1998

The effect of a flat tax on the individual taxpayer

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The Effect of a Flat Tax on the Individual Taxpayer

Presidential Scholar Senior Thesis

University of Northern Iowa

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Spring 1998

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4-8-98

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May 7, 1998
The Effect of a Flat Tax on the Individual Taxpayer

The 1996 presidential election brought the subject of the U.S. tax system up for debate. Politicians and citizens alike disagree over whether our tax system should be restructured, and if so whether a flat tax is the policy to impose. This paper examines our tax structure, explains the components of a flat tax, and presents support and opposition for a flat tax policy.

U.S. Tax Structure

The primary purpose of the income tax is to raise revenue for the U.S. government. Congress enacted the income tax in 1913. At that time, less than two percent of families were required to file a return. The tax rate ranged from one percent to seven percent, “with the highest rate applying only to American families who had the equivalent of $7.7 million in income in today’s terms.”

To discuss tax reform, it is necessary to have a basic understanding of our current tax structure. Today, as then, we have a progressive tax structure. A progressive tax applies a higher rate of tax as the amount of taxable income rises. Currently, our tax structure has five rates ranging from 15% to 39.6%. So, for example, a single person with less than $25,350 in taxable income pays 15% in taxes. However, if the person’s income is between $25,350 and $61,400 he/she pays 15% on the amount up to $25,350 and 28% on the amount over $25,350 (see Table 1).

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When computing taxable income, taxpayers are allowed a personal exemption for themselves and a dependency exemption of the same amount for each dependent. This amount is $2,700 for 1998.

In addition, a taxpayer may either take a standard deduction or itemize deductions for the year. Itemizing involves keeping records of allowable deductions and listing these deductions on the tax return. The taxpayer chooses the option that results in the larger deduction amount. See Table 2 for the 1998 standard deduction amounts.

**TABLE 1 - 1998 Tax Rate Schedules for Filing Status Single and Married Filing Jointly**

<table>
<thead>
<tr>
<th>Single- Schedule X</th>
<th>If taxable income is:</th>
<th>But not over-</th>
<th>The tax is:</th>
<th>Of the amount over-</th>
</tr>
</thead>
<tbody>
<tr>
<td>over-</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>25,350</td>
<td>................ 15%</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>25,350</td>
<td>61,400</td>
<td>$3,802.50 + 28%</td>
<td>25,350</td>
<td></td>
</tr>
<tr>
<td>61,400</td>
<td>128,100</td>
<td>13,896.50 + 31%</td>
<td>61,400</td>
<td></td>
</tr>
<tr>
<td>128,100</td>
<td>278,450</td>
<td>34,573.50 + 36%</td>
<td>128,100</td>
<td></td>
</tr>
<tr>
<td>278,450</td>
<td></td>
<td>88,699.50 + 39.6%</td>
<td>278,450</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Married filing jointly- Schedule Y-1</th>
<th>If taxable income is:</th>
<th>But not over-</th>
<th>The tax is:</th>
<th>Of the amount over-</th>
</tr>
</thead>
<tbody>
<tr>
<td>over-</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>42,350</td>
<td>................ 15%</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>42,350</td>
<td>102,300</td>
<td>$6,352.50 + 28%</td>
<td>42,350</td>
<td></td>
</tr>
<tr>
<td>102,300</td>
<td>155,950</td>
<td>23,138.50 + 31%</td>
<td>102,300</td>
<td></td>
</tr>
<tr>
<td>155,950</td>
<td>278,450</td>
<td>39,770.00 + 36%</td>
<td>155,950</td>
<td></td>
</tr>
<tr>
<td>278,450</td>
<td></td>
<td>83,870.00 + 39.6%</td>
<td>278,450</td>
<td></td>
</tr>
</tbody>
</table>
TABLE 2- Standard Deduction Amounts for 1998

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Standard Deduction Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$4,250</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>7,100</td>
</tr>
<tr>
<td>Head of Household</td>
<td>6,250</td>
</tr>
<tr>
<td>Married, filing separately</td>
<td>3,550</td>
</tr>
</tbody>
</table>

Perhaps one of the most often listed itemized deductions is a deduction for home mortgage interest. Generally, interest on a loan to obtain a house is deductible. The interest deducted is limited to loan amounts of up to one million dollars. This deduction was enacted mainly for the purpose of lessening the burden of buying a house. Policymakers wanted to encourage people to buy houses and build stable relationships within a community.

Another commonly taken itemized deduction is a deduction for state and local income taxes. Congress enacted this deduction to reduce multiple taxes on the same source of revenue.² See Table 3 for a list of common itemized deductions.

TABLE 3- Some Common Itemized Deductions

These deductions may have limits or requirements for deductibility. This table is only presented for the purpose of understanding our basic tax structure and is not intended to be a comprehensive listing.

<table>
<thead>
<tr>
<th>Medical Expenses</th>
<th>Charitable Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and Local Income Taxes</td>
<td>Fees Paid for Tax Return Preparation</td>
</tr>
<tr>
<td>Casualty and Theft Losses</td>
<td>Unreimbursed Business Expenses</td>
</tr>
<tr>
<td>Property Taxes</td>
<td>Home Mortgage Interest</td>
</tr>
</tbody>
</table>

The personal, dependency, and standard deduction or itemized deductions are used to determine taxable income in the following manner:

- Adjusted Gross Income
  - Less: itemized deductions or the standard deduction (whichever is greater)
  - Less: personal and dependency exemption(s)

Taxable Income

Tax credits are another tool used to lessen the tax burden of some taxpayers. Tax credits are subtracted from the amount of tax a person would normally pay. In the equation above, taxable income would be plugged into the rate structure shown in Table 1 to determine the amount of tax owed the federal government. A tax credit would then be subtracted from this tax amount owed to directly reduce the amount of tax paid.

Some credits are designed to offset regressive taxes. A regressive tax imposes a heavier burden on low-income taxpayers. For example, if your gross wages are greater than $68,400 (for 1998) you are exempted from paying most of the social security tax. This causes the majority of social security tax to be paid by those least able to pay it. Therefore, a credit is established to offset this perceived unfairness.

Tax credits are offered for a variety of activities. Three of the most common credits are the earned income credit, the credit for elderly or disabled taxpayers, and the credit for child and dependent care expenses. The earned income credit is a credit for low income persons and was

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3 Adjusted gross income is the total income earned by the taxpayer after subtracting income deemed non-taxable by Congress (e.g. - inheritances and gifts).
established to encourage poor individuals to work. Congress believes individuals attempting to make a living instead of taking public assistance should not be penalized for their efforts by having to pay large amounts of their limited income to taxes.

The earned income credit and taxes withheld on wages are refundable credits. Most credits cannot be used to reduce owed tax to a negative amount. A taxpayer either owes zero tax or positive tax. However, a refundable credit allows the taxpayer to reduce his/her tax liability to a negative amount and receive a refund check for that amount. This provision for the earned income credit allows low-income families a form of partial public assistance.

The credit for the elderly and disabled was enacted as a way of protecting the income of retired or disabled persons. The credit is available for disabled persons receiving disability income from an employer because of the disability or taxpayers over the age of 64.4

Individuals who incur dependent or childcare expenses as a result of being employed may be eligible for the credit for dependent and childcare expenses. Taxpayers who are employed and have to hire care for either a dependent under the age of 13 or a dependent or spouse who is physically or mentally incapacitated can receive a credit for part of the care expenses incurred.5 Like the earned income credit, this credit helps enable individuals to be employed.

It is important to note that while the income tax was originally imposed to raise revenue, it has also been used to influence economic and human behavior. Itemized deductions and tax credits are allowed by Congress to promote social equity and/or actions that are considered socially beneficial. For example, certain tax breaks have been given to encourage investment

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5 Ibid., 11-20.
and, therefore, economic growth. Examples of influence on human behavior include a deduction for charitable contributions and the exclusion of deductions for legal fines and penalties. Some people believe these provisions promote charity and discourage illegal actions.

**Problems with the U.S. Tax Structure**

Many citizens complain about the current tax system. The three most common complaints involve its complexity, the saving and investment penalty, and Internal Revenue Service (IRS) injustices. It is these complaints, outlined below, that have driven the movement for tax reform and the proposal of a flat tax system.

Some taxpayers contend the current system is too complex to be understood by the average taxpayer. For example, "The 1984 (tax) bill was more than 1,000 pages..." Few people will read and comprehend a document of that length. The problem has become so severe that it is the focus of a magazine special. Every year *Money Magazine* sends a hypothetical tax return to fifty professional tax return preparers. Every year it receives a range of responses and sometimes even fifty different answers. If trained professionals cannot agree on an answer, how is the average American supposed to comply with the tax code without spending hundreds of dollars in accountants' fees?

The current tax structure contains what has been deemed by many critics as the saving and investment penalty. Taxpayers are taxed on their income. If they choose to save or invest this

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6 Ibid., 1-23.
income, they receive interest or dividends. The interest or dividends received are taxed as income. On the other hand, the income can be spent on a good or service. Critics contend that a vacation, new vacuum cleaner, etc. is as much a benefit to the taxpayer as the interest or dividend received. The government taxes the interest/dividend benefit but not the benefit received from a good or service purchased. Therefore, taxpayers are penalized for saving and investing.

Supporters of tax reform claim the IRS has abused its power as a taxing authority. In September 1997 the Senate Finance Committee heard complaints concerning the actions of the IRS. Taxpayers across the nation came forward with horrific stories of IRS injustices. The following are summaries of a few of the stories presented.

- A catholic priest, monsignor Lawrence F. Ballweg, related his battle with the IRS regarding a trust. The monsignor filed taxes for the trust, which had been established by his deceased mother, for every year from 1988-1994. In 1996 he was informed he owed $18,000 in taxes and penalties for 1995. He filed an application and paid a $14 fee to receive a copy of the reports he had filed for 1995. Instead, he received a notice saying the application was invalid because he put his name as Lawrence F. Ballweg. The appropriate name should have been Lawrence F. Ballweg Trustee U/W Elizabeth D. Ballweg. He sent a letter explaining that he signed all forms for the trust as Lawrence F. Ballweg and asking again for a copy of his records. His request was unanswered, but he received a notice of intent to seize his bank account, car, or other property. In March of 1997 when his story became public, the IRS sent Ballweg notice that he owed zero tax.

- Katherine Lund Hicks filed her last joint return in 1983 before being divorced. The IRS assessed $7,000 in additional tax against that return. All notices of the $7,000 owed were mailed to her ex-husband. It was over a year before he informed her of the tax owed. Hicks immediately attempted to resolve the issue with the IRS, but the matter had been outstanding for so long that the IRS refused to reexamine her records. She filed a Tax Court Petition to settle the matter. They settled out of court on an agreed $3,500 in additional tax owed. Hicks tried to pay this amount immediately. She testified in the Senate Hearings that, "The IRS refused my payment until they had sent me a bill because they would not have anywhere to credit the money without the bill and they claimed they needed time to calculate the exact interest due."
The IRS claimed they needed six months to generate the bill, which should arrive no later than January 1989. Hicks never received the bill and called the IRS in February, March, and again before July. Each time she was told she owed no tax and that a receipt proving such could not be issued. She got remarried believing she was debt free. The IRS assessed a lien on her property and all community property of her new marriage. Ultimately, to try and escape the harassment of the IRS, Hicks filed for bankruptcy and divorce.

- Mrs. Nancy Jacobs also testified at the Senate Hearings on behalf of herself and her husband, Dr. Fredric Jacobs, optometrist. The Jacobs have operated an optometry office since 1979. They paid all quarterly tax payments under their assigned Employer Identification Number (EIN).

In 1981 the IRS placed an unexpected lien of $11,000 on the Jacobs for unpaid payroll tax deposits. They were unable to clear the matter up and paid the $11,000 just to have things resolved, despite being sure they did not owe the tax.

After the $11,000 was paid, the IRS continued to issue liens against the Jacobs. Between 1987 and 1996 the Jacobs enlisted the help of two congressional representatives and a tax attorney. They discovered their EIN was being shared with another taxpayer of a similar name. Despite this discovery they could not convince the IRS to clear their account.

They finally had their story published in a local newspaper. Approximately two hours after the story’s appearance the Jacobs received a telephone call from the IRS acknowledging the mistake and promising a refund.

In the Senate hearings, IRS officials denied any intentional wrong doing but admitted there may be management problems. They also pointed out the fact that they are responsible for the complex task of collecting taxes from millions of families and businesses, which can lead to mistakes and confusion.

However, more than one IRS agent testified to the contrary. One of the most damaging statements came from IRS Agent Jennifer Long. “I can personally attest to the use of egregious tactics used by IRS revenue agents which are encouraged by members of the IRS management. These tactics, which appear nowhere in the IRS manual, are used to extract unfairly assessed
taxes from taxpayers, literally ruining families lives and businesses, all unnecessarily and sometimes illegally.”

**Flat Tax Proposals**

This general dissatisfaction with the current system has led to many flat tax proposals, which promise to “fix” many of the above problems. The central theme of these proposals is a fairer tax for all Americans. Rather than the progressive structure we have now, flat tax proposers seek to establish one percentage rate at which all income would be taxed. They claim the burden on low-income families would not increase because of increased personal and standard deductions.

Almost all flat tax proposers eliminate most deductions and credits. Supporters believe that the reduction in the tax rate will offset the loss of the deductions and credits.

With this simplification comes the promise of reduced paperwork. Taxpayers would be able to file their claim on a postcard, reducing the need for extensive record keeping and regulation by the IRS.

Representative Dick Armey and Senator Richard Shelby, Senator Phil Gramm, and Presidential Candidate Steve Forbes created three of the most popular flat tax proposals. These three plans are representative of most flat tax proposals. Examination and critique of these plans will provide a suitable framework for evaluating the effects of a flat tax on the American taxpayer.
The Armey-Shelby flat tax plan proposes an income base consisting of wages, salaries, and pensions. Under this plan fringe benefits, earned income abroad, interest, dividends, and capital gains would not be taxed. Social security benefits would also be non-taxable.

The Armey-Shelby plan eliminates all itemized deductions and tax credits. To compensate, the plan increases the standard and dependency deductions. However, taxpayers would not be allowed a personal exemption amount for themselves. Recall under the current system, a taxpayer has a $2,700 exemption for himself/herself and the same amount for each dependent. The Armey-Shelby plan would allow a $5,300 deduction for each dependent, but not for the taxpayer.

As stated earlier, to make up for eliminated deductions and to exempt many low-income families from paying taxes, the amount of the standard deduction would increase. Table 4 shows the current standard amounts and the amounts proposed by the Armey-Shelby plan.

The standard deduction and dependency exemptions would be subtracted from the taxpayer's income to arrive at taxable income. The taxable income would be taxed at a single 17% rate for all taxpayers, regardless of income level.

The taxpayer would show all of this information on a form the size of a postcard, as recreated on the page 12.

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10 Ibid., 15.
TABLE 4

Standard Deduction Amounts for 1998

<table>
<thead>
<tr>
<th></th>
<th>Current Standard Deduction Allowed</th>
<th>Armey-Shelby Proposed Standard Deduction Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>4,250</td>
<td>11,350</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>7,100</td>
<td>22,700</td>
</tr>
<tr>
<td>Head of Household</td>
<td>6,250</td>
<td>14,850</td>
</tr>
</tbody>
</table>


Gramm’s proposal is much less comprehensive. His focus is on the implementation of a single tax rate, but with only slight modifications of itemized deductions and tax credits.

Gramm’s flat tax proposal retains the current definition of taxable income. The only modifications made would be to capital gains and dividends. All capital gains would be indexed for inflation.12 Under the current tax code taxpayers must report the purchase and selling prices of the asset. The difference between the two is capital gain and must be reported as income. Gramm’s argument is that if the purchase price of the asset is adjusted for the inflation that occurred during its holding period, the reported gain would more clearly reflect the actual value of the cash received.

Similarly, dividends would be excluded from personal income. Currently, dividends are subject to double taxation. They are taxed as income to the corporate business and then again as income to the individual shareholder. Gramm proposes to tax dividends only at the business level and exclude them from individual taxation.

The standard deduction would be $22,000. Gramm has not mentioned a variable standard deduction based on filing status. I assume the $22,000 amount would apply to all taxpayers.

The dependency exemption would be $5,000. Taxpayers would not be allowed a personal exemption. Taxable income would be taxed at a rate of 16%.  

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13 Ibid.
Forbes' plan is a hybrid of Gramm and Armey-Shelby. There would be zero tax on social security, pensions, interest, and capital gains. Forbes calls for a $36,000 standard deduction and elimination of all other credits and deductions, including the personal and dependency exemption. Like Armey-Shelby, Forbes proposes a 17% tax rate.

Analysis of Flat Tax Proposals

So what plan is the best? There are many different issues to be considered when trying to determine the effects a flat tax would have on the American taxpayer. Some questions that need to be addressed are:

1. How would taxpayers' actions change given the elimination of certain deductions?
2. What effect will the elimination of certain income tax credits have on taxpayers?
3. Will capital losses be non-deductible?
4. Will the reduced rate and increased standard deduction result in a tax reduction for taxpayers? If so, which taxpayers?
5. Would the plan raise enough revenue for the federal government?
6. Will all the information really fit on a postcard? Would the shorter format facilitate fraud?
7. Would the flat tax really make the tax system more understandable for most Americans?
8. What would prevent the reemergence of complicated tax laws?
9. How would the transition occur?

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14 Ibid., 56.
An issue in tax reform is the extent to which tax deductions and credits influence human behavior. There are two models that are used to varying degrees when proposing tax law, a dynamic model and a static model. The dynamic model says tax policy is extremely influential in determining the behavior of taxpayers. On the other hand, the static model believes taxpayers' actions are based just as heavily on personal factors.

These models can be demonstrated easily by looking at the deduction for charitable contributions. The dynamic model would say taxpayers contribute solely for the tax benefit of doing so. Therefore, the elimination of this deduction would eliminate all charitable contributions. The static model would contend that people give for other reasons, such as generosity and compassion. Consequently, there would be no reduction in contributions if the deduction was taken away.

Obviously these models can be applied to different kinds of people. What motivates one person may not motivate another. Although it is impossible to predict human behavior, it is important to keep these ideas in mind when discussing the elimination of certain deductions and credits.

Some deductions that should be kept in mind when considering taxpayer behavior are the deductions for charitable contributions, home mortgage interest, and property taxes. Voters should keep in mind donations to charities may decrease, and people would have less incentive to purchase homes. On the other hand, taxpayers' behaviors might not change at all. "Almost
one-half of charitable contributions today are not claimed as deductions. That was in 1995.
So, the loss of deductions may serve only to simplify the tax code, as some reformists suggest.

The removal of deductions simplifies the tax code by reducing paperwork, record keeping, and compliance regulation. For example, if there are no itemized deductions, Schedule A for the taxpayer's 1040 is no longer needed. Also, large sections of the 1040 are not required.

Record keeping for both the government and the taxpayer is reduced. Taxpayers would not need to save receipts or other documentation for deductions. The government would not have to track things such as the childcare credit. Currently, the amount of credit claimed is cross-referenced to the return of the childcare provider. In this way, the government ensures that providers report their income. The need for this kind of detailed information would not be needed.

These record keeping issues relate to compliance regulation. Having fewer deductions would reduce the amount of time the IRS spends checking taxpayers' returns for accuracy. The IRS would not have to worry about who was eligible for deductions or credits. The number of audits would be reduced, as would the amount of money spent on compliance by the government and taxpayers.

The elimination of tax credits should also be considered. Two common credits are the childcare credit and the earned income credit (EIC). Without the childcare credit, taxpayers would need to make more to afford childcare. The lost tax break would increase the cost of childcare. For some taxpayers the cost may actually outweigh the benefit of working.

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Perhaps of more importance would be the loss of the EIC. As explained before, the EIC is a refundable credit. Recall that the excess of the credit over taxes owed is refunded to the taxpayer, providing a kind of partial public assistance.

Armey-Shelby and Forbes plan to eliminate the EIC and all other credits. Gramm did not mention whether credits would be retained or not. This would certainly be something to ask before supporting his plan.

All three plans emphasize instead the increase in standard and dependency deductions. They promote the fact that a large number of families would have to pay zero taxes. However, the taxpayers eligible for the EIC would lose the amount normally refunded to them. The loss of this refund could cause families to lose up to $3,656 (for 1997) in assistance each year. This could have a significant impact on the standard of living for the families affected.

All three plans mention the treatment of capital gains. Capital gains are either eliminated from income or indexed for inflation. However, none of the plans addresses capital losses. Currently, capital losses can be used to offset all capital gain income and up to $3,000 of ordinary income. Will these losses be disallowed? This is an important issue, because the loss of the deduction from taxable income would increase the risk associated with investments. For example, suppose a taxpayer has a capital loss of $5,000 in the current year. Under our current system, the taxpayer would be allowed to offset up to $5,000 in capital gain income and/or $3,000 in ordinary income. If the loss could not be deducted, not only would the taxpayer be out $5,000, but he/she would also have to pay tax on up to $5,000 more in income. The total loss on the investment would be $5,000 plus tax paid on $5,000, which even in a 15% tax bracket amounts to an additional $750 in taxes.
Perhaps the easiest way to measure the impact of a flat tax is to compare an individual or family's taxable income under each plan to the current system. To illustrate, I will use a family of four, the Johnsons, with combined gross wages and salaries of $80,000. Mr. and Mrs. Johnson file a joint return and have two dependent children ages 5 and 8. Let us also assume the family has stock dividends received during the year of $5,000 and itemized deductions of $10,000.

Under our current tax system the Johnsons would have gross income equal to $85,000 ($80,000 wages and salaries plus $5,000 dividends received). The Johnsons can subtract from their gross income the itemized deductions of $10,000. They can also subtract a personal and dependency exemption amount of $2,700 for each of them and their children, resulting in a total exemption of $10,800. Therefore, the Johnsons' taxable income is $64,200 (85,000 - 10,000 - 10,800).

Using the rate schedule from page 2, the Johnsons' tax liability is equal to $6,352.50 plus 28% of $21,850 (64,200 - 42,350), or $12,471.

Under the Armey-Shelby plan the Johnsons have gross income of $80,000. The dividends received are excluded from income. The Johnsons cannot itemize deductions under Armey-Shelby and they are not allowed personal exemptions for themselves. They are, however, allowed a standard deduction of $22,700 and a dependency deduction of $5,300 for each of their dependent children. The result is $33,300 in deductions and taxable income of $46,700. Income is taxed at a 17% rate regardless of the taxpayer's income level. Under the Armey-Shelby plan the Johnsons have a tax liability of $7,939.
Gramm’s proposal also excludes dividends from income, giving the Johnsons gross income equal to $80,000. The standard deduction and dependency exemption amounts would be $22,000 and $5,000 respectively. The Johnsons have taxable income of $48,000 (80,000-22,000-10,000). Gramm proposes a 16% tax rate, giving the Johnsons a tax liability of $7,680.

Forbes eliminates several items from taxable income, but dividends are not mentioned. The Johnsons have $85,000 in gross income. The dependency exemption is eliminated but the standard deduction is increased to $36,000, resulting in taxable income of $49,000. The Johnsons’ income would be taxed at 17%. Their tax liability would be $8,330.

TABLE 5- Summary of Tax Liability of the Johnson Family

<table>
<thead>
<tr>
<th></th>
<th>Current System</th>
<th>Armey-Shelby</th>
<th>Gramm</th>
<th>Forbes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Liability</td>
<td>$12,471</td>
<td>$7,939</td>
<td>$7,680</td>
<td>$8,330</td>
</tr>
</tbody>
</table>

A concern with these plans involves the definition of taxable income. The Armey-Shelby and Gramm plans exclude dividends received from taxable income. All three plans affect the treatment of capital gains. Armey-Shelby and Forbes eliminate capital gains from taxable income and Gramm indexes them for inflation, resulting in less gain to be reported on the sale. One source of capital gain is from the sale of stock. My concern is that wealthy individuals could structure their income to be mostly or entirely from dividends and capital gains on investments. If these individuals can make it so they do not have reportable wages, they will be
able to report zero taxable income. While they are making money on investments, none of their income would be taxed.

The results of these plans depend not only on the definition of income and the deduction amounts, but also on the percentage rate charged. It is well known that our country usually operates on a budget deficit and that a major part of the government’s working capital comes from taxes. Economists and politicians have expressed concern that a tax rate cut under flat tax plans would result in a loss of revenues to the government. “Some economists have argued that a flat tax rate of at least 23% would be required to avoid revenue losses.”¹⁶ In the example above the lowest tax the Johnsons owed was $7,680, under the Gramm proposal. If Gramm’s tax rate had to be changed from 16% to 23%, the Johnsons’ tax liability would increase to $11,040.

While the Johnsons pay less tax under a flat tax it is critical to note that this is just one example. To measure the true effect on taxpayers, a number of varying scenarios would need to be calculated. However, the example should be helpful in illustrating how to substitute your own income and measure the result.

While flat tax proposals may look good on paper there are some procedural issues that should be evaluated. For example, will the information reported really fit on a postcard as promised? The Armey-Shelby plan is the only plan that has actually drafted such a form. Based on their form, recreated previously, I do not think it will work quite as smoothly as some would like to believe. First, the taxpayer would still have to attach some sort of W-2 listing wages and salaries received. This would necessitate some sort of envelope, not just a postcard.

Second, the form leaves no space for listing the dependents claimed or their social security numbers. This kind of system could lead to taxpayers claiming their pets and other non-dependents.

Another issue is whether the tax code would really be simplified to the point that more Americans would understand and be able to fill out their own returns. Some critics say that the changes made would not really simplify the tax law. They contend that taxpayers would still have questions. Some examples of questions are (1) Who qualifies as a dependent? (2) Do I have to include the insurance premiums my employer paid as income? (3) My fourteen-year-old child has income from a babysitting job; do I have to report it? (4) How do I report income from rental property? (5) How do I report income from a sole proprietorship or partnership? It is questions like these that make some tax professionals confident that taxpayers will still need help interpreting tax law.

Supporters of flat tax claim these questions would affect only a small number of people. They believe most taxpayers would be able to sit down with just their W-2 and fill out a tax return in a matter of minutes. However, a taxpayer with only wages already can sit down with a 1040EZ form and fill it out in a matter of minutes. So some critics say we already have a flat tax for many taxpayers. Anyone in the 15% bracket pays a flat 15%, and most of these taxpayers can fill out their returns quickly and easily.

Our tax code started out simple. In the early nineteen hundreds few citizens even paid taxes. We now have hundreds of laws, some so confusing a tax professional cannot figure them out. What will stop the flat tax from becoming complicated? Most plans, including the three I have been discussing, talk about the possibility of limits on Congress. Most flat tax supporters have
mentioned a system where Congress would need a super-majority vote to pass changes in tax law. This means a two-thirds vote in both the House and the Senate would be required for a reform to pass. This requirement could make the tax law more difficult to change.

Finally, consideration should be given to transition issues. Before approving of a plan, taxpayers should investigate the proposed rules for transition from our current system to the new one. Perhaps most important is time for taxpayers to restructure their income. For example, if capital losses were disallowed under the new system as discussed earlier, some taxpayers may want time to sell those assets and claim the tax benefit of the losses. Or perhaps individuals would want to restructure their compensation to include more stock and less wages since dividends and possibly capital gains would be tax exempt.

CONCLUSIONS

We need a more solid plan to evaluate before jumping on the flat tax bandwagon. The questions I presented in the previous paragraphs are not minor details, but large questions of feasibility that should be addressed.

Proposers of a flat tax promise a simple, fair tax. The thought of fewer forms, less record keeping, and lower taxes is very appealing; but reaching a conclusion about the flat tax requires examining other factors as well. A flat tax may be appropriate if the purpose of the income tax is to raise revenue for the government. A flat tax accomplishes that goal with relative simplicity assuming the percentage rate set raises the same amount of revenue as the current system.
However, I believe the income tax has grown from its initial goal of raising revenue to become an instrument for societal goals. The current income tax strives to reduce the burden on low-income taxpayers and encourage socially beneficial behaviors.

Some taxpayers may not do things, like contribute to charity, solely because of the tax law. However, I think it is reasonable to assume that at least some taxpayers are motivated by the tax law. If we take away this vehicle for Congress, other plans may have to be enacted. For example, will employers find themselves bargaining over business expenses incurred by employees? If employees do not receive a tax benefit from an unreimbursed item they will not want to incur such expenses without additional compensation. Similarly, without the deduction for home mortgage interest, buying a house becomes more expensive. We may see a downturn in the housing industry that may require government assistance.

Regardless of the effect on social and economic behaviors, most taxpayers are concerned with their total tax bill and how that compares to the tax bill of others. We want a progressive structure that puts more of the tax burden on those that are most able to pay it: the wealthy. With respect to this view, there are two points to be reiterated about the flat tax. First, the loss of the earned income credit could be damaging to low-income taxpayers. While they still do not have to pay taxes under the flat tax, they also do not receive the excess from the earned income credit. These individuals may have to seek assistance from other sources, such as welfare. The problem is that many welfare programs penalize the working person by reducing their assistance when they get a job. Some taxpayers may find it beneficial to stop working so they can receive more in welfare to replace the up to $3,656 they would have received from the earned income credit.
Second, if capital gains and dividends are excluded from income, wealthy individuals will see a large tax break. The middle-income taxpayers may be left to shoulder the tax burden of the United States. Low-income taxpayers will be exempt from paying tax due to the large standard deduction amounts. High-income taxpayers can arrange to have a majority of their income coming from investments, resulting in dividends and capital gains. The middle class is then left to raise the same amount of revenue as was once shouldered by many more taxpayers. This is one reason economists and tax experts believe the percentage charged under the flat tax would more realistically have to be in the middle 20s.

Tax reform is an important issue that should be carefully analyzed before any new plan is adopted. This paper illustrates how a plan that sounds good on the surface can have many complicated ramifications for the U.S. taxpayer. Individuals must assess for themselves the consequence to their own tax return as well as the effect on the United States as a whole. Simplicity cannot be easily achieved in a country where taxes must be collected from millions of people. Beware of people that claim their plan is easy and beneficial to everyone. Instead, analyze the numbers yourself, and listen to what tax professionals and economists have to say.