

## 5. Questions and Answers about the Flat Tax

WE HAVE PRESENTED the flat tax and answered questions about it on radio talk shows, before professional and lay audiences, before congressional committees, and in interviews with newspaper and magazine reporters. In this chapter we have assembled the most asked questions together with our answers, a format we hope will answer any questions you may have about the flat tax.

### DEDUCTIONS

**Q:** *What about charitable deductions?*

**A:** No charitable deductions would be allowed under the flat tax. We do not believe that current tax incentives are a major part of why people, apart from the very rich, contribute to community, religious, and other organizations. Almost half of all contributions are made by people who take the standard deduction and thus do not benefit from an itemized deduction for charitable contributions. However, the tax code allows deductible gifts of appreciated property, such as stock or works of art, thus allowing wealthy taxpayers to pay little or no taxes. On net, you, the average taxpayer, will save more by blocking the tax-avoiding tricks of the wealthy than you will lose from eliminating tax deductions from your

own contributions. Remember, the value of any deduction depends on your tax bracket: if you are in the 15 percent bracket, you get less than one-third the benefit of someone who is in the 39.6 percent bracket. There is little merit in public subsidy for organizations whose success in raising funds depends on tax deductibility rather than the intrinsic merits of their activities.

**Q:** *But aren't there many deserving activities that will disappear if charitable contributions are no longer deductible?*

**A:** The simple answer is no. Remember, the top rate fell from 70 percent in 1980 to 28 percent in 1986, until it was increased to 31 percent beginning with the 1991 tax year. During 1980–1989, individual giving grew at a compound annual rate of 5.2 percent despite the fact that the benefit of deducting contributions declined from a maximum refund of seventy cents on the dollar to no more than twenty-eight cents. Compared with the 1980s, individual giving grew at a much slower compound annual rate of 3.1 percent between 1955 and 1980, a period of much higher marginal rates. In real terms, expressed in constant (inflation-adjusted) 1990 dollars, individual giving increased from \$64.7 billion in 1980 to \$102 billion in 1989. Sustained, strong economic growth, which increased the real income of the average American, was the most important factor in the sharp rise in giving, far more important than any tax break. Indeed, the real 57.7 percent

increase in total individual giving in the 1980s greatly exceeded the 32.8 percent growth in real total consumer expenditures. The 1980s, a period of steadily declining tax rates, was more a period of giving than of greed.

**Q:** *What would happen to the restaurant industry?*

**A:** Business meals in restaurants would be fully deductible as business expenses under the flat tax, an improvement over the current situation, where only 50 percent of meals are deductible. Lower tax rates, in contrast, would reduce the incentive for businesses to splurge on restaurant meals. The net effect on the restaurant industry would probably be around zero.

**Q:** *Shouldn't the tax system provide some relief to families with high medical costs?*

**A:** Virtually the entire U.S. population is now covered by medical insurance, Medicare, or medical benefits through welfare. The medical deduction under the current personal income tax is a source of many abuses, including the deduction of swimming pools and other home improvements that are available only to the wealthy. Remember, the higher the marginal rate, the greater the tax benefit of any deduction. The nearly half of all taxpayers who take the standard deduction, the bottom half of the income distribution, rarely take advantage of this deduction. Few families would suffer, and the overwhelming

majority would gain by closing off this source of abuse.

The IRS publication Statistics of Income reported that only 5.5 million of the 113.8 million returns filed in 1992 selected medical and dental expense deductions, with a total value of \$25.5 billion. The richest 5 percent of those 5.5 million returns took more than 10 percent of total medical deductions, which means the richer you are, the greater the tax subsidy you receive—which is surely absurd.

**Q:** *What about alimony?*

**A:** Under the flat tax, the spouse that pays alimony does not get to deduct it and therefore pays the tax on it. The spouse that receives it does not pay any additional taxes. This is as fair as the current arrangement but eliminates the opportunity to take advantage of differences between the tax rates of the two sexes.

**Q:** *Why is there no deduction for moving costs in the flat tax?*

**A:** Moving costs are only one of hundreds of costs incurred by taxpayers in order to earn an income. It is inconsistent to permit deduction of moving costs when costs of commuting, purchase of special clothing, and other employment costs cannot be deducted. Many moves are undertaken for reasons unrelated to earning a higher income and so should not escape taxation. The deduction for moving ex-

penses is one of a number of tax provisions abused by a small minority of taxpayers at the expense of the great majority. It should be eliminated. Eliminating each tax break enlarges the tax base, which permits lower rates to generate sufficient revenue to run the government.

*Q: I am a salaried employee. How would I treat unreimbursed business expenses? There is no room for this deduction on the simple individual wage tax form.*

A: Deducting so-called business expenses of salaried employees is a major loophole in the current tax system in that it subsidizes summer travel for teachers, trips to conventions, and other activities for which special incentives are inappropriate. Genuine business expenses ought to be borne by employers, in which case they are deductible under the business tax.

*Q: Won't state and local governments be irrevocably damaged in their capacity to tax local residents if the federal deduction for state and local taxes is eliminated?*

A: Who benefits from this deduction? Primarily wealthy taxpayers. Altogether, slightly fewer than 32 million returns, about 28 percent of those filed in 1992, claimed this deduction. Among these, the richest 22 percent of taxpayers, those with adjusted gross incomes over \$75,000, got the benefit of half the \$159 billion claimed in deductions. Recalculated, just over 6 percent of all taxpayers claimed

\$80 billion, about half, of all itemized deductions for state and local taxes. This deduction amounts to a huge benefit for the richest Americans and for those states in which the rich disproportionately live, such as New York, Connecticut, and California, at the expense of North Dakota, Alabama, and Tennessee.

Moreover, current law is less generous than it was a decade ago. Sales taxes, which were deductible as recently as 1986, are no longer deductible. State and local governments did not collapse when this deduction was removed from the federal income tax. Moreover, itemized deductions can no longer be deducted in full above adjusted gross income of \$108,450 (married, filing jointly). Form 1040 includes a ten-line worksheet in which you are asked to calculate and subtract “excess itemized deductions.” The worksheet invites you to multiply 80 percent of most of your itemized deductions, subtract \$108,450 (married, filing jointly), multiply the difference by 3 percent, enter the smaller of line 4 or line 8, subtract that sum from total itemized deductions, and enter the balance on Schedule A. Because Congress has an insatiable appetite for more revenue, we expect it to further limit the itemized deduction for state and local taxes, if not eliminate it altogether. Under the flat tax, those who lose this benefit gain from the incentive of lower rates.

**Q:** *What about interest deductions?*

**A:** The flat tax would end the deduction for interest of

all kinds. (See the next Q & A for the answer to home mortgage interest in particular.) As recently as 1986, credit card and charge account interest were deductible. In 1987, only 65 percent of personal interest was deductible. In 1993, only home mortgage interest was deductible, up to a maximum of \$1 million. In 1992, less than 0.1 percent of all returns could exploit this maximum. Altogether, 14 million filers (12 percent of all returns) with adjusted gross incomes of more than \$50,000 claimed 68 percent of all interest deductions. About 88 percent of all taxpayers get no or little benefit. Remember, the higher your tax bracket, the greater your tax benefit. The number of nondeductible interest items listed in Form 1040 has steadily expanded in recent years.

The flat tax changes the tax treatment of interest for businesses and individuals. All interest is placed on an after-tax basis. Interest expense is no longer deductible by business, and interest income is no longer taxable to individuals. The level of interest rates in the economy will fall from the high level of taxable corporate bonds to the low level of tax-free municipal bonds. Taxpayers who lose interest deductions will benefit from lower interest rates overall.

#### HOUSING

**Q:** *What would happen to the housing market as a result of ending the deduction for mortgage interest?*

A: The flat tax eliminates the deduction for all kinds of interest, not just mortgage interest. It would not discriminate against housing. However, improvements in the taxation of business investment would tend to draw wealth out of housing and into plant, equipment, and other business investment, which might reduce housing values temporarily. The effect would not be more than a few percent and would last only for the duration of the investment boom set off by the new tax system. In the longer run, the outlook for housing values would be improved as overall economic activity increased in response to the tax.

Q: *The only way I can afford my house today is the large tax deduction I get for the interest on my mortgage. Won't I have to sell my house if I can no longer take the deduction?*

A: The parallel removal of interest deduction and interest taxation under the flat tax will bring about lower interest rates. Lower interest rates reduce monthly mortgage payments, which offsets the loss of mortgage interest deduction for most taxpayers. Only the wealthiest taxpayers may lose out from the elimination of mortgage interest, but they receive compensation in the form of lower rates. A transition measure would allow present homeowners to deduct 90 percent of their interest until they renegotiated the loans at the new, lower rate.

Q: *Why shouldn't we tax the capital gains from the sale of a house?*



A: These capital gains are rarely taxed under the current system because of the rollover provision, forgiveness of \$125,000 of capital gains for those aged fifty-five and over, and the stepping up of the basis for capital gains at the time of inheritance. We believe that taxing housing is properly ceded to local governments under our federal system. Local property taxes capture part of the value of the services of a house.

Q: *I own a building that is part of a low-income housing project, for which I get a low-income housing credit. If you take this credit away from me, what will happen to those poor people who live in low-income housing projects?*

A: Like all the credits in the existing tax system, such as the jobs credit for business employers who hire members of special targeted groups, credit for alcohol used as fuel, credit for increasing research activities, disabled access credit, enhanced oil recovery credit, renewable electricity production credit, and qualified electric vehicle credit, the low-income housing credit would disappear with the advent of the flat tax. All these credits distort the economy and narrow the tax base, thereby raising rates for everybody else. These tax credits result in taxpayers' money being put into elaborate installations and activities that are at or below the margin of economic efficiency. It would be far more efficient for the government to subsidize these activities directly, rather than indirectly through the tax code.

In particular, poor people need not suffer; the government could give them cash or housing vouchers to find housing in the market economy.

The tax system is not the proper place to undertake social engineering. The merits and financing of social programs are subjects for open public discussion during the annual appropriations process in which members of Congress have to vote on the record for each expenditure. These programs should not be tucked away in the tax system. Our present complicated, costly income tax is partly the result of using the tax system for social engineering, instead of simply to collect revenue.

**Q:** *Because your plan removes the tax incentives now offered for preserving historic structures, won't this accelerate the destruction of many buildings that belong to our national heritage and that should be saved for future generations to enjoy?*

**A:** For every genuinely important historic building saved by the tax incentives, dozens or perhaps even hundreds of buildings are subsidized that are not important or would be kept by their owners anyway. Giving tax incentives for historic structures is a terribly inefficient way to accomplish the goal of preservation—most of its effect is to create another tax shelter. Directly appropriating government funds for saving individual buildings is a far superior social policy for preservation.

**Q:** *Doesn't the flat tax encourage speculation in land by granting first-year write-off for land purchases?*

- A: The sellers of land have to count their proceeds as taxable income; this offsets the deduction granted to the purchaser. Prices of undeveloped residential land may rise a little, but with a 19 percent tax rate, the effect should be small. Land transactions are included in the flat tax because it is difficult to separate the value of land from the value of the buildings on it.

#### INTERGOVERNMENTAL RELATIONS

**Q:** *How would local governments be affected by the change in the taxation of bonds?*

- A: Local governments derive a small advantage from the tax-free status of their bonds and the taxation of all competing bonds in the current system. Able to borrow at artificially low rates, state and local governments have issued billions of dollars in debt that is unwarranted for legitimate public purposes. Many bond issues finance questionable activities, as is evidenced by state legislators' refusing to vote for higher taxes. Excess state and local borrowing also diverts money away from more productive corporate uses.

Under the flat tax, local government bonds would remain untaxed, but all other bonds would also provide tax-free interest because the earnings of business would be taxed at the source. Corporate bonds would be placed on a level playing field with government bonds. The immediate impact would lower the borrowing costs of other borrowers to the

levels paid by local governments. In the ensuing investment boom, as interest rates rise, local borrowing costs would gradually rise. The slightly adverse effect on local governments would be confined to a few years and would not be large. In the longer run, local governments would face no higher interest rates and would benefit in many other ways from the improved performance of the U.S. economy. There is simply no substitute for a prosperous citizenry.

**Q:** *What about such other taxes as state, county, excise, and sales taxes? What would happen to them under the flat tax?*

**A:** Although we would prefer that other units of government besides the federal government switch to taxes based on the same principle as the flat tax, we have limited our proposal to federal action. The only important implication of our proposal for other federal taxes is the elimination of the deduction for state and local income taxes and property taxes under the federal income tax (the deduction for state and local sales taxes was eliminated in 1987). This deduction overwhelmingly favors rich people; just over 6 percent of all taxpayers, those with adjusted gross incomes over \$75,000, get half the benefit. But these same taxpayers benefit from lower rates under the flat tax. Remember, every time a deduction is eliminated, the tax base is broadened. The broader the base, the lower the tax rate. Eliminating this deduction also promotes efficiency by reducing the

incentive to channel economic activity through state and local governments to exploit a tax break.

**Q:** *How does the flat tax affect state income taxes where the tax returns are linked to the federal tax system?*

**A:** Because the flat tax would raise approximately the same revenue as the old tax system, a state that retained the linkage would continue to receive about the same revenue as well.

**Q:** *How does the flat tax treat government? Are state and local activities taxed? Does the federal government tax itself?*

**A:** State and local governments pay no taxes themselves, but their employees pay the individual wage tax. The same is true for the federal government.

#### THE INDIVIDUAL WAGE TAX

**Q:** *The current income tax does not tax fringe benefits. Your flat tax doesn't tax them either, but it also doesn't permit my employer to deduct them. What will happen to my fringe benefits under the simple tax?*

**A:** Fringe benefits arose in World War II as employers tried to find a way to pay their employees more under stringent wartime regulations. During the past fifty years, employees have often struggled harder for better fringe benefits than for pay increases because of the tax-free status of fringes. Today, fringe benefits are an extremely important part

of any compensation package, and your employer will not cut your benefits without compensating you in some other way.

Fringe benefits are among the largest contributors to narrowing the tax base. It is important to include the value of fringe benefits in the tax base; otherwise, tax rates, levied on a smaller tax base, will remain unnecessarily high. The flat tax eliminates the distortion toward fringe benefits created by the fact that employers can deduct them, thereby receiving a subsidy that can be passed on to their employees. The best alternative, and one we expect your employer to select, is to offer you higher pay in exchange for lower fringes. You can then use the extra cash to buy whatever combination of benefits you desire or for any other purpose, such as travel, housing, educational expenses, and so forth.

**Q:** *My teenage daughter has taken a part-time job and will earn about \$3,000 this year. Can she use the personal allowance of \$9,500 to avoid paying tax? Will I lose my dependent's allowance of \$4,500 for her?*

**A:** All taxpayers are entitled to the personal allowance, including your daughter. You will retain the dependent's allowance as long as you provide more than half her total support over the year.

**Q:** *I am an American citizen and now enjoy a \$70,000 exclusion for income earned abroad. How will this income be treated under the flat tax?*

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A: All income earned from work performed abroad, or from enterprises located abroad, will be taxed by the country where you earn it. The flat tax applies only to the domestic operations of all businesses, regardless of ownership. The flat tax would not apply to the foreign earnings of Americans.

Q: *The flat tax eliminates the credit for child and dependent care expenses. Won't this force people to stay home to take care of their children and elderly dependents, thereby increasing their dependence on welfare, reducing their participation in the labor force, and costing the government more money than it would save from its elimination?*

A: Like many of the complicated, special provisions in the tax system, the child care credit fails to focus its benefits in an area of particular social need. It potentially lowers the taxes of a significant fraction of all taxpayers—families with two earners and one or more children. It is available at all income levels. In 1993, for example, even the very rich were able to claim a credit of \$480, although some taxpayers subject to the alternative minimum tax were not eligible for the full credit. Higher tax rates are required to compensate for this lowering of the amount of taxes. Features like the child care credit are antithetical to the flat-tax philosophy, which favors the broadest possible tax base with the lowest tax rate. We think that the special problems of helping families with child care and other responsibilities should be attacked specifically within the wel-

fare system, not with the scattergun of the tax system. The flat tax provides plenty of revenue for a generous welfare program.

**Q:** *Isn't it unfair to start taxing workers' compensation benefits and insurance for injury or sickness?*

**A:** Workers' compensation benefits are money that replaces wages when a worker is disabled on the job. The wages themselves would have been taxed, so it stands to reason that the replacement should be taxed. Failure to tax workers' compensation benefits creates an inappropriate incentive for workers to remain off the job after a period of disability.

**Q:** *Why does the flat tax eliminate the extra exemptions for the blind and the elderly? What makes you want to lay higher taxes on these two especially unfortunate groups in our society?*

**A:** Many of the elderly and a few of the blind are well off. It raises everybody's tax rate inappropriately to provide extra exemptions to every elderly and blind individual. The road to a narrowly based, high-rate tax system begins with just a few small loopholes. It is far better, and more conducive to both an efficient economy and a simple tax system, to use Social Security and other social programs, which supply the lion's share of the incomes of many elderly persons, and other public or private welfare organizations to assist the blind.

**Q:** *Part of my compensation comes in the form of stock options. How are these taxed?*



- A: The full market value of the options is included in your compensation in the year you receive them, whether or not you exercise them.

#### THE BUSINESS TAX

Q: *What would happen to the unused depreciation deductions from capital investments made under the old tax system?*

- A: It is important to keep in mind that this is not an issue of tax policy but of how to make the transition from the complicated, costly current code to the simple, efficient flat tax. The first point to note is that much lower tax rates make these deductions much less important. From the standpoint of the economy as a whole, the reduced taxation of the earnings of capital under the flat tax offsets the decline in the value of the deductions because of lower tax rates. From the point of view of each business, a first-year write-off is more attractive than multiyear depreciation deductions for all new investment.

However, some firms may not be planning to make new investments in the immediate future, but would lose out if their scheduled depreciation deductions were taken away. How much money is at stake? In 1992, total depreciation deductions under the personal and corporate taxes came to \$597 billion. At the 35 percent corporate rate, and at a similar average rate for individual recipients of most business income, those deductions were worth \$209

billion. If Congress chooses to honor unused depreciation predating tax reform, it would take \$597 billion out of the tax base for 1995. This would require an increase in the tax rate from 19 percent to 20.1 percent. But, this slightly higher tax rate would only be temporary, to last no more than five years, as the transition depreciation is paid off. The rate would then be reset at 19 percent.

An alternative approach, which would not require a temporary increase in the tax rate, would let firms choose to take the depreciation deductions but would limit their write-off of new investment to, say, half the purchase price of new investment. They could take the remaining half as soon as they chose not to continue to take the old depreciation. Each firm could select the most advantageous strategy.

**Q:** *I'm a traveling saleswoman. I earn commissions and pay my own travel expenses. I do not receive a salary. How would I fill out the flat tax?*

**A:** All self-employed individuals will file Form 2, the business tax form, where they can deduct travel and other business expenses. To take advantage of the personal allowance, you will want to pay yourself a salary of at least \$16,500 if you are married. Report this amount along with your husband's earnings on Form 1, the individual wage tax. In this way you will be able to deduct your legitimate business expenses and receive the personal allowance. You will need to keep records to document your income and expenses.

**Q:** *You say that the current system taxes income twice. Isn't income income no matter what its source?*

**A:** Income is an individual's command over resources. Only people have income. The income of a corporation is just the income of its owners, the stockholders. The current system taxes the same income twice, once when the corporation receives it and again when it is paid as dividends to stockholders. The combined tax rate on this single stream of income, 34 percent on the corporation and up to 39.6 percent on dividends received by individuals, is 60 percent. This does not take into account additional state taxes. Double taxation amounts to confiscation, which violates every concept and definition of fair.

**Q:** *What about capital gains? You eliminate the taxation of capital gains on the sale of financial assets, claiming that it also amounts to double taxation. Won't the elimination of capital gains give a wind-fall to business and the rich?*

**A:** First, capital gains are taxed under the flat tax. Capital gains from the sale of business property—an office or apartment building or a house held for investment purposes—would be taxed under the business tax, which treats the proceeds from the sale of plant, equipment, and buildings as taxable income for the business. Capital gains on stocks, bonds, and other financial instruments are a separate matter; they arise from the capitalization of after-tax income. As the earnings of a business grow,

the value of a share of stock also rises because stock constitutes a claim on the firm's after-tax income. Remember, all business earnings are fully taxed at 19 percent. Another tax on the appreciation of shares would amount to a second tax on a single stream of income. Put another way, share values rise because investors have every reason to believe that retained earnings, which permit firms to expand, significantly increase the probability of higher future earnings.

As to residential property, capital gains on owner-occupied homes arise from the capitalization of rental values, which are heavily taxed by state and local governments; again, it would be double taxation for the federal government to tax the capital gains as well. Finally, it must be recognized that a good part of any capital gains on owner-occupied homes is simply inflation, especially for those who have remained in their homes a long time. If an effective, comprehensive capital gains tax were imposed on owner-occupied homes under current law, many homeowners would actually pay a tax on their original purchase price, a confiscation of capital, because the tax code does not provide for indexing the buying and selling prices of any asset for inflation.

**Q:** *How are tax losses for individuals and businesses treated?*

**A:** Remember that self-employed persons fill out the business tax form just as a large corporation does. Business losses can be carried forward without limit

to offset future profits (assuming your bank or rich relatives will keep lending you money). There is no such thing as a tax loss under the individual wage tax. You can't reduce your compensation tax by generating business losses. Well-paid individuals who farm as a hobby or engage in other dubious sidelines to shelter their wages from the IRS had better enjoy their costly hobbies; the IRS will not give them any break under the flat tax.

**Q:** *Would a company going bankrupt get a tax refund in proportion to its loss?*

**A:** No. The flat tax would never make payments (except refunds of overpayments) to taxpayers. However, a bankrupt company could be acquired by another firm, which would assume the tax loss.

**Q:** *Some companies pay so much interest today that disallowing the deduction of interest would make them operate at a loss. Isn't this bad economic policy?*

**A:** This is a problem only during the transition to the flat tax. Corporations and homeowners with large amounts of debt will suffer, just as those with large holdings of bonds or mortgages will gain. For two reasons, the problem is not serious. First, the dramatic reduction in the tax rate to 19 percent largely offsets the increase in taxes from the loss of interest deductions in most cases. Second, most corporate debt can be called and reissued at lower rates when the flat tax is law. As for homeowners, incentives can be provided to encourage banks and other lend-

ing institutions to rewrite home mortgages at the new, lower interest rates that will prevail when the flat tax is put into place.

**Q:** *If a firm plowed back all its income into plant and equipment, and hence paid no business tax, couldn't the firm increase its value forever without paying taxes? Wouldn't the stockholders receive the capitalized value of the firm as untaxed capital gains?*

**A:** Sooner or later, the firm will run out of sufficiently profitable opportunities and will start paying out its income to its owners instead of plowing it back. If the market didn't believe this, the stock would have no value because the stockholders would not believe that they were ever going to get anything; stockholders would sell their shares to buy stock in firms that were paying out some of their income to their owners. The market will always know that the tax will be imposed on any returns earned by the stockholders, so the market value of the firm will always be the capitalized value after taxes.

**Q:** *Won't businesses constantly buy and sell equipment or land in order to take advantage of the immediate write-off?*

**A:** No. There is nothing to be gained from extra purchases and sales. The proceeds of the sale of any equipment must be reported as income to be taxed, which offsets the tax benefits of a subsequent purchase. The only winner is the broker who executes the sale.

**Q:** *How are individuals taxed on their rental activities? Is rental income part of wages or business income? Would individuals have to file both business and individual tax forms if they had both kinds of income?*

**A:** Renting is definitely a business activity and would require a business tax form. Rental receipts are taxed as business income, but purchase of rental property qualifies for a first-year write-off. Because there are no complicated depreciation computations, little effort would be required to fill out the business tax form for rental units. If rental income is your only source of income, you should pay yourself a salary from rental income and fill out the wage form to take advantage of the generous personal allowance enjoyed by every taxpayer.

**Q:** *If my company provides me with subsidized lunches, physical exercise facilities, a company car, and other benefits, how are these treated under the flat tax?*

**A:** Your company cannot deduct fringe benefits under the business tax. It can only deduct cash payments paid out as wages and salaries. It can still provide you with fringe benefits, but these no longer enjoy any tax benefits; you would be better off taking the value of fringe benefits in cash and spending the money any way you want, buying only those services you truly require.

**Q:** *I am involved in a highly leveraged investment company. Won't my company and others like it be forced*

*out of business because we will no longer be able to deduct interest expenses?*

A: It is true that you will no longer be able to deduct interest expenses. But it is likely that your borrowing is linked to market interest rates. Remember, the decline in interest rates caused by the flat tax will offset most or all the loss of the deduction. Also, don't forget that the income from your company will be taxed at only 19 percent. Try filling out the business tax form to see what will happen to your total tax payment.

Q: *Does the flat tax cover the fringe benefits of government and nonprofit organizations?*

A: Yes. They are required to file the business form in a particular way that exempts all their income except what is paid to their employees as fringe benefits. In this way, the flat tax avoids a distortion in favor of government and nonprofit activities that would arise if they alone could pay untaxed fringes.

Q: *How will the flat tax affect the value of the U.S. dollar in the foreign exchange markets?*

A: The tax treatment of imports and exports of goods and services will be essentially the same under the flat tax as under the existing system, so there will be no change in the value of the dollar on that account. The lower interest rates that will accompany the adoption of the flat tax may bring a temporary decline in the value of the dollar, which will stim-



ulate U.S. exports and discourage imports, but this will be a one-time adjustment only.

**Q:** *Will foreign investment in the United States increase or decrease under the flat tax?*

**A:** The flat tax is 19 percent for business firms and individuals. In addition, business firms can use 100 percent first-year write-off of new investment, and individuals do not pay capital gains taxes. The flat tax makes the business climate in the United States far more attractive than that in every country in Western Europe and most other countries. Foreign investment should pour into the United States after the flat tax is adopted. The inflow of foreign investment will raise the value of the U.S. dollar in foreign exchange markets.

**Q:** *Why does the flat tax collect the business tax from firms and the wage tax from individuals? Wouldn't it be easier and simpler to just use one form and collect both taxes from firms or from individuals?*

**A:** The IRS has not been terribly successful in trying to collect income taxes on interest and dividends from individuals. A distinct advantage of the flat tax is that it permits airtight collection of taxes on business income at the source, where enforcement is easiest. Remember, the low 19 percent rate significantly reduces the benefits of cheating, which will help ensure fuller reporting of all business income.

We make individuals fill out the wage tax for two main reasons. First, it ensures that taxpayers get

the benefits of their personal allowance. The tax-withholding system already in place can be adapted to collect almost exactly the full amount of taxes each individual owes, so that taxpayers would not be faced with a large bill at the end of the year. This is relatively easy to do with a 19 percent flat tax.

Second, it is crucial that all taxpayers do an annual accounting of their taxes every year to determine how much they are paying for government services. The beauty of the flat tax is that all taxpayers would pay higher taxes in the same proportion to pay for new government programs. If individuals did not file returns, advocates of more government spending could promise voters new benefits without higher costs. They would promise to place new taxes solely on rich, anonymous corporations, as if those taxes will not affect the employees or the owners of those corporations. Remember, businesses don't pay taxes; only individuals do. And higher taxes on business are borne in part by the employees in the form of fewer jobs and lower wages.

#### TAX REFORM AND THE RICH

**Q:** *You keep talking about broadening the tax base. What's so important about this?*

**A:** Tax rates are high today because the tax base is so narrow. Personal income in the United States is about \$5 trillion. A raft of exclusions reduces this number to about \$3.6 trillion in adjusted gross in-

come and \$2.4 trillion in taxable income. A lower rate on all or most personal income would collect the same amount of money as a much higher rate on taxable income.

The same situation applies to business income. Much of this income escapes taxation because it does not fall into the net of taxable income. Altogether, less than half the national income is subject to income taxation, which means that relatively high rates of tax are required to collect enough money to run the government. The only way to enjoy the economic benefits of low tax rates and achieve real simplification is to broaden the tax base to all national income. The only exclusions in the flat-tax base from the entire gross domestic product are personal allowances, which inject a large measure of progressivity into the flat tax, and the investment incentive of 100 percent first-year write-off, which transforms the flat tax into a tax on consumption.

**Q:** *What's so important about choosing a 19 percent rate? Why not 18 percent or 20 percent?*

**A:** Actually, 19 percent is not, in and of itself, critical. It is important that the rate be low, so 18 percent or 20 percent would be acceptable. When we first designed our integrated, simple flat-tax proposal in 1981, we calculated that 19 percent would be revenue neutral, which means that it would collect the same amount of money in 1981 as the then personal and corporate income taxes. We have stayed with

19 percent partly out of loyalty to our original plan and to retain name recognition for it. But we have also stuck with 19 percent to avoid breaking through what is for us a politically important psychological barrier of 20 percent. We do not want politicians to add fractions or whole percentage points to the tax rate that would rapidly push rates up into the mid or high 20s.

**Q:** *Personal and corporate income taxes generate revenues that equal about 11 percent of the gross domestic product. So why can't you use a flat rate of 11 percent?*

**A:** We could. However, an 11 percent flat tax would not permit the inclusion of a large personal allowance that exempts poor people from income taxes or include any provision for depreciation. Personal allowances amount to about 27 percent of GDP, and our 100 percent first-year write-off amounts to about another 11 percent. When this 38 percent of GDP is subtracted from the tax base, a rate of 19 percent is required to generate the same revenues as the current income tax.

It is possible, of course, to have smaller personal allowances and stretched-out depreciation, which would permit a lower flat rate of tax. But that mix would impose higher taxes on low-income households and provide less in the way of investment incentives. We believe that our package—100 percent first-year write-off, large personal allowances, and a 19 percent rate—is the best mix.

**Q:** *Isn't the flat tax a windfall to the rich?*

**A:** Taxation of families with high incomes and few deductions would be dramatically reduced under the flat tax. But those who have taken advantage of the many opportunities in the tax code to reduce or postpone taxes through tax shelters, large deductions, purchasing municipal bonds, and other gimmicks will pay significantly higher taxes. Those who work hard will do better; those who have concentrated on avoiding tax will do worse.

Remember, the flat tax includes a generous personal allowance. This means that millions of working families will no longer pay any income taxes. Those in the middle class will face a lower rate of tax. The flat tax will improve every taxpayer's incentive to work, save, and invest and shift from avoiding or reducing taxes to producing income.

**Q:** *Won't the flat tax be a step backward in terms of fairness? Isn't it less progressive than the current income tax?*

**A:** In our view, the flat tax, under which every taxpayer pays the same rate and no taxpayer is exempt from taxation, is much fairer than the current income tax with its unfathomable complexity and unconscionably high compliance costs. Remember, until recently, fairness meant equal treatment under the law. Equating fairness and making the rich pay more is a modern invention of those who believe the tax system should be used to redistribute income to make everyone equal.

The good news is that the flat tax is progressive in that families with higher incomes pay a larger fraction of their income in taxes. Families with incomes below the personal allowance level pay no tax at all. For a married couple, filing jointly, with two children, there is no tax on the first \$25,500 of income. The proportion of income paid in tax rises to close to 19 percent for the highest income. For 1995, the proportions of income paid as tax for this four-person family are

<i>Income</i>	<i>Tax</i>
\$10,000	0.0%
\$20,000	0.0%
\$30,000	2.9%
\$40,000	6.9%
\$50,000	9.3%
\$75,000	12.6%
\$100,000	14.2%
\$200,000	16.6%

Finally, recall the history of reductions in tax rates in the 1920s, 1960s, and 1980s. In every case, the share of taxes paid by the rich increased while the share of taxes paid by lower- and middle-income categories fell. Since the 1990 tax increase went into effect, the share of taxes paid by the richest few percent has declined, while the share paid by the poor and middle classes has increased. Higher tax rates achieve the opposite effect of their proponents' intentions.

**Q:** *Will business pay its fair share of taxes under the flat tax?*

**A:** It must be repeated over and over again that only people pay taxes. Remember, the true incidence or burden of income taxes on corporations is not fully known—some is effectively paid by owners, some by employees, and some by consumers (who are workers in another guise). The flat tax is designed to collect all the tax that business owes, much of which escapes taxation under the current system because the IRS attempts to collect it from individuals instead of at the source.

Income from business sources is taxed at the same rate as income from employment, so that all productive economic activity is taxed fairly—at the same rate. Under the current system, some business income is taxed at excessive rates because of the double taxation of corporate dividends and capital gains. Other business income is lightly taxed or even subsidized through tax shelters, such as farming income.

**Q:** *Isn't the flat tax unfair because rich people can live off interest and capital gains income and thereby pay no taxes?*

**A:** The flat tax puts the equivalent of a withholding tax on interest and capital gains. The business tax applies to business income before it is paid out as interest or if it is retained in the business and generates capital gains for stockholders. The interest, dividends, and capital gains received by individuals

in all income categories have already been taxed under the business tax. The rich, along with all other recipients of business income, have already been taxed under the business tax—they cannot escape it. What they receive as dividends, interest, or capital gains is after-tax income, in exactly the same way that recipients of wages receive take-home pay.

**Q:** *Won't part of the tax on capital (on business) be shifted onto consumers in the form of higher prices rather than being paid by the owners of the capital? Isn't this unequal treatment relative to the wage tax, which cannot be shifted?*

**A:** Yes. There is a fundamental difference between capital, which is a produced input, and labor, which is a primary, unproduced input to the economy. Because the flat tax permits first-year write-off of investment, it puts no tax on the marginal addition to capital. The tax benefit of the write-off in the first year counterbalances the taxes that will be paid from its productivity in the future—the 19 percent deduction for investment write-off equals the 19 percent tax on future higher earnings.

Higher rates of economic growth mean higher incomes, higher wages, and higher living standards for all Americans. The growth in revenue from the flat tax comes primarily from growth in the number of and real incomes of paid employees because value added by labor represents three-quarters of the gross domestic product. Recipients of capital in-



come will also pay more in taxes as the stock of capital expands in the country.

A last comment: Economists of all persuasions agree that a tax on consumption rather than income would increase efficiency; some argue that it might increase the growth rate. The flat tax converts the income tax into a tax on consumption as it exempts all new investment from the tax base each year. It does, however, tax the returns to that investment in future years as it shows up in higher productivity and output.

#### NONPROFIT ORGANIZATIONS

**Q:** *How does the simple tax treat nonprofit organizations?*

**A:** They are exempt from the business tax, but their employees must pay the individual wage tax. As under present law, their dividends are untaxed. Nonprofit organizations cannot benefit from the investment incentive of first-year write-off.

**Q:** *What about nonbusiness entities such as trusts, estates, or charitable organizations, including churches and schools?*

**A:** Any actual business owned by one of these entities must file the business tax form. Their employees must pay the individual wage tax. Otherwise, these entities are not taxed. Note that a conventional personal trust, which holds stock and bonds, deals en-

tirely in after-tax income, so there is no reason for the tax system to pay attention to it.

#### INHERITANCE

**Q:** *What about the inheritance tax?*

**A:** The inheritance tax should be eliminated. It is not necessary under a system with comprehensive, watertight taxation of income, which taxes all income once. An inheritance tax constitutes double taxation, which violates a sacred principle of sound tax policy.

**Q:** *Wouldn't it be a good idea to broaden the tax base by including gifts, life insurance proceeds, inheritances, and so forth?*

**A:** No. The tax base for the flat tax is carefully chosen to provide the most efficient economic incentives. Further broadening to the listed items would be double taxation. Gifts represent a transfer of income that has already been taxed, and there is no reason to tax it again. Life insurance proceeds are a mixture of interest earnings, which have already been taxed by the business tax, and return of premiums, which were paid from income already taxed. Inheritances are just a special form of gifts.

#### ECONOMIC AND SOCIAL BENEFITS

**Q:** *How will the flat tax change the spending and savings patterns of individuals and businesses?*

**A:** The improved, uniform investment and savings incentives provided by universal first-year write-offs will channel capital into its most productive uses because all returns to investment will be taxed at the same low 19 percent rate. No tax shelters can provide a higher return or lower tax rates than regular business investments subject to the simple flat tax. Applying the same tax rate to all taxpayers will prevent the widespread abuse of tax shelters that divert savings from their efficient destinations. Dramatic reductions in marginal tax rates will stimulate investment and work effort and draw activities out of the underground economy and into the more efficient market economy.

The flat tax will dramatically reduce the disincentive costs faced by individuals and businesses. These costs run in the tens of billions of dollars. When the disincentives of high rates are eliminated, real incomes, wages, and living standards will rise.

**Q:** *How much will we save by each year having to fill out only the two postcard returns in place of Form 1040 and all its schedules?*

**A:** A conservative estimate, based on careful studies commissioned by the IRS, is \$50 billion. Some estimates are even higher. This is a staggering amount of money, equal to 10 percent of all individual income taxes. The simple flat tax eliminates most of this cost.

**Q:** *It sounds like the flat tax is just a clever ploy to raise taxes on the already overburdened American tax-*

*payer. Aren't we actually better off with the present system, with all its defects?*

- A: Actually, the present system won't stand still long enough for taxpayers to understand and cope with all of its details. Remember, the top rate was 28 percent in 1986. It rose to 31 percent in 1991 and to 39.6 percent in 1993. Other details of the tax code also change just about every year.

Almost everyone is better off under the flat tax. The poorest families are completely exempt from the income tax, which is much better than their treatment under current law. Some middle-income and rich taxpayers will pay more because they have been aggressive users of shelters and itemized deductions, but any losses they face will be offset in future years by dramatically improved incentives.

Remember, the current tax system imposes compliance costs of \$50 billion or more and disincentive costs of \$50 billion or more, and it engenders hostility among Americans toward their government. The economy as a whole will be better off by well over \$100 billion, perhaps as much as \$200 billion or more, if we move to the flat tax. This sum is almost equal to the annual federal budget deficit, about which so much has been made.

- Q: *How will the flat tax help the American economy grow?*
- A: Every study we can find shows that lower tax rates on businesses and employees, by improving incentives, increase the supply of labor, capital, and en-

trepreneurship. More people will join the labor force or work longer hours, especially in two-earner households; more people will risk their capital; and more people will undertake risky ventures to start up new businesses. Today's double tax on business income means that entrepreneurs face rates as high as 60 percent on the rewards for successful innovation. A low flat tax of 19 percent will attract bright people to innovation and away from tax-sheltered activities favored by the current system. The flat tax provides dramatically improved incentives for capital formation, through its first-year write-off provision, an important source of growth in the longer run.

The evidence compiled by the country's leading tax experts is that the flat tax will increase real incomes about 6 percent in the seven years after it is adopted. Higher growth will generate more revenues than the current system, which means that future deficits will be lower. To the extent that lower deficits imply lower interest rates, due to diminished federal borrowing, the economy will benefit.

**Q:** *What will happen to the stock market when the flat-tax law goes into effect?*

**A:** We expect the stock market to rise. Lower tax rates on corporations, coupled with the elimination of both the taxation of dividends and/or capital gains, will increase corporate income and make ownership of stock more attractive. High-growth firms that can

make productive use of the 100 percent first-year write-off will attract investor interest and command higher price-to-earnings ratios than slower-growth firms. In contrast, companies that depend heavily on interest deductions and depreciation on existing plant and equipment may look less attractive to investors, but these firms can be protected under transition arrangements that permit such firms to utilize those benefits that will be eliminated under the flat tax.

**Q:** *What about the international value of the dollar?*

**A:** Adopting the flat tax would lower interest rates in the United States to the level of tax-free bonds. To an extent that would depend on the monetary policies of other major nations, world interest rates would fall in tandem. (Financial markets are global, and changes in U.S. interest rates immediately affect bonds and stocks in all major world markets.) If world rates do not fall as much as U.S. rates, the dollar would depreciate relative to other currencies. Offsetting this effect is the inflow of foreign investment, seeking to take advantage of the improved investment climate in the United States, which would bid up the value of the dollar. In the longer run, interest rates around the world will tend to equalize, and the effects of the tax reform on exchange rates will disappear.

## RETIREMENT

**Q:** *How are existing IRA and Keogh retirement accounts treated under the flat tax?*

**A:** IRA and Keogh accounts have provided benefits to a limited fraction of taxpayers of the same type that the flat tax would provide to all taxpayers. Under the flat tax, they would be treated exactly as under the current system, except that the tax rate would usually be much lower. When the accounts begin to pay retirement benefits, those benefits would be taxed as compensation. It would no longer be necessary to impose a minimum age for the payment of benefits. Holders of IRA and Keogh accounts could elect to draw benefits at any time and pay the tax due. For the future, IRA and Keogh accounts would not be necessary because the taxation of interest at the business rather than the personal level would give any form of savings the same advantage that IRAs and Keoghs have today, namely, tax-deferred compounding.

**Q:** *What about Social Security? How does it fit in with the flat tax?*

**A:** First of all, it is worth pointing out that the Social Security tax is a completely successful flat tax. Since its inception in the 1930s, it has remained remarkably free from complicating amendments. Indeed, its history shows that we are capable of keeping a tax flat.

Under the flat tax, the employer's contribution

would be treated like other fringe benefits—it would not be deductible from the business tax. As at present, the employee’s contribution would be included in taxable income under the wage tax. Thus all Social Security contributions would be included in the tax base. However, Social Security benefits would be completely untaxed. We would eliminate the current partial taxation of benefits for higher-income taxpayers. Eliminating the employer’s deduction for contributions is a better way to tax benefits.

**Q:** *Interest on the savings in my life insurance policy is excluded from current taxation under today’s law. What will happen to the life insurance industry and the value of my insurance when taxation of all interest is eliminated?*

**A:** As far as you are concerned, the tax benefits you are enjoying will continue—there will be no taxes on the interest you are earning. Furthermore, when your insurance pays off, you will not have to pay income tax on the interest component, as you do under current law. As far as the industry is concerned, taxing its interest earnings and deducting its interest payments will end. Only its actual insurance premiums will count as income, not the saving that goes with some types of insurance, and only its pay-off for death and other insured events will count as business expenses.



## POLITICS AND THE FLAT TAX

**Q:** *Does the flat tax have any chance of being adopted?*

**A:** We remain optimistic, despite vigorous opposition from those individuals and special interests who have an ideological or financial stake in the current tax system. The flat tax has received support from a broad cross section of past and present politicians, along with endorsements from many prominent editorial writers. The list of those who expressed interest in the flat tax in 1982 includes some surprising entries: Lloyd Bentsen, former chairman of the Senate Finance Committee and President Clinton's first secretary of the treasury; Leon Panetta, former member of the House of Representatives and President Clinton's first head of the Office of Management and Budget; former and current Congressmen Philip Crane, Ron Paul, John Duncan, and George Hansen; and former and current Senators Charles Grassley, Jesse Helms, Dennis DeConcini, Steve Symms, and Dan Quayle.

In 1992, the most noteworthy proponent was former California governor Jerry Brown, who made the flat tax the economic centerpiece of his run for the presidency in 1992. When both the New York Times and the Wall Street Journal endorse the Hall-Rabushka flat tax on successive days, you can be sure the idea commands great interest and support.

In 1994, Congressman Dick Armey of Texas introduced HR 4585, which included a 17 percent

flat tax modeled after Hall-Rabushka. We expect that many members of Congress will give the flat tax serious consideration during 1995—1996.

**Q:** *So why isn't the flat tax the law of the land?*

**A:** Remember, there are thousands of lobbyists in Washington, D.C., who work full time to preserve tax benefits for their interest groups and clients. They contribute large sums to the campaign coffers of the two congressional tax-writing committees. They fiercely resist the flat tax because it would put them all out of business.

We are prepared to support, on this one occasion, a federally subsidized retraining program for those several hundred thousand bright people, despite our general opposition to government intervention in the economy. Most of them won't need it, but it is a small price to pay for a low, simple flat tax. We suspect that the overwhelming majority of Americans agree.

Remember, too, that the reduction in the top marginal rate from 70 percent in 1980 to 28 percent in 1986 took much of the steam out of the flat-tax movement. However, now that the top rate has been raised to 39.6 percent, there is growing support for lowering high marginal rates.

**Q:** *What is your strategy for getting the flat tax adopted?*

**A:** We believe that the main political support for the flat tax will come from millions of taxpayers who will insist that dozens of forms and hundreds of

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pages of tax instructions and regulations be replaced with two simple postcards. The flat tax will ultimately succeed because of the American taxpayer's demand for a true simplicity. We also believe that the politics of envy will not withstand a convincing demonstration that the flat tax is fair.