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## Tax Reform Proposals: Which one is the Best?

### Abstract

Lawmakers from both parties are proposing sweeping changes in the income tax system, but they achieve this in significantly different ways. The question is, which approach would be best for taxpayers and the economy? In order to answer this question, it is necessary to identify what is wrong with the current system and then determine how each reform plan addresses each of these flaws. The four most popular reform proposals are the Flat Tax, the Value Added Tax, the National Retail Sales Tax, and the USA Tax. In the following discussion, I will test these proposals on the different criteria that are needed to evaluate any tax structure. Obviously, no tax structure can be perfect. Yet, after evaluation, I believe that the Flat Tax is the best choice, followed by the VAT and the Sales Taxes, and the USA Tax.

# Tax Reform Proposals: Which one is the Best?

*By Sunil Jagwani*

## **I. INTRODUCTION**

The current U.S. tax system is infested with many problems. It is both anti-growth and discriminatory. Some of its major problems are high tax rates, complexity, multiple taxation and interference in the social lives of citizens. It is not a surprise then, that tax reform is gaining momentum. Lawmakers from both parties are proposing sweeping changes in the income tax system, but they achieve this in significantly different ways. The question is, which approach would be best for taxpayers and the economy? In order to answer this question, it is necessary to identify what is wrong with the current system and then determine how each reform plan addresses each of these flaws. The four most popular reform proposals are the Flat Tax, the Value Added Tax, the National Retail Sales Tax, and the USA Tax. In the following discussion, I will test these proposals on the different criteria that are needed to evaluate any tax structure. Obviously, no tax structure can be perfect. Yet, after evaluation, I believe that the Flat Tax is the best choice, followed by the VAT and the Sales Taxes, and the USA Tax.

## **II. DESCRIPTION OF THE PROPOSED STRUCTURES**

While there is widespread agreement on what is wrong with the current tax system, there is considerable debate over which plan best solves these problems. The following are the key features of the Flat Tax and some of its major contenders:

### **A. Hall/Rabushka Flat Tax**

The Hall/Rabushka Flat Tax, sponsored by House Majority Leader Richard K. Armey (R-TX) and Senator Richard Shelby (R-AL), would replace the current personal and corporate income tax system. Here's how it works: individuals would calculate their wage and pension income, subtract a personal allowance, and pay a flat 19% tax on the rest. That's it. You could file your return on a form

the size of a postcard.

Business income would also be taxed at the same 19% rate. Businesses, from a family farmer to a Fortune 500 company, would subtract expenses from revenue and pay 19 % on the remainder. Taken together, the business and wage taxes ensure that the flat tax system taxes every dollar of income earned in the economy. Also, the Flat Tax does away with any deductions/credits that are provided under the current system. Another important change is that depreciation is no longer needed. Any capital investments made by a business can be expensed immediately.

### **B. National Retail Sales Tax**

The National Sales Tax is a consumption tax being proposed by Indiana Senator Richard Lugar. Under this proposal, the state shall administer a 17% consumption tax on retail goods and services. This tax will replace all current personal and corporate income taxes, as well as capital gains taxes and the estate and gift taxes. Many details remain unknown. For example, it is not clear what tax rate would be applied and which goods and services, if any, would be exempted.

### **C. Value-Added Tax (VAT)**

The value-added tax is another consumption tax. Under the VAT, instead of implementing one tax of a certain percentage at the time of retail sale, there is a smaller tax, proposed at 5 percent, added each time the product is resold or when value has been added. For example, a tax is added when a product is passed from a manufacturer to a wholesaler, and again from the wholesaler to the retailer. The Value Added Tax proposal is sponsored by Representative Sam Gibbons of Florida and Senator Ernest Hollings of South Carolina.

### **D. Nunn/Domenici USA Tax**

This tax was proposed by two senators -

Nunn and Domenici. The USA Tax combines a revised individual income tax with a new business tax that would replace today's corporate income tax. The major change in personal income taxes would be the introduction of "unlimited savings allowances" (the "USA" part of the plan). These would allow the deduction from tax calculations of all the money an individual has saved during the year, including deposits in savings accounts, purchases of stocks and bonds, and start-up capital contributed to one's own small business. Existing deductions for charitable contributions, home mortgage interest, and alimony would be retained. Families would also be able to deduct up to an additional \$2,000 per household member for college tuition, vocational education, or remedial education.

Once these deductions are taken, personal income would be taxed at rates of 19%, 27%, or 40 % under Nunn- Domenici. The highest of these rates begin at \$14,400 of taxable income for a single taxpayer, \$21,100 for the head of a household, and \$24,000 for couples. Once income taxes are calculated, the amount of Social Security and Medicare taxes paid will be subtracted to determine the final amount a taxpayer owes. The corporate income tax is simply replaced by a VAT.

### **III. EVALUATING THE TAX PLANS**

While each reform has an overall impact, it is particularly useful to see how the different proposals address specific flaws in the current system. The way each plan fares on each criterion will collectively indicate the extent to which different tax plans reflect the important principles of sound tax policy.

#### **A. Simplicity**

The current income tax has more than 400 different types of filing forms, requires more than one billion forms (tracking interest and dividend income), and necessitates more than five billion hours of effort each year. While individuals rightly complain about the costs of simply compiling information, calculating their taxes, and understanding forms, compliance costs for business are twice as high.

The Hall/Rabushka Flat Tax would greatly

simplify the current system's plethora of documents, paperwork, and complex record-keeping as they would be replaced by two postcard-sized forms, one for individuals and one for business.

The National Sales Tax too, fares well under this criterion. Compliance costs for individuals would disappear. However, retail businesses would bear an increased burden because they would be responsible for collecting the tax and complying with reporting requirements. Similar to the Sales Tax, the Value-Added Tax would eliminate individual compliance costs, as well as the daunting complexities of the corporate income tax. The businesses would, however, have to maintain detailed records to calculate their share of tax liability as goods and services travel through the production process. To sum up, the VAT and the Retail Tax are simple, although less simple than the Flat Tax.

Since the burden of the corporate income tax currently used is even worse than a VAT, compliance costs for businesses would fall under the USA tax. Individual compliance costs could rise relative to the current system, because of requirements for tracking deposits and withdrawals into the unlimited savings account. Compared to the Flat Tax, this is more burdensome under both personal and business categories, which makes it the least simple of all the choices.

#### **B. Savings and Investment**

By double-taxing, triple-taxing, and sometimes even quadruple-taxing income from capital, the current system significantly hinders capital formation. This reduces the quality and quantity of machinery, equipment, and technology in the economy and lowers wages by reducing the amount workers can produce.

In the Flat Tax system, all income is taxed, but is only subject to one level of tax. The current multiple taxation of capital income is eliminated. While this would boost savings and investment compared to current law, the effect would be to make the tax code neutral, neither encouraging nor discouraging savings, investment, or consumption.

The National Retail Sales Tax, by not taxing income directly, removes the bias in the existing

system against savings and investment, giving them the much-needed boost. Its cousin, the Value-Added Tax, also addresses the capital formation problem by ending income taxation altogether. The aspect that makes these two proposals less appealing than the Flat Tax is that there is no guarantee regarding a future amendment to re-incorporate income taxes under a Sales Tax/VAT system. Such an amendment could renew the bias against savings and investments, hurting capital formation in the process.

As for the USA Tax, it is not clear whether it is able to alleviate this problem or not. While the USA tax eliminates the bias against savings and investment multiple taxation by providing an unlimited savings account, it dampens incentives to save and invest by imposing sharply graduated rates.

### C. Social Engineering

The tax code today rewards many types of activity, everything from putting a child in daycare to buying a home. Other behaviors, however, such as savings and investment, are penalized harshly. Particularly disturbing is the ability of special interests to add special preferences to the tax code on behalf of wealthy clients. The optimal proposal in this regard would be one where any form of social interference is eliminated. Economic theory suggests that the less a tax distorts economic behavior, the more efficient it is.

The Flat Tax passes this test with flying colors. The only preference in the pure flat tax is a family allowance. Government would not attempt to steer economic decisions or penalize and reward different types of behavior. Although, the Hall/Rabushka version of this tax does incorporate a zero tax bracket for those with income below a certain threshold, it is only a minor distortion compared to the current system.

The National Retail Sales Tax also effectively solves this problem. It would remove

government from the business of micromanaging private decisions, presuming it would apply equally to all goods and services. There is a danger though, that politicians would engage in social engineering by imposing higher rates on unpopular goods and services (tobacco, caviar, imports, etc.) while granting lower or zero rates to others (food, shelter, health care). Similarly, a pure VAT ends government favoritism and efforts to subsidize certain industries or activities. The same caveat—the potential for discriminatory rates—applies.

Under the USA Tax proposal, some deductions are eliminated, but this is offset by the creation of new ones, such as a deduction for educational expenses. The USA proposal, however, does end the current code's explicit penalties on savings and investment. In other words, it is only a short step toward improvement on the current system.

### D. Problems with Intrusion

The IRS engages in tax collection activities that many believe are abusive, in part because of the code's numbing complexity, but also because of legislative directives. A simple tax code, with easily understood rules that apply to everyone, would solve much of this problem. Because all tax systems ultimately are based on coercion, and thus are accompanied by police powers for the taxing authority, the optimal structures are the ones that minimize the scope and opportunity for intrusion.

By dramatically reducing the complexities of the current system, the Flat Tax would leave taxpayers with less reason to fear the IRS. For individual taxpayers, the only possible areas of controversy are the size of one's family and the amount of labor income earned (taxes on capital income are withheld and paid at the business level). Whatever problems remain — including how the self-employed handle deductions, particularly if they

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work out of their homes — would be a fraction of those that exist now. Less fear of the IRS translates into smaller compliance costs.

The convenience of the National Retail Sales tax lies in the fact that 45 states already have the necessary apparatus in place. In its pure form, the VAT too should minimize most tax collection abuses. Businesses would need to maintain records, but the impositions on privacy would be small compared with the current system. The level of intrusion by the government is therefore reduced. However, small businesses may not appreciate the extra burden of collecting taxes for the federal government, making the VAT less desirable than the Flat Tax in this respect.

Unlike the other proposals, the USA tax leaves much of the current system in place. Moreover, the government will require detailed financial records from individuals who lower their tax burden by saving. The result: little or no improvement in terms of compliance or intrusion.

### **C. Fairness**

Fairness in the tax system should mean equal treatment. Any special treatment, either preference or penalty, violates this principle. All taxpayers — and all income — should be treated equally.

The Hall/Rabushka Flat Tax does just that. All taxpayers pay the same rate, and all income is taxed once. The only exemption is the zero bracket amount (allowance) based on family size.

The National Retail Sales Tax and the VAT too, minimize discrimination. All taxpayers presumably will pay the same rate, and all goods and services will be taxed. Problems arise when dealing with the issue of granting exemptions to those with low incomes. The Flat Tax has a simple solution of providing a common threshold allowance. The mechanism with the VAT/Sales Tax is more complex. A way to define a threshold limit for consumption for every citizen must be found. This would entail recording bulky data to track the consumption of each individual.

The USA Tax runs into even more problems, with respect to fairness. Although graduated tax rates are used to ensure progressivity, maintaining steeply graduated rates means that the law will not apply equally to all taxpayers. Government would continue to interfere with economic decisions by granting preferential treatment to certain activities. Also, the estate tax would remain, applying double taxation to the affected income.

### **D. Evasion**

Support for any tax system and its long-term viability depends on how well the laws in place work. If there are opportunities for individuals to evade taxes — and if enough of them take advantage of those opportunities — the public will view the law as corrupt. Moreover, the loss of revenue will encourage politicians to raise rates on those who do comply with the law, thereby encouraging still more evasion. The circle of higher rates followed by more evasion could be endless.

Because of the low rate under the Flat Tax, there are minimal incentives for evasion. Moreover, taxing business income at the source eliminates the need for more than one billion forms and simplifies enforcement considerably. In addition, it is predicted that the tax rates would drop over a sufficiently long period of time, further reducing incentives for tax evasion.

History bears out evidence that the National Retail Sales Tax leads to wide-spread evasion, (although not as much as the current system). Almost every country with a VAT originally had a sales tax, but was forced to switch, once rates crept above the level of 10%. The evidence suggests that retail sales taxes higher than about 10% are subject to widespread evasion.

A VAT modifies the sales tax and allows the government to enforce much greater compliance than is possible under a sales tax. This is possible because the tax is collected at each stage of the production process and there is no need to track

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whether a product is being sold at retail or wholesale. However, the collection of tax at each step makes the process relatively more cumbersome than the Flat Tax.

As for the USA Tax, it does reduce incentives for evasion by removing the tax burden on savings, but at the same time, it faces a threat of using the underground economy, because of its high tax rates. Moreover, because there will be no tax on income put into savings (and no taxes levied on funds withdrawn from savings), there could be incentives to find ways to manipulate this system. Therefore, the evasion problem will continue to persist.

### **E. Low Rates**

Low tax rates ensure that taxpayers have little incentive to hide, shelter, and underreport income. Willingness to work, save, invest, and take risks is tied to the expected rewards of such behavior, therefore the lower the tax rate(s), the higher the level of economic growth.

The Hall/Rabushka Flat Tax will be implemented at 19%. It is also estimated that the rate could be cut down to 17% in 3-5 years' time. This rate is much lower compared to the average rate at which tax is paid under the current system and is expected to boost economic growth.

Similarly, under a National Retail Sales Tax, if a low rate is assumed and given that income is not taxed directly, the penalty on the creation of wealth would be minor. The Value-Added Tax is another winner in this regard. Just like the National Sales Tax, a VAT with a low rate would have minimal impact on working, savings, and investment.

The Nunn/Domenici USA Tax fails in this category. The top tax rate in the USA Tax is as high as 40%, even higher than the current law. To make matters worse, it applies to taxable incomes as low as \$24,000 for a family of four.

## **IV. CONCLUSION**

The current income tax system demands comprehensive reform. With the plethora of reforms available, it becomes vital that the one picked corrects the flaws of the current system as best as

possible.

In the discussion above, it is clear that direct consumption taxes like the retail sales tax and VAT theoretically achieve similar results as the Flat Tax, though such proposals also risk creating major new sources of tax revenue for the federal government. Moreover, these plans do not address certain issues like tax evasion, fairness and government intrusion with as much efficiency as the Flat Tax. On the other hand, plans that attempt to preserve features of the current system, such as the USA Tax also fall short of the goal. By maintaining a discriminatory system of graduated rates, these plans fail the critical tests of growth, simplicity, and fairness. Gains from such plans are questionable.

Overall, the Flat Tax fares the best in all categories, as explained above. It replaces the current five-tiered punitive rate structure with a simple, fair 19% rate. The current system's loads of documents, paperwork, and complex record-keeping is replaced by two postcard-sized forms, one for individuals and one for businesses. It encourages savings and investments, minimizes tax evasion, and maintains progressivity with minimal government intrusion.

With such promising and attractive features, there is no reason why American citizens should have to suffer any longer at the hands of the current tax system. An expeditious implementation of the Flat Tax is the best hope.

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