent) both before and after taxes. Tax reform will put this buyer behind by $4 per thousand dollars of house per year, or $800 per year for the $100,000 house.

If this $800 per year were the end of the story, it would bring a modest decline in house prices. But there is another factor we haven't touched on yet. The buyer's equity position—the down payment—must come from somewhere. By putting wealth into a house, the buyer sacrifices the return that wealth would have earned elsewhere. The alternative return from the equity in the house is another component of the carrying cost. Tax reform almost surely reduces that component. As just one example, take a prospective buyer who could put wealth into an untaxed retirement fund if he didn't put it into a house. The fund holds bonds; after reform, the interest rate on bonds would be perhaps 3 percentage points lower, and so the implicit cost of the equity would be lower by the same amount.

To take a conservative estimate, tax reform might lower the implicit cost of equity by one percentage point as interest rates fall. Then the carrying costs of the buyer's equity would decline by $5 ($500 at 1 percent) per thousand dollars of house per year. Recall that the buyer has come out behind by $4 on the mortgage-interest side. On net, tax reform would lower the carrying costs by $5 − $4 = $1 per thousand, or $200 per year for the $200,000 house. Then housing prices would actually rise under the impetus of tax reform.

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small—small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects—to reduce in-

terest rates and related costs of funds (and so to stimulate housing and other asset markets) and to deny interest deductions (and so to depress housing). To a reasonable approximation, these influences will cancel each other out.

If tax reform sets off a rip-roaring investment boom, interest rates might rise in the years following the immediate drop at the time of the reform. During this period, when corporations will be competing strongly with home buyers for available funds, house prices would lag behind an otherwise brisk economy. The same thing happened in the great investment boom of the late 1960s. But to get the strong economy and new jobs that go with an investment boom, minor disappointments in housing values would seem a reasonable price. In the long run, higher incomes will bring a stronger housing market.

What about the construction industry? Will a slump in new housing accompany a tax reform that banishes interest deductions, as the industry fears? The fate of the industry depends intimately on the price of existing housing. Were tax reform to depress housing by raising carrying costs, the public's interest in new houses would fall in parallel with its diminished enthusiasm for existing houses. Because tax reform will not dramatically alter carrying costs in one direction or another, it will not enrich or impoverish the construction industry.

So far, we have looked at the way prospective buyers might calculate what value of house they can afford. These calculations are the proximate determinants of house prices. But they have no bearing on the situation of an existing homeowner who has no intention of selling or buying. To the homeowner, loss of the tax deduction would be pure grief.

Our transition proposal takes care of the problem of existing mortgages without compromising the principles of the flat tax or diminishing its revenue. Homeowners would have the right to continue deducting 90 percent of their mortgage interest. Recall that the bank would then be required to pay tax on the interest it received, even though interest on new mortgages would be untaxed. Homeowners could expect to receive attractive propositions from their banks to rewrite their mortgages at an interest rate about three percentage points lower, but without tax deductibility. Even if banks and homeowners could not get together to lower rates, the homeowner could still deduct 90 percent of what he deducted before.

CONCLUSIONS

The flat tax comes with strong recommendations. It would bring a drastic simplification of the tax system. It imposes an across-the-board consumption tax at the low rate of 19 percent. It raises enough revenue to replace the existing personal and corporate income taxes. Through consistent use of the source principle of taxation, it would drastically limit leakage the pervades today's taxes based on the destination principle. The flat tax is progressive—it exempts the poor from paying any tax, and imposes a tax that is a rising share of income for other taxpayers. The economy would thrive under the improved incentives that the flat tax would provide.

PREPARED STATEMENT OF JOEL B. SLEMROD

Amid all the controversy and disagreement about flat taxes, one thing is certain. Replacing the existing income tax structure with any one of several proposals labeled as a flat tax would make the Tax Reform Act of 1986 look like a technical corrections bill. Because of this, it is a proposition that must be preceded by a deliberate, careful conversation about its impact. I applaud this Committee's efforts to further that conversation, and am grateful to be able to participate in this panel.

WHAT EXACTLY IS A FLAT TAX?

This conversation should begin by carefully considering what exactly is meant by flatness in a tax system, and by examining the advantages and disadvantages of each separate aspect of flatness. After all, in other contexts "flat" is not always a good thing—think of beer, or musical notes. Webster's Unabridged Dictionary lists sixteen major definitions for flat as an adjective, ranging from praiseworthy ones such as "level" and "exact" to much less attractive ones, including "shallow," "dull and stupid," "commercially inactive," and even "having no money." In the context of taxation, the word flat conjures up Webster's definition of "not varying." But even that is open to multiple interpretations.

A SINGLE-RATE TAX?

As currently used, a flat tax does not mean that tax liability is invariant with respect to indicators of a household's level of well-being, be that measured by in-

come or consumption. Economists call this a lump-sum tax, often assessed as a poll tax. Experience with poll taxes, most recently in the guise of the British "community charge," reveals them to be difficult to administer and, most tellingly, in violation of most citizens' sense of fairness.

It is the rate of tax, rather than tax liability, that is invariant under a flat tax. A single tax rate would replace our current system of graduated tax rates that increase with higher incomes. While a truly flat rate tax would apply the single rate of tax to the entire tax base, from the first dollar to the last, flat tax proposals usually exempt a certain amount of income, or consumption, from taxation. For that reason they are really a form of graduated tax, with an initial bracket to which a zero tax rate applies, plus an open-ended bracket subject to a single tax rate. Under such a system, the average tax rate increases gradually as the tax base increases, and the degree of progressivity can be varied by adjusting the level of tax-exempt income.

To distinguish this aspect of flatness from the others, I will refer to a tax system with this characteristic as a single-rate tax. Eliminating the graduation of tax rates can be accomplished independently of any and all of the changes in the tax base that are usually associated with flat taxes, and should be evaluated separately.

Moving to a single-rate system by itself , with no change in the tax base, would certainly shift the burden of taxes away from upper-income families and increase the burden on lower and middle-income families. Whether this is a good idea or not is not a matter of economics—it is a matter of fairness. If asked to design an income tax rate structure, most Americans choose one that features graduated rates. In making such a choice, however, most people probably do not consider that a single-rate system, by lowering the average marginal tax rate, probably increases the aggregate incentive to work and therefore national income. The tradeoff between the progressivity and national income is a bread-and-butter economics question. Unfortunately, scores of studies have failed to produce a consensus about the terms of this tradeoff.

The number of tax brackets per se does not cause substantial complexity. One of the great red herrings during the debate over the Tax Reform Act of 1986 was that collapsing 14 tax brackets (15, for single filers) to three was an important simplification. This is nonsense, because once taxable income is computed, calculating tax liability from the tax tables is a trivial operation that is not perceptibly simplified by having fewer brackets.

However, having most, or all, individuals in the same tax bracket does facilitate a major administrative simplification. If most everyone has the same tax rate, say 25%, then most tax could be remitted at the source of the income payment, rather than by the recipient. Banks could withhold 25% of interest payments before paying them out, so that interest income need not be reported; corporations could withhold 25% of dividends, so that dividends need not be reported by individuals. Withholding at source could be greatly expanded, which would significantly reduce the complexity of the income tax system. Reducing the disparity of tax rates (not the same thing as the number of rates) also reduces the incentives of individuals to shift taxable income from high-rate to low-rate taxable entities, and from high-tax to low-tax periods; this also serves to dampen tax complexity.

A CLEAN-BASE TAX?

A second aspect of flatness concerns the tax base. Because nearly every economic issue has a tax angle, just about any time someone comes up with a bright idea about how the government should encourage some economic activity or another, or reward some category of household or another, the tax system gets the call. One result of this is that our tax system is an awkward mixture of a revenue-raising system plus scores of incentive and distributional programs, and the tax system is much more complicated than it would be if its only function were to raise revenue in the most cost-efficient way possible. What this also means is that tax reform is never only about who should pay how much tax—it is also about housing policy, family policy, child care policy, R&D policy and a lot of other things.

Should the tax system excuse itself from being involved in all these areas of policy, and concern itself only with raising revenue? Probably not entirely. After all, the administrative machinery already exists for the government to collect and, in some cases, remit money to over 100 million households and several million corporations. If we as a society decide to subsidize child care expenditures, from a purely administrative point of view it doesn't make sense to set up a separate system for processing child care credit applications and remitting checks to eligible people. Since the IRS is already set up to process tax forms and send out checks, it is surely cost-effective to piggyback a child-care credit onto the tax administration. Why not

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just keep one set of accounts between the government and private citizens? Although using the tax system for all sorts of government policies surely adds to its complexity, the costs of running an administratively separate child care subsidy, or R&D credit, or charity incentive, would probably be even higher than the incremental costs of running these programs within the tax system.

A serious problem with this approach is that the policies that are piggybacked onto the revenue-raising system are often thereby obscured, with the result that there are important economic policies hidden in the tax system which would never be enacted as stand-alone policies. As an example, consider the political prospects of the following proposal. The federal government has decided to subsidize the activities of state and local governments. It has decided not to limit the kinds of activities it will subsidize—municipal swimming pools and golf courses will be treated the same as primary education and fire departments. The subsidy will not be remitted to the state and local governments, but rather remitted directly to the residents. The rate of subsidy, though, will not be the same for all citizens. Only the most affluent one-third of Americans will receive the subsidy, and furthermore there will be several rates of subsidy: 15%, 28%, 31%, 36%, and even 39.6%—the higher one's income, the higher the rate of subsidy. And one last thing—the subsidy is lost to the extent that governments decide to finance their expenditures with sales tax.

This is certainly a very peculiar kind of subsidy program, and one which I am sure would never be passed. But it is exactly the system we have now in the form of the deduction for state and local income and property taxes. This deduction can be claimed only by households that itemize their deductions, generally the most affluent one-third of families. The value of the deduction depends on the household's marginal tax rate, which is higher for higher-income households. Sales tax payments are not deductible, only income tax and property tax payments are.

Most of the bells and whistles in the current individual tax base are justified by supporters on the basis of one (or both) of two arguments. The first is that, in many circumstances, income is not an accurate measure of a household's level of well-being; therefore, in the absence of certain adjustments basing tax liability on income will generate (horizontal) inequity. This argument applies most clearly to involuntary medical expenses, but its merit is debatable as it applies to features such as dependent exemption allowances and state and local tax deductions. These provisions result in a personalized tax system, in which tax liability is fine-tuned to individual circumstances, at the cost of increased complexity.

The current tax system is not only personalized, but also incentivized. Many of the deviations from a clean tax base are justified by supporters on the grounds that they encourage socially desirable behavior—the deduction for charitable contributions is a good example of this. But social desirability is not a sufficient reason for preferential tax treatment; there must be benefits to the activity not valued by the taxpayer that spill over to others.

This testimony is not the appropriate place to address all of the arguments for personalizing tax liability and favoring some activities over others; some of the arguments are sensible, others less so. In my judgment, eliminating all of these features, producing what I call a "clean-base" tax system, would on balance improve both the equity of the tax system and the performance of the economy itself by rationalizing the allocation of resources.

One dimension of rationalization would be achieved if the tax system is neutral with respect to investment choices. Straying from neutrality implies that the country's capital resources are not being put to their best use.Differences in the effective tax rate on investment—by sector, by type of capital good, and by type of financing—were rife in the early 1980's, and reducing these differences was one of the principal objectives of the Tax Reform Act of 1986. Entirely eliminating such differences is very difficult under an income tax because it requires, among other things, setting depreciation allowances equal to economic depreciation, inflation-proofing the measurement of capital income, and dealing appropriately with vexing time-value-of-money issues. Perhaps not surprisingly, it is easiest to establish a uniform effective tax rate on investment when that tax rate happens to be zero. By allowing expensing of all capital purchases (along with no interest deductibility), the tax system will not distort investment choices among assets; it will also eliminate any tax disincentive on the overall volume of investment.

A CONSUMPTION TAX?

Whether the tax base is income or consumption is not commonly associated—by other than economists—with flatness. But to economists a consumption tax imposes a uniform, call it flat if you like, tax on current consumption and future consump-

tion. In contrast, an income tax, because it taxes the return to saving, makes consumption in the future more expensive than consumption now.

Calling a consumption tax flat by no means settles the question of whether consumption as a tax base is superior to income. There is no more controversial issue in the economics of taxation. Which base is superior has been debated in terms of equity, efficiency, and simplicity.

Most economists would argue that, ignoring bequests and inheritances, consumption taxation avoids imposing a tax penalty on those who are relatively frugal; over a lifetime it levies the same present value of taxation regardless of one's saving propensity, while an income tax tends to penalize savers. However, a consumption tax which does not include bequests or inheritances in the tax base will lower the average tax rate over the lifetime of those (generally high-income) families who pass on wealth to their heirs.

On a year-by-year basis, a consumption-based tax appears to be much more regressive than an income tax with the same rate structure. This argument, though, can be exaggerated. Comparing the distribution of tax burdens under an income tax and a consumption tax by looking at a snapshot of cross-sectional data can significantly overstate the regressivity of the consumption tax, because it will include people with temporarily low income who have maintained a level of consumption corresponding to their usual income. The apparent conclusion is that the burden of a consumption tax would greatly exceed that of an income tax for these people. Over a long period, however, consumption must match up more closely with income than a single year's snapshot suggests.

There is another distributional issue lurking here. A switch from income taxation to consumption taxation redistributes the tax burden across generations, toward those at or near retirement who have already paid income tax on their earnings, and who expected to be relatively free from taxation from that point on. Instituting a consumption tax will substantially increase their tax burden, as they pay tax on consumption during their later years. From an efficiency point of view, it is not unattractive to transfer the tax burden toward people whose working life is finished or nearly finished—there are no costly disincentives created thereby—and who have a relatively high propensity to consume, but this transfer of tax burden raises another equity issue on which economic analysis is mute.

What are the long-term economic benefits of switching to a consumption tax? One that I have already discussed is that it would eliminate tax-induced distortions to the allocation of the nation's capital stock and other resources. In large part, though, the case rests on its impact on saving and investment, which ultimately determine the country's wealth; there is wide consensus that saving and investment rates are too low.

Whether a consumption tax would significantly increase saving and/or domestic investment is an unsettled proposition, which depends on their responsiveness to the after-tax return. One reading of the evidence generated by the major tax changes of the 1980's is that saving and investment have proven to be less responsive to taxation than many economists previously believed. Furthermore, there is evidence that the current combination of nominal interest deductibility, accelerated depreciation allowances, and arbitrage opportunities implies that the aggregate average tax on capital income is already at or close to zero. The bottom line is that switching to a consumption tax does not guarantee a big boost in saving and investment. My best guess is that it would increase the private saving rate, although probably by not more than one or two percentage points. Because there are more direct ways to increase national saving (e.g., lowering the federal deficit), the likely but not assured prospect of a higher saving rate does not seem to be, by itself, a reason to undertake a wholesale transformation of the tax system.

Whether a consumption tax is simpler to administer and comply with than an income tax depends on what other aspects of flatness are present. Merely converting from an income base to a consumption base, without going to a single rate or eliminating the bells and whistles of the tax base, does not promise much simplification. I have in mind a graduated personal consumption tax which establishes what is essentially an unlimited and unrestricted Individual Retirement Account. The personal side of this tax would be more, not less, complex than our current system, although the business tax component of such proposals often promises considerable simplification.

A SINGLE-RATE, CLEAN-BASE, CONSUMPTION TAX?

Although not all consumption-based taxes are less complex than our present system, some certainly are. A single-rate, clean-base, consumption tax would certainly represent a vast simplification. But a single-rate (with no exemption level), clean-

base consumption tax is, administration aside, equivalent to a retail sales tax (RST) or, in slightly different form, a value-added tax (VAT). Most tax experts believe that an RST is unadministrable—because of enforcement problems—at the rate that would be needed to replace the revenue from the income tax—about 25%. Three decades of European experience with the VAT, in some cases with basic rates approaching 25%, provide some assurance that this form of consumption tax could eventually be well administered.

The Hall-Rabushka flat tax is precisely a value-added tax, plus a rebate of taxes to families based on their labor income and family size; labor income, which is in the business tax base under a VAT, is taxed instead (at the same rate) by the personal tax in the Hall-Rabushka scheme. Although no country operates such a tax, its similarity to the VAT suggests that many of the administrative and compliance problems are manageable, and that the resource cost of operating it would be much lower than that of our current system, although not trivial; value-added taxes present their own unique operational problems, such as how to tax the financial sector.

A few warnings are in order, though. The European countries that levy a VAT do so in addition to an income tax system featuring rates comparable, and in some cases higher, than our own. Eliminating our income tax system raises serious issues of how to coordinate what replaces it with the income tax systems of other nations, including, but not limited to, the need to rethink and renegotiate our bilateral tax treaties. Second, no nation levies a substantial personal tax on labor income while completely exempting capital income in the form of interest, dividends, capital gains, rental income, and so on. I have serious doubts that this aspect of the Hall-Rabushka tax would pass the "sniff test" most Americans apply to judge what is fair and what is not, notwithstanding economists' arguments about how the business tax mitigates this problem. Finally, European countries generally adopted a VAT as a replacement for turnover taxes on output, and therefore did not have to confront the difficult fairness and administration issues regarding how to make the transition from an income to a consumption tax. This is not the place to address these issues; it is clear, though, that an equitable transition to an equitable and simple tax can be exceedingly complex.

Although the Hall-Rabushka flat tax would be much simpler than the current income tax, I believe that the same statement could be made about a single-rate, clean-base income tax system, or even about a two-rate, clean-base income tax system—there is a lot of room for streamlining, simplification, and rationalization. For that matter, there is much to be gained with a two-rate, clean-base consumption tax, along the lines of the "X-tax" proposed by David Bradford. Because of the inescapable difficulties of accurately measuring capital income, a consumption tax is inherently less complex than an income tax, but only in its indirect (VAT or Hall-Rabushka, as opposed to personal consumption tax) form.

The Congress ought to debate whether we should have a single-rate tax. The Congress ought to debate whether we should have a clean-base tax that eliminates the fine-tuning of tax liability, and establishes a level playing field for businesses. And, the Congress ought to debate whether we should have a tax based on consumption (or labor, and not capital, income).

One particular tax reform proposal, the one originally conceived by Robert Hall and Alvin Rabushka, has become widely known as the flat tax. This moniker may be deserved, because the Hall-Rabushka flat tax is a single-rate, clean-base, level-playing-field, consumption-based tax. But choosing among these aspects of flatness is not an all-or-nothing proposition. Each aspect of flatness should be considered on its own merits.

From a tactical point of view, I see much to be gained from the Congress clearly separating the distinct aspects of flatness I have discussed here, and debating which aspects are not desirable, rather than considering what, if any, steps toward flatness should be taken. In closing I offer the example of Hercules, who, as penance for having killed his wife and children in a fit of madness, was given twelve tasks of immense difficulty. The fifth of these tasks was one of the most daunting of all—to clean, in one day, thirty years of accumulated manure left by thousands of cattle in the stables of Augeas. (The analogy to the tax system is, I fear, obvious). Hercules did not attempt to clean out the stables one shovelful at a time. Instead, Hercules diverted the rivers Alpheus and Peneus through the stables, ridding them of their filth at once. There is much to clean in the tax system, and contemplating a Herculean approach is an appropriate way to begin the national conversation about tax reform.

PREPARED STATEMENT OF HON. RICHARD C. SHELBY

Mr. Chairman, thank you for presenting a forum to discuss the advantages and disadvantages of a flat tax. Although I will say from the start, I believe the disadvantages of a flat tax are little to none.

I would like to begin the discussion by answering the question why is Congress even considering tax reform? The current system, while serving its purpose of revenue collection, has been criticized for not being fair, for punishing individuals who save and for being too complicated. Keeping in mind those criticisms, I believe any reform we implement must address these problems.

Over the years, the income tax has had many graduated rates, each adjusted during different era's of history. During the Hoover Administration, rates ranged from 25% to 63%. During the Kennedy year's rates ranged from 14% to 70%. Now the top rate is 39.6%. Which of these rates are fair? Is a rate of 39. 6% on the rich more fair than 70%? Or is it less fair? Clearly these so called "fair" rates are arbitrary.

In addition, the current tax code punishes thrifty individuals who save and invest—individuals who work hard to pay the taxes on his/her wage income, put food on the table, a roof overhead and clothes on the children. If the individual is thrifty and saves money, this person is currently taxed for his investment income. This double taxation hinders capital formation. Indeed, individuals now hold on to capital gains simply to avoid paying taxes. Instead of putting the capital to the highest valued use, individuals feel their money is trapped by the current high marginal rates of investment income.

As for simplicity, the current tax code is anything but simple. With approximately 480 tax forms, the tax code makes the average individual's head spin. The time and resources wasted just to comply with the current tax code is estimated at 5.4 billion hours or a cost of over $150 billion. Clearly, the United States could be more productive with a less burdensome tax system.

The flat tax addresses each of these problems.

The definition of fair as defined by Webster's dictionary states, "marked by impartiality and honesty; free from self-interest, prejudice, or favoritism." The Armey-Shelby flat tax has one integrated rate of 17%. Everyone is treated the same and there is no favoritism. The beauty of the Armey-Shelby flat tax is the generous individual allowances which in effect make the system progressive. As a result, the flat tax meets the criteria of fairness as historically defined and as the current political rhetoric would have it.

The savings rate in America is anemic. A great deal of this can be attributed to the current tax code. The flat tax repeals the double taxation of investment income by taxing it once and only once at the source. As a result, individuals will not feel that their capital is "locked-in" and will be able to move capital into the highest valued use. In addition, the flat tax is expected to pull down interest rates because today's interest rates are sustained partly by the income tax deduction for interest paid and the tax on interest earned. By repealing this treatment of interest in the tax code, interest rates are expected to fall to about the same level as that of Municipal Bonds. This will reduce the cost of capital and also aid in capital formation.

On the issue of simplicity, no other plan meets this criteria better than the flat tax. Although the Nunn-Domenici tax reform achieves some of the same goals of a flat tax, like ending double taxation, it does not simplify the code. Indeed, some may argue Nunn-Domenici complicates the code. Instead of countless hours and expensive accountants, the individual can fill out the income taxes on two simple tax forms the size of a postcard.

Lastly, I would like to say that any tax reform Congress may adopt must reduce the marginal tax rate. Economists on both sides of the aisle agree that a lower marginal tax rate will stimulate growth in the economy. In the face of the current fiscal crisis, I am convinced the most effective but least painful way to address the issue is with strong, sustained economic growth. The Armey-Shelby flat tax would provide that growth.

PREPARED STATEMENT OF HON. ARLEN SPECTER

[APRIL 5, 1995]

Mr. Chairman, I applaud you and the Senate Committee on Finance for convening this hearing on the issue of the flat tax. The tax system that we use in America today is a national disgrace, with a dedicated deduction for every interest group and a loophole for every lobbyist. Our current system is bizarre, burdensome, and biased against growth. The flat tax will give the American people a system which is simple, fair and pro-growth.

With all the current discussion about tax cuts circulating on Capitol Hill, one proposal which has received very little notice is a proposal for reducing a hidden tax of *$200 billion* levied every year on Americans by the Internal Revenue Service. This hidden tax is the amount that individuals and businesses spend every year in compliance with a byzantine tax code that has ballooned to over 12,000 pages of regulations and 5.6 million words.

My bill, the Flat Tax Act of 1995 (S. 488), would virtually eliminate this enormous hidden tax. The Flat Tax Act, which I introduced on March 2, 1995, would scrap the vast majority of these IRS rules and regulations, with the myriad rates, deductions and instructions, and replace them with a 20% flat tax under which Americans could file their tax returns on a simple 10-line postcard. Thus, instead of spending billions of dollars every year on high-priced tax attorneys or accountants who are a virtual necessity for anyone seeking to fill out tax returns, and billions of hours, Americans could devote their energies to more productive pursuits.

The basic model for my legislation comes from a plan created by Professors Robert Hall and Alvin Rabushka of the Hoover Institute and a flat tax bill introduced in the House of Representatives by Majority Leader Richard Armey. These other plans, however, would eliminate all deductions.

I have included limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications limit the purity of the flat tax principle, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness—and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult; but without them, probably impossible.

In this Congress, we have been concerned with the work of reducing the size and cost of government, and this is work which is vitally important. But the work of downsizing government is only one side of the coin. What we must do at the same time, and with as much energy and care, is to promote economic growth. As we reform the welfare programs and government bureaucracies of past administrations, we must replace those programs with a prosperity that extends to all segments of American society through private investment and job creation—which can have the additional benefit of producing even lower taxes for Americans as economic expansion adds to federal revenues. Just as Americans need a tax code that is fair and simple, they also are entitled to tax laws designed to foster rather than retard economic growth.

Under my tax plan, individuals would be taxed at a flat rate of 20% on all income they earn from wages, pensions and salaries. Individuals would not be taxed on any capital gains, interest on savings, or dividends. The flat tax will also eliminate all but two of the deductions and exemptions currently contained within the tax code. Instead, taxpayers will be entitled to "personal allowances" for themselves and their children: $9,500 for a single taxpayer, $14,000 for a single head of household and $16,500 for a married couple filing jointly; and $4,500 per child or dependent. These personal allowances would be adjusted annually for inflation. Thus, a family of four would be entitled to $25,500 in tax-free income before any taxes were assessed on their wages.

Businesses would also be taxed at a flat rate of 20%. My legislation would eliminate the intricate scheme of depreciation schedules, deductions, credits, and other complexities. Instead, businesses would only deduct wages, direct expenses and purchases. Businesses would be allowed to expense 100% of the cost of capital formation, including purchases of capital equipment, structures and land, and to do so *in the year in which the investments are made.*

The key advantages of this flat tax plan are three-fold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts, and as interest rates drop. By contrast, there will be a contraction of the IRS if this proposal is enacted.

SIMPLICITY

The first major advantage to this flat tax is simplicity. According to reliable studies, Americans spend approximately 5.4 billion hours each year filling out tax forms. Much of this time is spent burrowing through IRS laws and regulations, which, according to the Tax Foundation, have grown from 744,000 words in 1955 to 5.6 million words in 1994. Even those IRS forms which are intended to be simple are not.

The IRS notes proudly that it should take taxpayers "only" 2 hours and 54 minutes to complete and file the 1040EZ form, which is supposedly the most simple tax form available.

Whenever the government gets involved in any aspect of our lives, it can convert the most simple goal or task into a tangled array of complexity, frustration and inefficiency. By way of example, most Americans have become familiar with the absurdities of the government's military procurement programs. If these programs have taught us anything, it is how a simple purchase order for a hammer or a toilet seat can mushroom into thousands of words of regulations and restrictions when the government gets involved. The Internal Revenue Service is certainly no exception. Indeed, it has become a distressingly common experience for taxpayers to receive computerized print-outs claiming that additional taxes are due, which require repeated exchanges of correspondence or personal visits before it is determined, as it so often is, that the taxpayer was right in the first place.

My plan would eliminate these kinds of frustrations for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete literally millions of words from the Internal Revenue Code. Instead of billions of hours of nonproductive time spent in compliance with (or avoidance of) the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

The flat tax I have proposed can be calculated just by filling out a small postcard which requires a taxpayer only to answer a few easy questions. The postcard would look like this:

Form 1	Individual Wage Tax	1995
Your first name and initial (if joint return, also give spouse's name and initial)		Your social security number - -
Home address (number and street including apartment number or rural route)		Spouse's social security number - -
City, town, or post office, state, and ZIP code		

1. Wages, salary, pension and retirement benefits — 1 ________
2. Personal allowance (enter only one)
   - $16,500 for married filing jointly
   - $9,500 for single
   - $14,000 for single head of household — 2 ________
3. Number of dependents, not including spouse, multiplied by $4500 — 3 ________
4. Mortgage interest on debt up to $100,000 for owner-occupied home — 4 ________
5. Cash or equivalent charitable contributions (up to $2,500) — 5 ________
6. Total allowances and deductions (lines 2, 3, 4 and 5) — 6 ________
7. Taxable compensation (line 1 less line 6, if positive; otherwise zero) — 7 ________
8. Tax (20% of line 7) — 8 ________
9. Tax withheld by employer — 9 ________
10. Tax or refund due (difference between lines 8 and 9) — 10 ________

Filing a tax return would become a manageable chore, not a seemingly endless nightmare, for most taxpayers.

SLASH THE IRS

Along with the advantage of simplicity, enactment of this flat tax bill will help to remove the burden of costly and unnecessary government regulation, bureaucracy and red tape from our everyday lives. The heavy hand of government bureaucracy is particularly onerous in the case of the Internal Revenue Service, which has been able to extend its influence into so many aspects of our lives.

In 1994, the IRS employed over 110,000 people, spread out over 650 offices across the United States. Its budget was in excess of $13 billion, with some $7.1 billion spent annually just to administer the tax laws, and another $4 billion for enforcement. By simplifying the tax code and eliminating most of the IRS' vast array of rules and regulations, the flat tax would enable us to cut a significant portion of the IRS budget, including the bulk of the funding now needed for enforcement and administration.

In addition, a flat tax would allow taxpayers to redirect their time, energies and money away from the yearly morass of tax compliance. According to the Tax Foundation, in 1994, businesses spent approximately $127 billion in compliance with the federal tax laws, and individuals spent an additional $65 billion, for a total of $192 billion. Monies spent by businesses and investors in creating tax shelters and finding loopholes could be instead directed to productive and job-creating economic activity. With the adoption of a flat tax, the opportunities for fraud and cheating would also be vastly reduced, allowing the government to collect, according to some estimates, over $120 billion annually.

ECONOMIC GROWTH

Another major advantage to a flat tax is that it will be a tremendous spur to economic growth. Because of the incentives for savings and investment contained in my legislation, economists estimate that interest rates would fall by as much as two points and the economy would grow by up to *$2 trillion*, in present value terms, over a seven year period. That represents an increase of $1,900 in wealth for every man, woman and child in America.

The economic principles are fairly straightforward. Our current tax system is inefficient; it is biased toward too little savings and too much consumption. The flat tax creates substantial incentives for savings and investment by eliminating taxation on interest, dividends and capital gains—and tax policies which promote capital formation and investment are the best vehicle for creation of new and high paying jobs, and for a greater prosperity for all Americans.

It is well recognized that to promote future economic growth, we need not only to eliminate the federal government's reliance on deficits and borrowed money, but to restore and expand the base of private savings and investment that has been the real engine driving American prosperity throughout our history. These concepts are interrelated, for the federal budget deficit soaks up much of what we have saved, leaving less for businesses to borrow for investments.

It is the sum total of savings by all aspects of the U.S. economy that represents the pool of all capital available for investment—in training, education, research, machinery, physical plant, etc.—and that constitutes the real seed of future prosperity. The statistics here are daunting. In the 1960s, the net U.S. national savings rate was 8.2 percent, but it has fallen to a dismal 1.5 percent. In recent international comparisons, the U.S. has the lowest savings rate of any of the G-7 countries. We save at only one-tenth the rate of the Japanese, and only one-fifth the rate of the Germans, which is clearly reflected in the comparative growth rates of our economies over the last three decades.

An analysis of the components of U.S. savings patterns shows that although the federal budget deficit is the largest cause of "dissavings," both personal and business savings rates have declined significantly over the past three decades. Thus, to recreate the pool of capital stock that is critical to future U.S. growth and prosperity, we have to do more than just get rid of the deficit. We have to very materially raise our levels of private savings and investment. And we have to do so in a way that will not cause additional deficits.

The less money people save, the less money is available for business investment and growth. The current tax system discourages savings and investment, because it taxes the interest we earn from our savings accounts, the dividends we receive from investing in the stock market, and the capital gains we earn from successful investments in our homes and the financial markets. Indeed, under the current law these rewards for saving and investment are not only taxed, they are overtaxed—since gains due solely to inflation, which represent no real increase in value, are taxed as if they were really profit.

With the limited exceptions of retirement plans and tax free municipal bonds, our current tax code does virtually nothing to encourage personal savings and investment, or to reward it over consumption. As William Schreyer wrote recently in the *Harvard Business Review*, "the budget deficit is only one part of a larger national problem: the U.S. *saving deficit*.

S. 488 will change this system, and address this problem. The proposed legislation reverses the current skewed incentives by promoting savings and investment by in-

dividuals and by businesses. Individuals would be able to invest and save their money tax-free and reap the benefits of the accumulated value of those investments without paying a capital gains tax upon the sale of these investments. Businesses would also invest more as the flat tax allowed them to expense fully all sums invested in new equipment and technology in the year the expense was incurred, rather than dragging out the tax benefits for these investments through complicated depreciation schedules. With greater investment and a larger pool of savings available, interest rates and the costs of investment would also drop, spurring even further economic growth.

Critics of the flat tax have argued that we cannot afford the revenue losses associated with the tremendous savings and investment incentives the bill affords to businesses and individuals. Those critics are wrong. Not only is this bill intended to be revenue neutral, but historically we have seen that when taxes are cut, revenues actually increase, as more taxpayers work harder for a larger share of their take-home pay, and investor are more willing to take risks in pursuit of rewards that will not get eaten up in taxes. As one example, under President Kennedy individual tax rates were lowered, investment incentives including the investment tax credit were created and then expanded, depreciation rates were accelerated, and yet between 1962 and 1967 gross annual federal tax receipts went from $99.7 billion to $148 billion—an increase of nearly 50%. More recently under President Reagan, after his tax cuts in the early 1980's, government tax revenues rose from just under $600 billion in 1981 to nearly $1 trillion in 1989. In fact, the Reagan tax cut program helped to bring about the longest peacetime expansion of the U.S. economy in history. There is every reason to believe that the flat tax proposed here can do far more—and by maintaining revenue neutrality in this flat tax proposal, as we have, we can avoid any increases in annual deficits and the national debt.

As Professors Hall and Rabushka state it, the growth case for a flat tax is compelling. It is even more compelling in the case of a tax revision that is simple and demonstrably fair.

FAIRNESS

In addition to increasing federal revenues by fostering economic growth, the flat tax can also add to federal revenues *without increasing taxes* by closing tax loopholes. Personal income in the United States totals about $5 trillion. Of this amount, however, only $2.4 trillion is reported as taxable income. Thus, over 50% of personal income is sheltered by legal loopholes, deductions, credits, exemptions or outright fraud. Under a flat tax system, all tax shelters will disappear and all income will be subject to taxation. With a broader tax base, we can then lower tax rates and ensure that all Americans pay their fair share of taxes.

The flat tax also promotes fairness by lessening the tax burden on working families. By eliminating loopholes and thus broadening the tax base, my legislation will force many higher income taxpayers to pay their fair share of taxes—and it will allow us to lower the taxes paid by lower and middle income families.

Mr. Chairman, no one likes to pay taxes, and no one likes the billions of dollars in additional hidden taxes and costs they incur every year simply seeking to comprehend and comply with the tax code. My 20% Flat Tax Act will dramatically restructure the IRS by eliminating most of its rules and regulations and firing most of its employees, and, as a result, it will change the way Americans feel about the tax code. I believe that all Americans would be willing to pay their share of taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My 20% flat tax bill affords Americans such a tax system.

In sum, I believe the flat tax is an idea whose time has come. Whether it is my bill or some other legislation, I urge this Committee to work towards bringing flat tax legislation to the floor of the Senate at the earliest possible moment. And I look forward to working with you in this endeavor.

Thank you Mr. Chairman and members of the Committee.

ADVANTAGES TO FLAT TAX PLAN

- SIMPLICITY—A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.4 billion hours they currently spend every year in tax compliance.

- CUTS GOVERNMENT—The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which take up 12,000 pages, and have grown from 744,000 words in 1955 to 5.6 million words in 1994. It would also

allow us to slash the mammoth IRS bureaucracy of 110,000 employees spread out over 650 offices nationwide.

- PROMOTES ECONOMIC GROWTH—Economists estimate a growth of over $2 trillion in national wealth over seven years, representing an increase of $1900 in personal income for every man, woman and child in America.
- INCREASES EFFICIENCY—Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.
- REDUCES INTEREST RATES—Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.
- LOWERS COMPLIANCE COSTS—Americans would be able to save up to $192 billion they currently spend every year in tax compliance.
- DECREASES FRAUD—As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over $120 billion in uncollected revenue annually.
- REDUCES IRS COSTS—Simplification of the tax code will allow us to save significantly on the $13 billion annual budget currently allocated to the Internal Revenue Service.

PREPARED STATEMENT OF HON. ARLEN SPECTER

[MAY 18, 1995]

Mr. Chairman, I appreciate this opportunity to appear before the Senate Committee on Finance to testify regarding flat tax legislation. I was previously scheduled to testify before this Committee on April 5, 1995 regarding my bill, The Flat Tax Act of 1995, S.488. At the same time, however, the Senate Select Committee on Intelligence, which I chair, was conducting public hearings on human rights abuses in Guatemala, which precluded my appearance before your Committee. Nonetheless, I submitted testimony to the Committee for the record, and my testimony today will supplement my prior testimony.

Yesterday, I testified before the Joint Economic Committee regarding the incredible complexity of the tax code and the fact that very few people understand our tax laws, much less the implications of a dramatic reform of these laws. I firmly, believe, however, that the more Americans learn about the flat tax, the more they like it. A recent poll by Newsweek magazine demonstrates the breadth of this support already, with 61% of the respondents indicating they favor a flat tax and a majority of these supporters expressing their preference for my flat tax plan, S. 488.

This groundswell of support has extended to the halls of Congress, as several of my colleagues in the Senate and the House of Representatives have expressed their interest in the flat tax. This support has increased after our recent Easter recess, when many Members of Congress travelled to their home states and districts and heard first-hand the demands of their constituents for simplification and reform.

The tax system that we use in America today is a national disgrace, with a dedicated deduction for every interest group and a loophole for every lobbyist. Our current system is bizarre, burdensome, and biased against growth. The flat tax will give the American people a system which is simple, fair and pro-growth.

My flat tax bill would scrap the vast majority of IRS rules and regulations, with the myriad/ rates, deductions and instructions, and replace them with a 20% flat tax under which Americans could file their tax returns on a simple 10-line postcard. Thus, instead of spending billions of dollars every year on high-priced tax attorneys or accountants who are a virtual necessity for anyone seeking to fill out tax returns, and billions of hours, Americans could devote their energies to more productive pursuits.

The basic model for my legislation comes from a plan created by Professors Robert Hall and Alvin Rabushka of the Hoover Institute and a flat tax bill introduced in the House of Representatives by Majority Leader Richard Armey. These other plans, however, would eliminate all deductions.

I have included limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications limit the purity of the flat tax principle, I believe that those two deductions are so

deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness—and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult; but without them, probably impossible.

For example, I have had several meetings with representatives of the real estate industry, including the National Association of Realtors, and they have expressed their strong opposition to an outright repeal of a deduction which many low and middle income Americans desperately need in order to afford the homes they live in or to maintain the hope of eventual home ownership. According to the Congressional Research Service, however, my flat tax will accommodate over 80% of taxpayers who have home mortgages under $100,000 and the remaining taxpayers will reap the benefits of lower borrowing costs by a drop in interest rates of up to two points.

In this Congress, we have been concerned with the work of reducing the size and cost of government, and this is work which is vitally important. But the work of downsizing government is only one side of the coin. What we must do at the same time, and with as much energy and care, is to promote economic growth. As we reform the welfare programs and government bureaucracies of past administrations, we must replace those programs with a prosperity that extends to all segments of American society through private investment and job creation—which can have the additional benefit of producing even lower taxes for Americans as economic expansion adds to federal revenues. Just as Americans need a tax code that is fair and simple, they also are entitled to tax laws designed to foster rather than retard economic growth.

Under my tax plan, individuals would be taxed at a flat rate of 20% on all income they earn from wages, pensions and salaries. Individuals would *not* be taxed on any capital gains, interest on savings, or dividends. The flat tax will also eliminate all but two of the deductions and exemptions currently contained within the tax code. Instead, taxpayers will be entitled to "personal allowances" for themselves and their children: $9,500 for a single taxpayer, $14,000 for a single head of household and $16,500 for a married couple filing jointly; and $4,500 per child or dependent. These personal allowances would be adjusted annually for inflation. Thus, a family of four would be entitled to $25,500 in tax-free income before any taxes were assessed on their wages.

Businesses would also be taxed at a flat rate of 20%. My legislation would eliminate the intricate scheme of depreciation schedules, deductions, credits, and other complexities. Instead, businesses would only deduct wages, direct expenses and purchases. Businesses would be allowed to expense 100% of the cost of capital formation, including purchases of capital equipment, structures and land, and to do so *in the year in which the investments are made.*

The key advantages of this flat tax plan are three-fold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts, and as interest rates drop. By contrast, there will be a contraction of the IRS if this proposal is enacted.

SIMPLICITY

The first major advantage to this flat tax is simplicity. According to reliable studies, Americans spend approximately 5.4 billion hours each year filling out tax forms. Much of this time is spent burrowing through IRS laws and regulations, which, according to the Tax Foundation, have grown from 744,000 words in 1955 to 5.6 million words in 1994. Even those IRS forms which are intended to be simple are not. The IRS notes proudly that it should take taxpayers "only" 2 hours and 54 minutes to complete and file the 1040EZ form, which is supposedly the most simple tax form available.

Whenever the government gets involved in any aspect of our lives, it can convert the most simple goal or task into a tangled array of complexity, frustration and inefficiency. By way of example, most Americans have become familiar with the absurdities of the government's military procurement programs. If these programs have taught us anything, it is how a simple purchase order for a hammer or a toilet seat can mushroom into thousands of words of regulations and restrictions when the government gets involved. The Internal Revenue Service is certainly no exception. Indeed, it has become a distressingly common experience for taxpayers to receive computerized print-outs claiming that additional taxes are due, which require repeated

exchanges of correspondence or personal visits before it is determined, as it so often is, that the taxpayer was right in the first place.

My plan would eliminate these kinds of frustrations for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete literally millions of words from the Internal Revenue Code. Instead of billions of hours of non-productive time spent in compliance with (or avoidance of) the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

The flat tax I have proposed can be calculated just by filling out a small postcard which requires a taxpayer only to answer a few easy questions. The postcard would look like this:

Form 1 | **Individual Wage Tax** | **1995**

Your first name and initial (if joint return, also give spouse's name and initial)	Your social security number - -
Home address (number and street including apartment number or rural route)	Spouse's social security number - -
City, town, or post office, state, and ZIP code	

1	Wages, salary, pension and retirement benefits	1________
2	Personal allowance (enter only one) -- $16,500 for married filing jointly -- $9,500 for single -- $14,000 for single head of household	2________
3	Number of dependents, not including spouse, multiplied by $4500	3________
4	Mortgage interest on debt up to $100,000 for owner-occupied home	4________
5	Cash or equivalent charitable contributions (up to $2,500)	5________
6	Total allowances and deductions (lines 2, 3, 4 and 5)	6________
7	Taxable compensation (line 1 less line 6, if positive, otherwise zero)	7________
8	Tax (20% of line 7)	8________
9	Tax withheld by employer	9________
10	Tax or refund due (difference between lines 8 and 9)	10________

Filing a tax return would become a manageable chore, not a seemingly endless nightmare, for most taxpayers.

SLASH THE IRS

Along with the advantage of simplicity, enactment of this flat tax bill will help to remove the burden of costly and unnecessary government regulation, bureaucracy and red tape from our everyday lives. The heavy hand of government bureaucracy is particularly onerous in the case of the Internal Revenue Service, which has been able to extend its influence into so many aspects of our lives.

In 1994, the IRS employed over 110,000 people, spread out over 650 offices across the United States. Its budget was in excess of $13 billion, with some $7.1 billion spent annually just to administer the tax laws, and another $4 billion for enforcement. By simplifying the tax code and eliminating most of the IRS' vast array of rules and regulations, the flat tax would enable us to cut a significant portion of the IRS budget, including the bulk of the funding now needed for enforcement and administration.

In addition, a flat tax would allow taxpayers to redirect their time, energies and money away from the yearly morass of tax compliance. According to the Tax Foundation, in 1994, businesses spent approximately $127 billion in compliance with the federal tax laws, and individuals spent an additional $65 billion, for a total of $192

billion. Monies spent by businesses and investors in creating tax shelters and finding loopholes could be instead directed to productive and job-creating economic activity. With the adoption of a flat tax, the opportunities for fraud and cheating would also be vastly reduced, allowing the government to collect, according to some estimates, over $120 billion annually.

ECONOMIC GROWTH

Another major advantage to a flat tax is that it will be a tremendous spur to economic growth. Yesterday, I testified before the Joint Economic Committee, along with two of the fathers of the flat tax, Jack Kemp and professor Alvin Rabushka, on how the flat tax will unleash up to $2 trillion in new economic growth and a drop in interest rates by as much as two points.

The economic principles are fairly straightforward. Our current tax system is inefficient; it is biased toward too little savings and too much consumption. The flat tax creates substantial incentives for savings and investment by eliminating taxation on interest, dividends and capital gains—and tax policies which promote capital formation and investment are the best vehicle for creation of new and high paying jobs, and for a greater prosperity for all Americans.

It is well recognized that to promote future economic growth, we need not only to eliminate the federal government's reliance on deficits and borrowed money, but to restore and expand the base of private savings and investment that has been the real engine driving American prosperity throughout our history. These concepts are interrelated, for the federal budget deficit soaks up much of what we have saved, leaving less for businesses to borrow for investments.

It is the sum total of savings by all aspects of the U.S. economy that represents the pool of all capital available for investment—in training, education, research, machinery, physical plant, etc.—and that constitutes the real seed of future prosperity. The statistics here are daunting. In the 1960s, the net U.S. national savings rate was 8.2 percent, but it has fallen to a dismal 1.5 percent. In recent international comparisons, the U.S. has the lowest savings rate of any of the G-7 countries. We save at only one-tenth the rate of the Japanese, and only one-fifth the rate of the Germans, which is clearly reflected in the comparative growth rates of our economies over the last three decades.

An analysis of the components of U.S. savings patterns shows that although the federal budget deficit is the largest cause of "dissavings," both personal and business savings rates have declined significantly over the past three decades. Thus, to recreate the pool of capital stock that is critical to future U.S. growth and prosperity, we have to do more than just get rid of the deficit. We have to very materially raise our levels of private savings and investment. And we have to do so in a way that will not cause additional deficits.

The less money people save, the less money is available for business investment and growth. The current tax system discourages savings and investment, because it taxes the interest we earn from our savings accounts, the dividends we receive from investing in the stock market, and the capital gains we earn from successful investments in our homes and the financial markets. Indeed, under the current law these rewards for saving and investment are not only taxed, they are overtaxed—since gains due solely to inflation, which represent no real increase in value, are taxed as if they were really profit.

With the limited exceptions of retirement plans and tax free municipal bonds, our current tax code does virtually nothing to encourage personal savings and investment, or to reward it over consumption. As William Schreyer wrote recently in the *Harvard Business Review,* "the budget deficit is only one part of a larger national problem: the U.S. *saving deficit.*"

S. 488 will change this system, and address this problem. The proposed legislation reverses the current skewed incentives by promoting savings and investment by individuals and by businesses. Individuals would be able to invest and save their money tax-free and reap the benefits of the accumulated value of those investments without paying a capital gains tax upon the sale of these investments. Businesses would also invest more as the flat tax allowed them to expense fully all sums invested in new equipment and technology in the year the expense was incurred, rather than dragging out the tax benefits for these investments through complicated depreciation schedules. With greater investment and a larger pool of savings available, interest rates and the costs of investment would also drop, spurring even further economic growth.

Critics of the flat tax have argued that we cannot afford the revenue losses associated with the tremendous savings and investment incentives the bill affords to businesses and individuals. Those critics are wrong. Not only is this bill intended to be

revenue neutral, but historically we have seen that when taxes are cut, revenues actually increase, as more taxpayers work harder for a larger share of their take-home pay, and investors are more willing to take risks in pursuit of rewards that will not get eaten up in taxes. As one example, under President Kennedy individual tax rates were lowered, investment incentives including the investment tax credit were created and then expanded, depreciation rates were accelerated, and yet between 1962 and 1967 gross annual federal tax receipts went from $99.7 billion to $148 billion—an increase of nearly 50%. More recently under President Reagan, after his tax cuts in the early 1980's, government tax revenues rose from just under $600 billion in 1981 to nearly $1 trillion in 1989. In fact, the Reagan tax cut program helped to bring about the longest peacetime expansion of the U.S. economy in history. There is every reason to believe that the flat tax proposed here can do far more—and by maintaining revenue neutrality in this flat tax proposal, as we have, we can avoid any increases in annual deficits and the national debt.

As Professors Hall and Rabushka state it, the growth case for a flat tax is compelling. It is even more compelling in the case of a tax revision that is simple and demonstrably fair.

FAIRNESS

In addition to increasing federal revenues by fostering economic growth, the flat tax can also add to federal revenues *without increasing taxes* by closing tax loopholes. Personal income in the United States totals about $5 trillion. Of this amount, however, only $2.4 trillion is reported as taxable income. Thus, over 50% of personal income is sheltered by legal loopholes, deductions, credits, exemptions or outright fraud. Under a flat tax system, all tax shelters will disappear and all income will be subject to taxation. With a broader tax base, we can then lower tax rates and ensure that all Americans pay their fair share of taxes.

The flat tax also promotes fairness by lessening the tax burden on working families. By eliminating loopholes and thus broadening the tax base, my legislation will force many higher income taxpayers to pay their fair share of taxes—and it will allow us to lower the taxes paid by lower and middle income families. IRS statistics indicate that in 1994, over 50% of all tax returns were filed by taxpayers earning less than $30,000. The vast majority of these taxpayers would pay little or no taxes under my flat tax, because of the $25,500 income exclusion for a family of four and the continuation of limited deductions for home mortgage interest and charitable contributions.

Mr. Chairman, no one likes to pay taxes, and no one likes the billions of dollars in additional hidden taxes and costs they incur every year simply seeking to comprehend and comply with the tax code. My 20% Flat Tax Act will dramatically restructure the IRS by eliminating most of its rules and regulations and firing most of its employees, and, as a result, it will change the way Americans feel about the tax code. I believe that all Americans would be willing to pay their share of taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My 20% flat tax bill affords Americans such a tax system.

The flat tax is an idea whose time has come. I spoke yesterday at some length with Professor Rabushka, Jack Kemp and House Majority Leader Richard Armey regarding my commitment to working with them and others to ensure continued progress in the flat tax debate, both in Congress and throughout this country. In this regard, I am also encouraged by the formation of the Dole-Gingrich Flat Tax Commission, to be headed by Jack Kemp, which will work toward promoting passage of flat tax reform.

Therefore, I urge this Committee to bring the flat tax to the floor of the Senate, whether it is my bill or some other flat tax legislation or amendment, at the earliest possible moment so that all Senators may be allowed to express their support for this fundamental reform. I look forward to working with you in this endeavor.

Thank you Mr. Chairman and members of the Committee.

ADVANTAGES TO FLAT TAX PLAN

- SIMPLICITY—A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.4 billion hours they currently spend every year in tax compliance.

- CUTS GOVERNMENT—The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which take up 12,000 pages, and have grown from 744,000 words in 1955 to 5.6 million words in 1994. It would also

allow us to slash the mammoth IRS bureaucracy of 110,000 employees spread out over 650 offices nationwide.

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	1995 Income Tax		Flat Tax	
Income	Taxes Owed	Effective Rate	Taxes Owed	Effective Rate
<$25,500	$1,105	4.5%	None	0%
$30,000	$2,018	6.7%	None	0%
$40,000	$3,300	8.3%	$1,300	3.3%
$50,000	$4,500	9.0%	$2,900	5.8%
$60,000	$5,700	9.5%	$4,860	8.1%
$70,000	$7,810	11.1%	$6,820	9.7%
$80,000	$10,050	12.6%	$8,780	11%
$90,000	$12,290	13.7%	$10,740	11.9%
$100,000	$14,530	14.5%	$12,700	12.7%
$125,000	$20,217	16.2%	$17,600	14.1%
$150,000	$26,531	17.7%	$22,600	15.1%
$200,000	$40,708	20.4%	$32,600	16.3%
$250,000	$57,088	22.8%	$42,600	17.0%
$500,000	$138,666	27.7%	$92,600	18.5%
$1,000,000	$303,006	30.3%	$192,600	19.3%

COMMUNICATIONS

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

This statement is submitted by the American Petroleum Institute (API) for the record of the May 18 Senate Finance Committee hearing on flat tax proposals. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

Various flat tax and consumption tax proposals have been offered recently as complete substitutes for the current income tax system. This testimony will focus on the business tax aspects of 1) S. 488, the Flat Tax proposal introduced by Sen. Specter, 2) S. 722, the USA Tax sponsored by Sens. Nunn and Domenici, and 3) a European-style Value Added Tax.

API takes no position at this time as to whether the current income tax system should be completely replaced, but there is no doubt that as presently codified, it imposes wasteful and unnecessary burdens on the economy. We commend the sponsors of the Flat Tax and the USA Tax for their efforts to improve our tax system and for moving the public dialogue on these issues forward.

Over the years, particularly because of the changes brought about by the Tax Reform Acts of 1984 and 1986, the Internal Revenue Code and the regulations thereunder have created the most complex income tax system in the world. Because of this complexity, unreasonable compliance and collection costs (both to the government and to taxpayers) jeopardize the efficiency of the system; obscure or conflicting aspects of the Code and regulations fail to become operative as intended; and administrative implementation of complex provisions often takes years, creating long periods of uncertainty and uncontrollable exposure for taxpayers.

Furthermore, the income tax is biased against savings and investment and in favor of consumption. It taxes savings twice: once when the income from which savings are generated is earned and again when the earnings on savings are realized. Moreover, because real capital costs are not fully recovered, there is also a tax on the capital investment itself.

Finally, the income tax is not a "border adjustable" tax. Therefore, it does not allow domestic and foreign produced goods to compete on an equal basis in the marketplace. Most of our trading partners have some form of value added tax—almost exclusively a credit/invoice style VAT—that permits the tax, under the rules of the General Agreement on Tariffs and Trade (GATT), to be rebated on exports. U.S. businesses are disadvantaged vis a vis their competitors in these countries because the U.S. income tax does not qualify for border adjustment under GATT. The income tax cannot be rebated on our exported goods, and goods imported into the U.S. do not bear the tax burden of the domestically produced goods nor do they bear the VAT imposed in their country of origin. Thus, our domestically produced goods must bear the burden of our income tax in foreign markets and also in our home market where they compete against imports bearing no domestic or country of origin value added tax.

API believes that properly designed consumption taxes are preferable to income taxes. In studying consumption taxes over a number of years, we have developed a set of principles by which we evaluate alternative consumption tax proposals. They include the following:

1. Minimize economic distortions.
2. Ensure that foreign and domestically produced goods compete equally in the marketplace.
3. Permit current deduction of capital expenditures.
4. Impose only one rate or as few rates as possible.
5. Facilitate recovery in the marketplace.

6. Exclude from the base: Separately stated excise taxes, including sales and use taxes; Royalty payments to federal and state governments; Non-cash exchanges.

7. Be relatively easy to comply with and administer.

8. Make tax rate or amount of tax clear to the ultimate consumer.

The Flat Tax and the USA Tax—both of which are consumption taxes—each fully or partially satisfy several of API's criteria. Each also falls short on some of the criteria or leaves issues open to concern. A discussion of each proposal follows.

A. THE SPECTER FLAT TAX

1. In General

The particular strength of the Flat Tax, from our perspective, is that it permits an immediate deduction for capital expenditures—a criterion very important to capital intensive industries such as the oil and gas industry. It also has a single rate, which should contribute to simplicity. On its face, the flat tax is very simple to comply with and administer. However, on closer examination there are a number of areas where the application of the tax is unclear, or which give us concern.

2. Jurisdictional Scope

Although the jurisdictional scope of the Specter bill is not defined, it is clear from the descriptions by the developers of the Flat Tax concept (Robert E. Hall and Alvin Rabushka) that their taxing system is not border adjustable. There is not enough detail in either the Specter bill or the treatises on the flat tax to determine the full ramifications of substituting the flat tax for our existing income tax on inbound and outbound transactions, and this issue needs to be examined carefully. At the very least, the Specter bill and any future legislative variation of the Flat Tax proposal must make it very clear as to the jurisdictional scope of the proposal. Is it a territorial tax imposed only on activity in the U.S.? If not, the application of the present law foreign tax credit rules must be clarified.

3. Deductibility of State and Local Taxes

The treatment of excise taxes and other taxes imposed on businesses by state and local governments is another issue of importance to the petroleum industry. Excise taxes, including severance taxes, environmental taxes and sales and use taxes are imposed at almost every stage of our operations and on almost every product. Excise taxes are imposed on our industry where it is intended that we act as a collection agent for the government. These taxes may not be deductible under the flat tax proposal. Any tax reform proposal must be clarified to permit a deduction for all excise taxes.

The same is true for income and franchise taxes and property taxes paid to states and local municipalities. Disallowing deduction of these taxes will create unfair distortions between sectors of the economy. For example, disallowing a deduction for property taxes may have little effect on a corporation dealing principally in services. However, property taxes may represent a significant factor in determining the net profit for a corporation whose business requires the ownership of extensive real properties.

4. Deductibility of Leases and Royalties

Most flat tax proposals permit the expensing of business acquisitions. It should be made clear that leases and royalty payments made to federal and state governments are also included as deductible expenditures. In addition, if a distinction is made between active and passive income, with the criterion for classification being the immediate use of property in the business, there must be an allowance for the common practice in the oil and gas industry of mineral interests not being developed immediately. Leases are purchased on the expectation of finding oil or natural gas, but it takes many years of seismic testing and test borings to determine when and if the leased property will become an active part of the business. During this period, oil and gas leases should not be considered passive investments.

5. In-Kind Exchanges

No mention is made in any of the literature on flat taxes about non-cash exchanges. Under current law, tax-free exchanges are a common and important part of the oil and gas business. Inventory exchanges of equivalent or nearly equivalent valued barrels of oil or product are everyday occurrences involving extremely high volumes which permit the efficient transportation and supply of crude oil and product throughout the country. Certainly, compensatory cash payments for value differences on these exchanges should be taken into account for tax purposes, but the

full value of the exchanged products should not be considered a sale or income for tax purposes.

B. NUNN-DOMENICI USA TAX PROPOSAL

1. In General

The Nunn-Domenici USA Tax proposal fully or partially satisfies several of the API criteria for evaluating taxing systems. For example, the consumption tax would encourage investment in durable business assets by allowing businesses to immediately deduct capital expenditures. API also commends the proposal's authors for recognizing that excise taxes should be excluded from the base upon which the tax on business activity is imposed.

Several aspects of the USA Tax should make it easier to comply with and administer than the present income tax system. For example, the proposed immediate expensing of investments in capital equipment would be a great simplification compared to the current depreciation regimes. Perhaps more importantly, because the consumption tax would only apply to a business's U.S. operations, business would no longer have to incur many of the administrative and compliance costs of the current system which relate to foreign operations.

In certain respects, the proposed consumption tax would help to minimize economic distortions, as compared to the current income tax system. The current income tax system contains a large number of complex deductions and credits, many of which create competitive distortions in particular business sectors. Also, different rules currently apply depending upon whether a business operates in the corporate or partnership form. The consumption tax would be more neutral because it would impose a simple rate structure, with a few simplified deductions, to all business sectors and forms of business organizations.

2. Deductibility of Import Tax

However, there are also several ways in which the Nunn-Domenici proposal does not meet API's criteria. For example, the proposal would impose an 11 percent tax on the value of imports. Because the proposed import tax would not be deductible, when an importer sells an imported good in the United States, the importer would be subject to the 11 percent consumption tax on the already paid import tax. This double taxation would create an unwarranted economic distortion by precluding foreign and domestic goods from competing equally in the marketplace. Furthermore, additional consideration is necessary as to whether an import tax should be imposed at all. This is especially the case for raw materials, such as crude oil, that generally have already been subject to high foreign taxes (which would no longer be creditable against U.S. tax under the Nunn-Domenici proposal).

3. Tax Visibility

API is also concerned that the USA Tax is not structured in a manner which would facilitate recovery in the marketplace. As is the case with the current income tax, the consumption tax would be imposed on the net income of a seller of goods, rather than on the product sale. Such a system also makes the amount of tax less clear to the ultimate consumer than would be the case with a tax that could be separately stated as a specific percentage of gross sales.

4. Treatment of Non-cash Exchanges, State Taxes, Payroll Tax Credit

Further analysis and discussion is warranted regarding many other aspects of the consumption tax proposal. For example, as noted in our discussion of the Flat Tax, API believes that non-cash exchanges should be excluded from the tax base. Also, careful consideration must be given to the consequences of the proposed elimination of deductions for state income taxes and the replacement of the wages-paid deduction with a payroll tax credit.

C. THE CREDIT-INVOICE VALUE ADDED TAX

1. In General

A credit invoice value-added tax (CIVAT) on sales of all goods and services appears to most closely adhere to the principles API has identified for a properly structured consumption tax. A CIVAT is imposed as a multistage sales tax collected at each point in the production and distribution process. A business subtracts the tax paid on its purchases, including capital goods, from the tax due on its sales. If the difference is a positive number, the business remits that amount to the government; if it is negative, as may occur in the case of exported goods, the business claims a refund.

Compared to the current income tax, the CIVAT has the advantage of encouraging saving and investment. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S., or abroad.

2. Effective and Neutral Revenue Source

From an economic standpoint, a separately stated CIVAT on the sale of goods and services appears to be the least damaging way of raising revenue. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad. It does not favor either capital or labor intensive industries. Wages, rent, interest and profits—the return of the factors of production, labor, land, capital and entrepreneurship—each bear the same direct tax burden. Additionally, a CIVAT levied at the same rate on all consumption should not cause a significant distortion in consumption choices since the relative cost of goods and services would be the same after imposition of the tax as before. A broadly based CIVAT would not unduly burden the products of any one sector of the economy. Similarly, any regional distortions would tend to be minimized since no specific product or sector of the country is the focus of the tax. A uniform CIVAT applied to goods and services would induce fewer distortions within particular industries than other taxes.

3. Border Adjustability

A CIVAT is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with the tax when they are exported, but also imports must bear the same tax as comparable domestically produced goods. This border adjustment feature of the CIVAT, permitted under GATT rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods.

4. Differences With Flat Tax and USA Tax

Under the CIVAT, the tax liability of a firm is equal to the tax imposed on its sales minus the tax it has paid on purchases for business use. Under a subtraction method consumption tax like the Flat Tax or the Nunn-Domenici USA Tax, liability is determined by applying the tax rate directly to the firm's value added, or the difference between its sales and its purchases. CIVAT is a tax on a product while the other taxes are based on a business's books of account, similar to the current income tax system. From that underlying distinction flow a number of practical differences which API concludes favor the CIVAT.

Most commentators agree that while a single rate—without exemption—is preferable, the overwhelming weight of political experience shows that the United States would not adopt an across-the-board tax with no exemptions. Not one of the 45 countries which now have consumption taxes has a single-rate, no-exemption tax. Most have both exemptions and multiple rates. The CIVAT readily accommodates these features.

Because the tax a business pays is deducted from tax it owes, businesses are encouraged to register as taxpayers and to get invoices from their suppliers to document the tax paid. Also, a CIVAT would reach previously untaxed income in the underground economy, since all consumer consumption would be taxed when goods and services are purchased. The paperwork and compliance costs for small business could be minimized by exemptions; however, any exemptions granted would add complexities to administration.

Conservatives often argue that a CIVAT would become a "money machine" for big government—that because it is a "hidden tax" Congress could easily ratchet up the rates to fund vast new programs. That might be more likely with a subtraction method tax like the Flat Tax or the Nunn-Domenici USA Tax which operate like a tax on business and are buried in the price of goods and services. It certainly would not be the case with a CIVAT, where the tax may be separately stated at every stage including the final retail sale. How many consumers, for example, know that included in the cost of goods they purchase is some portion of a 35 percent corporate income tax? They are far more likely to know the sales tax rate in their state because they pay it directly.

D. TRANSITIONAL ISSUES

1. In General

While transitional issues will arise in the context of all tax reforms, they become especially critical where, for example, there is a significant shift in the basis of taxation from income to consumption. Capital intensive industries, such as the petroleum industry, have made long term investment decisions relying on the existing tax structure. Changes in that structure would impact different companies, often in direct competition, in an arbitrary and often inequitable manner. The most obvious

examples of transitional issues occur in the areas of capital outlays and borrowings. For example, a capital asset (or inventory) purchased immediately prior to the enactment of a consumption based tax would be denied any cost recovery, whereas the same asset purchased immediately following enactment would be permitted an immediate 100% recovery against the tax base. In a similar manner, borrowings based on the anticipation of an interest deduction could become a significant burden on a highly leveraged business after enactment of a consumption tax.

2. Depreciation

The proposed USA Tax Act partially addresses the transition issue but stops far short of providing equitable relief necessary for business taxpayers. The issue of unrecovered basis is addressed in the USA Tax Act through a system of amortization which substantially lengthens the recovery period under current law. This lengthened and arbitrary classification of unrecovered costs into four groups appears based on misconceptions regarding complexity and revenue costs. Continuing the current method for unrecovered basis of assets placed in service prior to tax reform would be preferable to inserting another new capital cost recovery regime. In a recent paper delivered by Robert E. Hall and Alvin Rabushka on their flat tax proposal (The Flat Tax: A Simple Progressive Consumption Tax, Hoover Institution; May 11, 1995), the authors indicate that a 1.1% temporary increase in flat tax would be all that is necessary "if Congress chose to honor all the unused depreciation from investment predating tax reform . . . " Permitting current law business deductions to play out, thus honoring prior business plans and commitments, is necessary to avoid inequitable distortions.

3. Interest on Pre-Reform Debt

Transitional rules which consider only lost depreciation deductions, however, fall far short of measures necessary to ensure the success of tax reform. A continuation of current law interest deductions for pre-reform debt can be as vital to a business as cost recovery, and if the interest deduction is offset by interest income on the particular pre-reform debt, there would be no significant revenue impact to the Treasury. Ignoring a continuation of the interest deduction results in arbitrary windfall gains and losses without any apparent justification.

4. Carryover of Other Tax Attributes

Among other items of significant impact to business are net operating loss and capital loss carryovers, business credit, foreign tax credit, and minimum tax credit carryovers as well as other pre-reform adjustments such as those required under Section 481 of the current Code. The USA tax attempts to solve the problem with a further complex overlay to the depreciation recovery rule. Operating and capital losses are simply a result of the annual accounting convention for tax payment determinations and their carryforward is a valid claim on future tax payments which would take into consideration the length of business cycles in various industries and other issues of timing. There is no valid distinction between unused business credits and the future deductions for depreciation and, in fact, credits are a specific and distinct Congressional incentive on which business has relied. The Alternative Minimum Tax was intended as an advanced payment of federal income tax. Therefore, unrecovered credits require a reimbursement mechanism. The transitional rules should include a provision clearly permitting the Internal Revenue Service to make appropriate adjustments to ensure that no transition rule permits a business taxpayer to take a double deduction for any cost or suffer a double inclusion of any income.

5. Tax Treaty Reconciliation

Furthermore, our existing tax structure governing international trade is a labyrinth of rules, regulations, agreements and treaties. A unilateral change in the basic taxation of inbound and outbound transactions by the U.S. will require a thorough and detailed investigation into the effects of the new system on our treaty relations to avoid harmful consequences to U.S. companies.

CONCLUSION

In conclusion, reform of the current U.S. tax system is a worthy goal, and each of the alternative consumption tax proposals make important contributions to the reform effort. However, we would also caution that any major upheaval such as the complete replacement of the current income tax with another form of taxation is not a step to be taken hurriedly or without careful analysis of all possible implications. We have lived with the current system for over eighty years; businesses have structured their affairs within that system; and any fundamental change unless carefully

orchestrated will cause massive turmoil, particularly in the transition period from the old system to the new. If a consumption based tax is enacted, a set of transition rules, which fully considers the impact on previous business decisions, should be part of such legislation. Where possible, a continuation of current cost recovery principles and timing should be employed. Questions of complexity or revenue loss must be addressed and resolved.

STATEMENT OF THE INDEPENDENT SECTOR

INDEPENDENT SECTOR (IS) is a nonprofit coalition of over 800 corporate, foundation and voluntary organization Members with national interest and impac in philanthropy and voluntary action. The organization's mission is to create a national forum capable of encouraging the giving, volunteering, and not-for-profit initiative that help all of us better serve people, communities and causes.

The organization of INDEPENDENT SECTOR and its mission derive from its Members' shared commitment to fundamental values relating to the creation and maintenance of a truly free society.

Some tax policy officials and analysts believe that the complexity of the current tax code causes an undue amount of unfairness and inefficiency in the raising of tax revenues. These concerns have prompted what are known as "flat tax" proposals. Such proposals have been offered over the last several years, and several are currently under consideration by Congress. The basic goal of a "flat tax" proposal is to apply a single, or "flat," tax rate to all income. A key to the single tax rate actually being flat across all taxpayers is for it to apply to all income. Thus, exclusions from income, and deductions not necessary to properly measure income, are generally not allowed in a flat tax proposal. To the extent deductions consistent with social policy are disallowed, the unintentional effect will be a tax code that is inconsistent with social policy. We believe that a flat tax proposal that disallows a deduction for charitable contributions contains such an inconsistency with the social policy of encouraging private support of charitable causes.

Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the cost to them of giving. This cost of giving can be significantly changed by the tax treatment of the gift. The current deductibility of charitable gifts reduces the taxes an individual pays, and thus reduces the net cost of giving. If deductibility of charitable giving is eliminated, then the cost of giving will increase. Generally, the more an activity costs, the less of the activity an individual will engage in. A large body of research has shown that tax incentives can have a powerful effect on the amount individuals give. Tax laws can also have important effects on the types of gifts and on the types of groups that receive these gifts.

THE MAGNITUDE OF THE EFFECT ON CHARITABLE CONTRIBUTIONS OF A FLAT TAX WITH NO DEDUCTION FOR CHARITABLE CONTRIBUTIONS

The effect of a change in tax rules on the amount of charitable contributions will depend on a number of factors, including the responsiveness of the taxpayers, the speed at which taxpayers adjust their behavior, the distribution of the magnitude of the tax change across taxpayers of different characteristics, and the response of charitable organizations with regard to their fund raising activities. While many flat tax proposals are similar in structure, apparently minor differences can have significant implications for the overall effect of the proposal on the level of charitable contributions. However, the following discussion is meant to provide an indication of the effect a flat tax with no deduction for charitable contributions could have on the level of charitable contributions.

Itemizers can currently deduct their charitable contributions, and the amount they give reflects this incentive. Most flat tax proposals would expand the measure of income subject to tax and reduce the tax rate. In expanding the amount of income subject to tax, some of these proposals would provide no deduction for charitable contributions. If this deductibility were eliminated, itemizers would reduce the amount they give. In 1992, approximately 32 million itemizers reported approximately $63 billion of charitable contributions. If the deductibility of contributions were eliminated, this level of giving would likely have been more than $20 billion lower. While charitable organizations may be able to offset some of this reduction by more aggressive fund raising techniques, a substantial short-fall is inevitable.

Most flat tax proposals are designed to be neutral with regard to tax revenues—e.g. to raise the same amount of tax revenues that are raised by the current tax rules. While some flat tax proposals would result in lower total individual income

taxes, they generally increase corporate income taxes by a like amount. Since all taxes are ultimately paid by individuals, such revenue neutral flat tax proposals will have no effect on the aggregate tax burden, and thus provide no increase in total after-tax income out of which to give to charitable causes. To the extent some individuals do experience a reduction in their tax liability as a result of a flat tax proposal, the additional after-tax income would likely be relatively small, and would be apportioned among a large number of consumption alternatives as well as savings. Thus, any increase in charitable contributions from increases in after-tax income would be expected to be quite small, and not nearly large enough to offset the reductions due to the increase cost of giving,

In addition to affecting the total amount of charitable contributions, the above tax law changes would significantly affect the proportion of gifts going to different types of recipients. For example, the $20 billion reduction in itemizer giving would likely come disproportionately from educational institutions, cultural institutions, and private foundations.

CONCLUSION

Although not the primary reason for individuals making charitable contributions, the tax treatment of charitable contributions can have very significant effects on both the level and composition of individual gifts. Enactment of a flat tax with no deduction for charitable contributions would result in a substantial reduction in the amount of individual charitable contributions relative to what would be given under the current tax rules. This reduction would come on top of a drop of 24% of household giving to charities, from 1989 to 1993, according to latest information available as reported in *Giving and Volunteering in the United States—Findings from a National Survey by INDEPENDENT SECTOR 1994.*

SENATOR RICHARD C. SHELBY'S ANSWERS TO QUESTIONS FROM MEMBERS OF THE FINANCE COMMITTEE ON VARIOUS FLAT TAX PROPOSALS (WEDNESDAY, APRIL 5, 1995)

Page 32, question on line 11 by Senator Conrad:

I do not believe the analysis you refer is correct. According to the Tax Foundation in a publication entitled "Tax Features," dated January 1995, the average effective rate of the income group between $60,000-$75,000 would be 11.9% of his/her income in federal taxes under the current rate. The flat tax would lower this effective average rate to 11.2%. As such, I strongly believe a 17% flat tax rate would make middle class Americans better off.

Page 33, question on line 12 by Senator Conrad:

The study in which you refer is a study prepared by the Department of Treasury. This study is flawed and is not a credible source to be used for debate. First of all, the Treasury study is based on a 17 percent rate which disregards the fact the Armey-Shelby bill sets the rate at 20 percent for the first two years. Second, the Treasury study does not account for the tax revenue from the financial institutions like banks and insurance companies. This is not the design of the bill and until Treasury provides a useful measure for the financial sector, any Treasury study will continue to be erroneous. Lastly, the Treasury study does not take into account the spending cuts included in the legislation. This will actually eliminate the revenue shortfall. Professional economists have estimated the revenue shortfall to be only about $40 billion in the first year which is offset by in the bill by the entitlement sequester and spending cap.

Page 41, question on line 6 by Senator Bradley:

No. Implementation of the flat tax and the repeal of the special tax treatment for interest would effectively lower the interest rates to that of Municipal Bonds. As a result, the homeowner could refinance at the lower rate and pay a lower monthly mortgage payment.

In addition, Table A-3 of a report by the Joint Committee on Taxation entitled "Discussion of Issues Relating to 'Flat' Tax Rate Proposals" specifically prepared for this hearing, suggests the benefit of the home mortgage interest deduction primarily benefits individuals in the higher income brackets.

Page 41, question on line 10 by Senator Bradley:

Employer-paid health insurance deduction would not be retained and it would not be included in an individual's income. Fringe benefits such as health insurance is a form of compensation and should be taxed. The current disparity in the tax treatment of health insurance has led to the overconsumption of health care services

which contribute to the rising costs in health care. Consistent with the principle that all income should be taxed once and only once, this form of compensation would be taxed.

Page 42, question on line 6 by Senator Bradley:

No. The flat tax would abolish all deductions except generous personal allowances.

Page 43, question on line 11 by Senator Bradley:

Under the Armey-Shelby proposal, Social Security would not be taxable income for the individual and neither would Social Security be deductible for the employer.

Page 45, question on line 6 by Senator Moseley-Braun:

State and local taxes would not be deductible. Indeed, that is a large part of the tax base under the flat tax system. The current tax code is biased in that it benefits individuals in high-tax states over individuals in low-tax states. The flat tax would eliminate the current disparities in the tax code because the flat tax is neutral.

Page 46, question on line 10 by Senator Moseley-Braun:

Again, the flat tax is neutral. There are no disparities under a flat tax. There are only disparities under the current tax code.

Page 47, question on line 16 by Senator Moseley-Braun:

Estate taxes will be repealed. Currently, the tax rate on gifts and estates can exceed 60% which is offensive to most individuals. The individual who is leaving the estate has already paid taxes on the money when he/she earned it. That same individual has also paid taxes a second time on interest and capital gains. And now government wants to tax it a third time when he/she gives the estate to relatives. This is one of the reasons the savings rate is so low in America because savers are punished. The flat tax taxes every dollar in the economy once and only once. This is both fair and efficient.

Page 50, question on line 17 by Senator Breaux:

The Armey-Shelby flat tax is progressive. Contrary to popular belief, a tax code does not have to possess graduated rates to be progressive. A family of four making $36,800 would pay zero percent of their income on federal income taxes, whereas the same family earning $50,000 would owe five percent of their income. Likewise, a family of four earning $100,000 would owe 13 percent and a family earning $200,000 would pay 16 percent. This progressivity is achieved by the generous personal allowances. Page 51, question on line 4 by Senator Breaux:

The individual making $1 million would pay 20% of his income in the first year and the individual earning $10,000 would owe nothing or zero percent.

Page 51, question on line 18 by Senator Breaux:

No. Table A-1 of the Joint Committee on Taxation report shows the amount of revenues lost to itemized deductions and the disproportionate amount that go to individuals in higher income brackets. A flat tax eliminates those deductions thereby taking away the benefits from individuals in higher income brackets.

Page 52, question on line 5 by Senator Breaux:

No.

STATEMENT OF JAY STARKMAN, P.C.

May 23, 1995

Mr. LAWRENCE O'DONNELL,
Minority Staff Director,
U.S. Senate,
Committee on Finance,
Washington, DC

Dear Mr. O'Donnell: Please add the enclosed article and my following comments on flat tax to the record for the hearing on fundamental tax reform.

A truly "flat" tax would raise inadequate revenues. Using exemptions, deductions and credits would accomplish through complexity that which is easier to accomplish through graduated rates. Originally, the income tax was supposed to be flat. It was the arguments of Rep. John Nance Garner which convinced the House to pass a graduated tax in 1913, and it wasn't until World War II that it applied to the masses.

Consider a three-prong approach to flat tax to raise adequate revenues through very low rates, free the vast majority from the annual drudgery and expense of reporting, and minimize disincentive economic effects.

First, institute a VAT at a low rate, as close to 10% as possible. At a low rate, taxation of savings under VAT which were previously subject to income tax would be minimized, and the transition to VAT would be simpler. Joel Slemrod has suggested that VAT could displace the income tax completely because of the structure of the U.S. economy. (See Joel B. Slemrod, "The Simplification Potential of Alternatives to the Income Tax," *Tax Notes*, February 27, 1995, pg. 1331.)

Second, institute a flat income tax with a high income threshold. Say, only those earning over $75,000 gross would be subject to income tax, at a 20% rate. Revenue from an income tax would allow a low VAT rate. The threshold should aim to exempt some 80% of the population from income tax.

Third, repeal the estate and gift tax, or reduce it to a very low 10%–20% rate. Without an estate tax, repeal of step-up basis becomes viable, without endangering small business. A recent study by The Tax Foundation concluded that income tax rates would have to be nearly doubled to achieve the disincentive effects of the estate and gift tax. (See Patrick Fleenor and J.D. Foster, "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship," Tax Foundation Background Paper #9, The Tax Foundation, June 1, 1994.) I'd prefer repeal because it's a very inefficient tax, comparing the disincentives and cost of estate tax planning and compliance to the revenues raised.

These changes would significantly reduce compliance costs. IRS could be down sized. Most people would no longer have to keep records and file annual income tax returns. Estate planning would become much simpler. Though consumption taxes are regressive, polls consistently rate sales tax as one of the fairest. Retention of an income tax would retain progressivity.

In all forums on simplifying taxes, the issue of wasteful government spending always arises. A simplified tax is possible, but note that Michigan's VAT is very complex. I have little faith that Congress would keeping it simple for long, or resist the temptation to raise rates or expand the tax base for some spending project.

Sincerely,

JAY STARKMAN.

The Atlanta Journal / The Atlanta Constitution •• Wednesday, April 26, 1995 A15

IS A CONSUMPTION TAX THE ANSWER?

The idea of a flat tax may be simple, but its implementation is more difficult

By Jay Starkman

The Bible tells of taxation in the wilderness. God loved his people and wanted them counted. It was unseemly to count heads. So, Moses collected a half-shekel from every man and counted the coins. Indeed, God loved his people so much, He had Moses count them three times during the first year after they left Egypt, collecting shekels each time.

This was a head tax. It is the simplest flat tax, unpopular in modern societies because it doesn't consider the ability to pay and raises insufficient revenue.

Every tax has two components: a tax rate and what is taxable. A flat tax means any tax system with only one tax rate and broad base. Most people are upset with the current income tax because rates are too high, the law is too complex and government spending is wasteful.

Progressive tax rates have always been intensely controversial. Proponents say more revenue can be raised when high earners pay tax at steeper rates. Recognizing ability to pay through other means requires deductions and credits which are more complex than progressive rates. If these mechanisms are not used, rates must be set low enough for the poorest taxpayers to afford, which may result in insufficient revenue.

Yet, federal tax revenues have remained constant — 18 percent to 19 percent of the gross domestic product for the past 40 years — whether the top rate was 92 percent or 28 percent. So, the net effect of tax law changes has been to redistribute income, add economic and social incentives or carve out an exception for a particular constituency. Not surprisingly, members of congressional tax-writing committees are among the top recipients of campaign contributions from special interests.

Out of 107 million individual income tax returns filed, only 31 million claim a deduction for home mortgage interest or for charitable contributions. Another 15 million claim an earned income tax credit. Emphasizing family values means tax breaks for having dependents and being married. How many of these should we keep in a "flat" tax?

There are harder questions: when, whether or not and how to tax capital gains, municipal bond interest, life insurance proceeds and gains on home sales. Some business expenses must be deductible, like the cost of goods purchased for resale. How about salaries, factory equipment, interest on business debt and employee health insurance?

In 1986, Congress "flattened" the tax to two rates — 15 percent and 28 percent — down from a top 50 percent rate. Nine years and 4,000 tax code changes later, we have five rates, with a top rate approaching 50 percent again.

It would be easier to create a flat "consumption tax," such as a national sales tax or value added tax, than a flat income tax. The biggest hurdle is avoiding double taxation. Those who paid income tax on their savings may again pay consumption tax when they spend their wealth.

Until this century, high tariffs were the major source of federal taxes. Because we imported most manufactured goods, tariffs worked like some of today's consumption tax proposals. The burden fell disproportionately on the poor because they spent a far higher percentage of their income on the affected goods than did the rich. Income tax was introduced to replace high tariffs and ease tax burdens on the poor.

The annual collection cost of the present income tax is estimated as high as $75 billion. Several less costly alternatives promising lower, simpler taxes have been proposed.

Finding one that is flat, fair and simple is difficult.

Jay Starkman, an Atlanta certified public accountant, is a member of the Tax Executive Committee of the American Institute of Certified Public Accountants. The views expressed are his own.