

### 3. The Postcard Tax Return

TAX FORMS really can fit on postcards. A cleanly designed tax system takes only a few elementary calculations, in contrast to the hopeless complexity of today's income taxes. In this chapter, we present a complete plan for a whole new tax system that puts a low tax rate on a comprehensive definition of income. Because its base is broad, the astonishingly low 19 percent tax rate raises the same revenue as does the current tax system. The tax on families is fair and progressive: the poor pay no tax at all, and the fraction of income that a family pays rises with income. The system is simple and easy to understand. And the tax operates on the consumption tax principle—families are taxed on what they take out of the economy, not what they put into it.

Our system rests on a basic administrative principle: income should be taxed exactly once as close as possible to its source. Today's tax system violates this principle in all sorts of ways. Some kinds of income—like fringe benefits—are never taxed at all. Other kinds, like dividends and capital gains, are taxed twice. And interest income, which is supposed to be taxed once, escapes taxation completely in all too many cases where clever taxpayers arrange to receive interest beyond the reach of the IRS.

Under our plan, all income is taxed at the same rate. Equality of tax rates is a basic concept of the flat tax. Its

logic is much more profound than just the simplicity of calculation with a single tax rate. Whenever different forms of income are taxed at different rates or different taxpayers face different rates, the public figures out how to take advantage of the differential. The basic trick is to take deductions at the highest available rate and to report income at the lowest rate. Here are some of the ways that the trick can be applied:

- A company pays its workers partly in the form of stock options because the options will eventually be taxed at lower capital gains rates.
- A real estate operator borrows from a bank and deducts the interest at his 40 percent marginal rate; the interest received by the depositors at the bank is taxed at their lower rates.
- An author arranges for royalties to be deferred to next year because she knows that she will be in a lower tax bracket next year.
- A corporation pays its shareholders exaggerated salaries as officers because salaries are taxed only once but dividends are taxed twice.
- A company gives its workers prepaid legal services as a nontaxable fringe benefit, in place of cash that would be taxed.

Our plan would sweep away all these inequities and inefficiencies. None of these opportunities to escape taxes by distorting economic choices would survive our reform.

## PROGRESSIVITY, EFFICIENCY, AND SIMPLICITY

Limiting the burden of taxes on the poor is a central principle of tax reform. Some ideas for tax simplification and reform flout this principle—neither a federal sales tax nor a value-added tax is progressive. Instead, all citizens, rich and poor alike, pay essentially the same fraction of their spending in taxes. We reject sales and value-added taxes for this reason. The current federal tax system avoids taxing the poor, and we think it should stay that way.

Exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income families. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating important differences in tax rates. Graduated taxes automatically create differences in tax rates among taxpayers, with all the attendant opportunities for tax avoidance tricks. Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax rate differentials, applying the same tax rate to these taxpayers for all their income in all years is the most important goal of flat-rate taxation.

Our proposal is based squarely on the principle of consumption taxation. Saving is untaxed, thus solving the problem that has perplexed the designers of the current tax system, which contains an incredible hodgepodge of savings and investment incentives. As a general matter, the current system puts substantial taxes on the earnings from savings. On that account, the economy is

biased toward too little saving and too much consumption. But Congress has inserted a number of special provisions to spur saving. Most important, saving for retirement is excused from current taxation. Workers are not taxed on the amount their employers contribute to pension funds, and the employers can deduct those contributions. The self-employed can take advantage of the same opportunity with Keogh, individual retirement account (IRA), and simplified employee pension (SEP) plans. The overall effect of the existing incentives is spotty—there are excessive incentives for some saving-investment channels and inadequate incentives for others. In our system, there is a single, coherent provision for taxing the return to saving. All income is taxed, but the earnings from saved income are not taxed further. We will explain how this works later in the chapter.

We believe that the simplicity of our system is a central feature. Complex tax forms and tax laws do more harm than just deforesting America. Complicated taxes require expensive advisers for taxpayers and equally expensive reviews and audits by the government. A complex tax invites the taxpayer to search for special features to exploit to the disadvantage of the rest of us. And complex taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and the spread of outright evasion.

#### AN INTEGRATED FLAT TAX

Our flat tax applies to both businesses and individuals. Although our system has two separate tax forms—one

for business income and the other for wages and salaries—it is an integrated system. When we speak of its virtues, such as its equal taxation of all types of income, we mean the system, not one of its two parts. As we will explain, the business tax is not just a replacement for the existing corporate income tax. It covers all businesses, not just corporations. And it covers interest income, which is currently taxed under the personal income tax.

In our system, all income is classified as either business income or wages (including salaries and retirement benefits). The system is airtight. Taxes on both types of income are equal. The wage tax has features to make the overall system progressive. Both taxes have postcard forms. The low tax rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1993, the last full year of data available as we write.

Here is the logic of our system, stripped to basics: We want to tax consumption. The public does one of two things with its income—spends it or invests it. We can measure consumption as income minus investment. A really simple tax would just have each firm pay tax on the total amount of income generated by the firm less that firm's investment in plant and equipment. The value-added tax works just that way. But a value-added tax is unfair because it is not progressive. That's why we break the tax in two. The firm pays tax on all the income generated at the firm except the income paid to its workers. The workers pay tax on what they earn, and the tax they pay is progressive.

To measure the total amount of income generated



Table 3.1 Flat-Tax Revenues Compared with Current Revenues

| <i>Line</i> | <i>Income or Revenue</i>                           | <i>Billions<br/>of<br/>Dollars</i> |
|-------------|--|------------------------------------|
| 1           | Gross domestic product                             | \$6,374                            |
| 2           | Indirect business tax                              | 431                                |
| 3           | Income included in GDP but not in tax base         | 217                                |
| 4           | Wages, salaries, and pensions                      | 3,100                              |
| 5           | Investment   | 723                                |
| 6           | Business-tax base (line 1 minus lines 2 through 5) | 1,903                              |
| 7           | Business-tax revenue (19 percent of line 6)        | 362                                |
| 8           | Family allowances                                  | 1,705                              |
| 9           | Wage-tax base (line 4 less line 8)                 | 1,395                              |
| 10          | Wage-tax revenue (19 percent of line 9)            | 265                                |
| 11          | Total flat-tax revenue (line 7 plus line 10)       | 627                                |
| 12          | Actual personal income tax                         | 510                                |
| 13          | Actual corporate income tax                        | 118                                |
| 14          | Total actual revenue (line 12 plus line 13)        | 627                                |

of the wage-tax form and would be deducted by businesses. Investment, line 5, is the amount spent by businesses purchasing new plant and equipment (each business could also deduct its purchases of used plant and equipment, but these would be included in the taxable income of the selling business and would net out in the aggregate). Line 6 shows the taxable income of all businesses after they have deducted their wages and investment. The revenue from the business tax, line 7, is 19 percent of the tax base on line 6. Line 8 shows the amount of family allowances that would be deducted.

The wage-tax base on line 9 shows the amount of wages, salaries, and pensions left after deducting all family allowances from the amount on line 4. The wage-tax revenue on line 10 is 19 percent of the base. Total flat-tax revenue on line 11 is \$627 billion. Lines 12 and 13 show the actual revenue from the personal and corporate income taxes. The total actual revenue on line 14 is also \$627 billion. The flat-tax revenue and the actual revenue are the same, by design. We propose to reproduce the revenue of the actual income tax system, not to raise or lower it.

These computations show that in 1993 the revenue from the corporate income tax, with a tax rate of 35 percent, was \$118 billion. The revenue from our business tax at a rate of 19 percent would have been \$362 billion, just over three times as much, even though the tax rate is not much more than half the current corporate rate. There are three main reasons that the flat business tax yields more revenue than does the existing corporate tax. First, slightly more than half of business income is from noncorporate businesses—professional partnerships, proprietorships, and the like. Second, our business tax does not permit the deduction of interest paid by businesses, whereas the corporate income tax does. Third, the business tax puts a tax on fringe benefits, which escape any taxation in the current system.

The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system. Because most business income goes to the rich, putting an airtight tax of 19 percent on that

income permits taxes and tax rates on working people to be lowered.

The other side of the coin, of course, is that our wage tax would yield less revenue than does the current personal income tax—\$265 billion in 1993 as against \$510 billion. We are not proposing a massive shift in taxes from wages to capital income. Our wage tax applies just to wages, salaries, and private pensions, whereas today's personal income tax includes unincorporated business income, dividends, interest, rent, and many other kinds of income that we tax as part of business income. The switch to the more reliable principle of taxing business income at the source, rather than hoping to catch the income at the destination, is one reason that the business tax yields so much more revenue than does the corporate tax.

Our calculations assume that the IRS will learn about all the income currently counted in the national income accounts except the \$217 billion allowed for in line 3 of table 3.1. The national income accounts are based primarily on income tax data but do make some projections for unreported income. On the one hand, it is possible that our estimates of the base for the flat tax are a little optimistic. On the other hand, our calculations of the amount of family allowances at line 8 definitely overstate the total dollar amount of the allowances. Another limitation on our calculations is that we do not consider the way the economy would respond to tax reform. In chapter 4, we discuss why the flat tax would increase national income and tax revenue. But part of that process might involve a burst of investment,

which would temporarily depress flat-tax revenue because of the expensing of investment. Only a detailed analysis using data not available to us would determine whether we have over- or underestimated the revenue from the flat tax. We do not think we are far off, however.

### *The Individual Wage Tax*

The individual wage tax has a single purpose—to tax the large fraction of income that employers pay as cash to their workers. It is not a tax system by itself but is one of the two major parts of the complete system. The base of the tax is defined narrowly and precisely as actual payments of wages, salaries, and pensions. Pension contributions and other fringe benefits paid by employers are not counted as part of wages. In other words, the tax on pension income is paid when the retired worker actually receives the pension, not when the employer sets aside the money to pay the future pension. This principle applies even if the employer pays into a completely separate pension fund, if the worker makes a voluntary contribution to a 401(k) program, or if the worker contributes to a Keogh, IRA, or SEP fund.

The tax form for our wage tax is self-explanatory (see figure 3.1). To make the tax system progressive, only earnings over a personal or family allowance are taxed. The allowance is \$25,500 for a family of four in 1995 but would rise with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based

| <b>Form 1</b>  |  | <b>Individual Wage Tax</b>      |  | <b>1998</b>                 |  |
|--|--|---------------------------------|--|-----------------------------|--|
| Your first name and initial (if joint return, also give spouse's name and initial) |  | Last name                       |  | Your social security number |  |
| Present home address (number and street including apartment number or rural route) |  | Spouse's social security number |  |                             |  |
| City, town, or post office, state, and ZIP code                                    |  | Your occupation™                |  |                             |  |
|  |  | Spouse's occupation™            |  |                             |  |
| <b>1</b>   | Wages and salary.....  | <b>1</b>                        |  |                             |  |
| <b>2</b>   | Pension and retirement benefits.....   | <b>2</b>                        |  |                             |  |
| <b>3</b>   | Total compensation ( <i>line 1 plus line 2</i> ).....                                | <b>3</b>                        |  |                             |  |
| <b>4</b>   | Personal allowance   | <b>4(a)</b>                     |  |                             |  |
|  | (a) <input type="checkbox"/> \$16,500 for married filing jointly.....                | <b>4(b)</b>                     |  |                             |  |
|  | (b) <input type="checkbox"/> \$9,500 for single.....                                 | <b>4(c)</b>                     |  |                             |  |
|  | (c) <input type="checkbox"/> \$14,000 for single head of household.....              | <b>5</b>                        |  |                             |  |
| <b>5</b>   | Number of dependents, not including spouse.....                                      | <b>6</b>                        |  |                             |  |
| <b>6</b>   | Personal allowances for dependents ( <i>line 5 multiplied by \$4,500</i> ).....      | <b>7</b>                        |  |                             |  |
| <b>7</b>   | Total personal allowances ( <i>line 4 plus line 6</i> ).....                         | <b>8</b>                        |  |                             |  |
| <b>8</b>   | Taxable compensation ( <i>line 3 less line 7, if positive; otherwise zero</i> )..... | <b>9</b>                        |  |                             |  |
| <b>9</b>   | Tax (19% of line 8).....   | <b>10</b>                       |  |                             |  |
| <b>10</b>  | Tax withheld by employer.....  | <b>11</b>                       |  |                             |  |
| <b>11</b>  | Tax due ( <i>line 9 less line 10, if positive</i> ).....                             | <b>12</b>                       |  |                             |  |
| <b>12</b>  | Refund due ( <i>line 10 less line 9, if positive</i> ).....                          |                                 |  |                             |  |

Figure 3.1 Individual Wage-Tax Form

on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort needed to satisfy the Internal Revenue Service. What a change from the many pages of schedules the frustrated taxpayer fills out today!

For the 80 percent of taxpayers who don't run businesses, the individual wage tax would be the only tax to worry about. Many features of current taxes would disappear, including charitable deductions, mortgage interest deductions, capital gains taxes, dividend taxes, and interest taxes. (We discuss these in detail later.)

Anyone who is self-employed or pays expenses directly in connection with making a living will need to file the business tax to get the proper deduction for expenses. Fortunately, the business-tax form is even simpler than the wage-tax form.

Again, we stress that the wage tax is not a complete income tax on individuals; it taxes only wages, salaries, and pensions. The companion business tax picks up all other components of income. Together they form an airtight tax system.

### *The Business Tax*

It is not the purpose of the business tax to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by

the business. Collecting business income tax at the source of the income avoids one of the biggest causes of leakage in the tax system today: Interest can pass through many layers where it is invariably deducted when it is paid out but frequently not reported as income.

Airtight taxation of individual business income at the source is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system has graduated rates, taxation at the source becomes a problem. If each owner is to be taxed at that owner's rate, the business would have to find out the tax rate applicable to each owner and apply that rate to the income produced in the business for that owner. But this is only the beginning of the problem. The IRS would have to audit a business and its owners together to see that the owners were reporting the correct tax rates to the business. Further, suppose one of the owners made a mistake and was later discovered to be in a higher tax bracket. Then the business would have to refile its tax form to collect the right tax. Obviously this wouldn't work. Business taxes have to be collected at the destination, from the owners, if graduated rates are to be applied. Source taxation is only practical when a single rate is applied to all owners. Because source taxation is reliable and inexpensive, it is a powerful practical argument for using a single rate for all business income.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax

every bit of income outside of wages but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm, resulting in an enormously simplified and improved tax system. Today, the IRS receives more than a billion Form 1099s, which keep track of interest and dividends, and must make an overwhelming effort to match these forms to the 1040s filed by the recipients. The only reason for a Form 1099 is to track income as it makes its way from the business where it originates to the ultimate recipient. Not a single Form 1099 would be needed under a flat tax with business income taxed at the source.

The way that we have set up the business tax is not arbitrary—on the contrary, it is dictated by the principles we set forth at the beginning of this chapter. The tax would be assessed on all the income originating in a business but not on any income that originates in other businesses or on the wages, salaries, and pensions paid to employees. The types of income taxed by the business tax would include

- Profits from the use of plant and equipment
- Profits from ideas embodied in copyrights, patents, trade secrets, and the like

- Profits from past organization-building, marketing, and advertising efforts
- Earnings of key executives and others who are owners as well as employees and who are paid less than they contribute to the business
- Earnings of doctors, lawyers, and other professionals who have businesses organized as proprietorships or partnerships
- Rent earned from apartments and other real estate
- Fringe benefits provided to workers

All a business's income derives from the sale of its products and services. On the top line of the business-tax form (see figure 3.2) goes the gross sales of the business—its proceeds from the sale of all its products. But some of the proceeds come from the resale of inputs and parts the firm purchased; the tax has already been paid on those items because the seller also has to pay the business tax. Thus, the firm can deduct the cost of all the goods, materials, and services it purchases to make the product it sells. In addition, it can deduct its wages, salaries, and pensions, for, under our wage tax, the taxes on those will be paid by the workers receiving them. Finally, the business can deduct all its outlays for plant, equipment, and land. (Later we will explain why this investment incentive is the right one.)

Everything left from this calculation is the income originating in the firm and is taxed at the flat rate of 19 percent. In most businesses, there is enough left that the prospective revenue from the business tax is the \$362

| <b>Form 2 Business Tax</b>   |                                | <b>1998</b> |
|--|--------------------------------|-------------|
| Business name  | Employer identification number |             |
| Street address   | County                         |             |
| City, state, and ZIP code  | Principal product              |             |
| <b>1</b> Gross revenue from sales.....                                 | <b>1</b>                       |             |
| <b>2</b> Allowable costs   | <b>2(a)</b>                    |             |
| (a) Purchases of goods, services, and materials.....                   | <b>2(b)</b>                    |             |
| (b) Wages, salaries, and pensions.....                                 | <b>2(c)</b>                    |             |
| (c) Purchases of capital equipment, structures, and land.....          | <b>3</b>                       |             |
| <b>3</b> Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>4</b>                       |             |
| <b>4</b> Taxable income (line 1 less line 3).....                      | <b>5</b>                       |             |
| <b>5</b> Tax (19% of line 4).....                                      | <b>6</b>                       |             |
| <b>6</b> Carry-forward from 1997.....                                  | <b>7</b>                       |             |
| <b>7</b> Interest on carry-forward (6% of line 6).....                 | <b>8</b>                       |             |
| <b>8</b> Carry-forward into 1998 (line 6 plus line 7).....             | <b>9</b>                       |             |
| <b>9</b> Tax due (line 5 less line 8, if positive).....                | <b>10</b>                      |             |
| <b>10</b> Carry-forward to 1999 (line 8 less line 5, if positive)..... |                                |             |

Figure 3.2 Business-Tax Form

billion we computed earlier. Many deductions allowed to businesses under current laws are eliminated in our plan, including interest payments and fringe benefits. But our excluding these deductions is not an arbitrary move to increase the tax base. In all cases, eliminating deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate and achieving a broad consumption tax.

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax business income at the source. It makes sense because we propose not to tax interest received by individuals. The tax that the government now hopes (sometimes in vain) that individuals will pay will assuredly be paid by the business itself.

We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, an immediate 100 percent first-year tax write-off of all investment spending. Sometimes this approach is called expensing of investment; it is standard in the value-added approach to consumption taxation. In other words, we don't deny depreciation deductions; we enhance them. More on this shortly.

Fringe benefits are outside the current tax system entirely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of the fringes. Consequently, fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and

more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929, when income taxes were unimportant, but reached almost 18 percent in 1993. The explosion of fringes is strictly an artifact of taxation and thus an economically inefficient way to pay workers. Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice. Further, failing to tax fringes means that taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates.

Under our system, each business would file a simple form. Even the largest business (General Motors Corporation in 1993, with \$138 billion in sales) would fill out our simple postcard form. Every line on the form is a well-defined number obtained directly from the business's accounting records. Line 1, gross revenue from sales, is the actual number of dollars received from the sales of all the products and services sold by the business, plus the proceeds from the sale of plant, equipment, and land. Line 2a is the actual amount paid for all the inputs bought from other businesses for the operation of the business (that is, not passed on to its workers or owners). The firm could report any purchase provided the purchase was for the business's operations and not part of the compensation of workers or owners. Line 2b is the actual cash put in the hands of workers and

former workers. All the dollars deducted on this line will have to be reported by the workers on their Form 1 wage-tax returns. Line 2c reports purchases of new and used capital equipment, buildings, and land. Note that the firm won't have to agonize over whether a screwdriver is a capital investment or a current input—both are deductible, and the IRS won't care which line it will appear on.

The taxable income computed on line 4 bears little resemblance to anyone's notion of profit. The business tax is not a profit tax. When a company is having an outstanding year in sales and profits but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated will be taxed at 19 percent.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the start-up period will have negative taxable income. But the government will not write a check for the negative tax on the negative income. Whenever the government has a policy of writing checks, clever people abuse the opportunity. Instead, the negative tax would be carried forward to future years, when the business should have a positive taxable income. There is no limit to the number of years of carry forward. Moreover, balances carried forward will earn the market rate of interest (6 percent in 1995). Lines 6 through 10 show the mechanics of the carry-forward process.

### *Examples*

The easiest way to explain how the business tax operates is through some examples. Our first example is the company with the highest level of revenue in 1993, General Motors (see figure 3.3; in this and other examples of real businesses, we have approximated the numbers from public financial statements for 1993).

Despite the low 19 percent flat tax, it would raise considerably more revenue than General Motors (GM) actually paid at the current 35 percent rate. (In 1993, GM actually paid about \$110,000,000 in income taxes.) The main reason is that GM has a large amount of debt—the company paid out \$5.7 billion in interest in 1993. The flat tax collects the tax on that amount from GM, instead of trying to collect it from the thousands of organizations and people who receive it. A second reason the flat tax generates more revenue is that GM invested relatively little in 1993, only about \$6 billion. Under the current tax, GM wrote off over \$9 billion in depreciation deductions for past investment.

Now look at the return for Intel Corporation (see figure 3.4). Because Intel is investing and growing rapidly, its taxes would be low and it would benefit tremendously from the first-year write-off for investment.

Intel's actual income tax in 1993 was \$1.2 billion. The flat tax is lower for three reasons:

- The flat-tax rate of 19 percent is much lower than the current rate of 35 percent.
- Unlike GM, Intel has no debt, so the switch to

| <b>Form 2 Business Tax</b>   |             | <b>1998</b>                                  |
|--|-------------|--|
| Business name<br>General Motors  |             | Employer identification number<br>48-2665679 |
| Street address<br>3044 W. Grand Blvd.                                  |             | County<br>Wayne                              |
| City, state, and ZIP code<br>Detroit, Mi 48202                         |             | Principal product<br>Automobiles             |
| <b>1</b> Gross revenue from sales.....                                 | <b>1</b>    | 138,219,500,000                              |
| <b>2</b> Allowable costs   |             |  |
| <b>(a)</b> Purchases of goods, services, and materials.....            | <b>2(a)</b> | 53,210,950,000                               |
| <b>(b)</b> Wages, salaries, and pensions.....                          | <b>2(b)</b> | 64,742,850,000                               |
| <b>(c)</b> Purchases of capital equipment, structures, and land.....   | <b>2(c)</b> | 5,935,800,000                                |
| <b>3</b> Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>3</b>    | 123,889,600,000                              |
| <b>4</b> Taxable income (line 1 less line 3).....                      | <b>4</b>    | 14,329,900,000                               |
| <b>5</b> Tax (19% of line 4).....                                      | <b>5</b>    | 2,722,681,000                                |
| <b>6</b> Carry-forward from 1997.....                                  | <b>6</b>    | 0  |
| <b>7</b> Interest on carry-forward (6% of line 6).....                 | <b>7</b>    | 0  |
| <b>8</b> Carry-forward into 1998 (line 6 plus line 7).....             | <b>8</b>    | 0  |
| <b>9</b> Tax due (line 5 less line 8, if positive).....                | <b>9</b>    | 2,722,681,000                                |
| <b>10</b> Carry-forward to 1999 (line 8 less line 5, if positive)..... | <b>10</b>   | 0  |

Figure 3.3 General Motors' Business-Tax Form

| <b>Form 2</b>                                      |   | <b>Business Tax</b>                          |               | <b>1998</b> |  |
|--|---|--|---------------|-------------|--|
| Business name<br>Intel Corporation                 |   | Employer identification number<br>96-8496331 |               |             |  |
| Street address<br>P.O. Box 58119                   |   | County<br>Santa Clara                        |               |             |  |
| City, state, and ZIP code<br>Santa Clara, CA 95052 |   | Principal product<br>Semiconductors          |               |             |  |
| <b>1</b>   | Gross revenue from sales.....                                 | <b>1</b>                                     | 8,782,000,000 |             |  |
| <b>2</b>   | Allowable costs   | <b>2(a)</b>                                  | 1,626,000,000 |             |  |
|  | (a) Purchases of goods, services, and materials.....          | <b>2(b)</b>                                  | 2,764,000,000 |             |  |
|  | (b) Wages, salaries, and pensions.....                        | <b>2(c)</b>                                  | 1,933,000,000 |             |  |
|  | (c) Purchases of capital equipment, structures, and land..... | <b>3</b>                                     | 7,323,000,000 |             |  |
| <b>3</b>   | Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>4</b>                                     | 1,459,000,000 |             |  |
| <b>4</b>   | Taxable income (line 1 less line 3).....                      | <b>5</b>                                     | 277,000,000   |             |  |
| <b>5</b>   | Tax (19% of line 4).....                                      | <b>6</b>                                     | 0             |             |  |
| <b>6</b>   | Carry-forward from 1997.....                                  | <b>7</b>                                     | 0             |             |  |
| <b>7</b>   | Interest on carry-forward (6% of line 6).....                 | <b>8</b>                                     | 0             |             |  |
| <b>8</b>   | Carry-forward into 1998 (line 6 plus line 7).....             | <b>9</b>                                     | 277,000,000   |             |  |
| <b>9</b>   | Tax due (line 5 less line 8, if positive).....                | <b>10</b>                                    | 0             |             |  |
| <b>10</b>  | Carry-forward to 1999 (line 8 less line 5, if positive).....  |  |               |             |  |

Figure 3.4 Intel Corporation's Business-Tax Form

source taxation for interest does not raise extra revenue from Intel the way it did for GM.

- Intel is investing heavily in new plant and equipment.

Now let's look at some smaller businesses and activities that would be taxed under the business tax, even though they may not usually be called businesses. Sigrid Seigneur and Sanford Seigneur are a prosperous couple who bought an apartment building a few years ago. Assuming that the business tax had been in effect from the year they bought the building, their 1995 tax return would look like the form we have included here (see figure 3.5). The gross revenue the couple would report is just the total of the rent paid by their tenants. Their costs include the payments to the plumber for the frozen pipe in February 1995, the insurance premiums, and a handful of other expenses. Neither the interest on the mortgage they have on the property nor their property tax bills would be counted as costs. Their tax for 1995, \$11,563, would be substantial, but the large carry forward from the purchase of the building means they would not pay anything in 1995. As time goes by, the carry forward will probably decline (depending on what happens to rents and interest rates), and they will begin to pay tax. If they sell the building, they will have to include the proceeds of the sale on line 1 and pay 19 percent of the sale price, minus any remaining carry forward.

Seymour Krankheit is a successful pediatric neurosurgeon. His gross revenue under the flat tax would be

| <b>Form 2 Business Tax</b>   |  | <b>1998</b> |
|--|--|-------------|
| Business name<br>Sanford and Sigrid Seigneur                           | Employer identification number<br>14-08041 |             |
| Street address<br>435 Riverside Drive                                  | County<br>Atchison                         |             |
| City, state, and ZIP code<br>Atchison, Kansas 10832                    | Principal product<br>Apartment rentals     |             |
| <b>1</b> Gross revenue from sales.....                                 | <b>1</b>                                   | 68,323      |
| <b>2</b> Allowable costs   |  |             |
| (a) Purchases of goods, services, and materials.....                   | <b>2(a)</b>                                | 7,467       |
| (b) Wages, salaries, and pensions.....                                 | <b>2(b)</b>                                | 0           |
| (c) Purchases of capital equipment, structures, and land.....          | <b>2(c)</b>                                | 0           |
| <b>3</b> Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>3</b>                                   | 7,467       |
| <b>4</b> Taxable income (line 1 less line 3).....                      | <b>4</b>                                   | 60,856      |
| <b>5</b> Tax (19% of line 4).....                                      | <b>5</b>                                   | 11,563      |
| <b>6</b> Carry-forward from 1997.....                                  | <b>6</b>                                   | 37,892      |
| <b>7</b> Interest on carry-forward (6% of line 6).....                 | <b>7</b>                                   | 2,274       |
| <b>8</b> Carry-forward into 1998 (line 6 plus line 7).....             | <b>8</b>                                   | 40,166      |
| <b>9</b> Tax due (line 5 less line 8, if positive).....                | <b>9</b>                                   | 0           |
| <b>10</b> Carry-forward to 1999 (line 8 less line 5, if positive)..... | <b>10</b>                                  | 28,603      |

Figure 3.5 Sigrid Seigneur and Sanford Seigneur's Business-Tax Form

the amount he collects from insurance companies, Medicare, Medicaid, and the occasional unlucky family who pays its own medical bills. He also receives a salary as a hospital employee, but that income would be reported on his wage-tax return (see figure 3.1). All the costs of running his office would be included in allowable costs, except the fringe benefits he provides his nurse and himself. Under the present tax system, as a professional corporation, he can deduct tens of thousands of dollars as contributions to his own pension plan, but the flat-tax reform would eliminate that deduction. He could still be a professional corporation if he wanted, but it wouldn't have any tax advantages. Even though he is in the 40 percent bracket under the current personal income tax and under the flat tax will pay only 19 percent, he would actually pay more dollars of tax under our system (see figure 3.6).

Although Dr. Krankheit can't set up a retirement plan and deduct contributions to it, he, along with everyone else, can get the same economic advantages that a retirement plan currently provides. If he sets aside some of his income after tax and puts it into a mutual fund, he will not pay any tax on the mutual fund's earnings and he can spend his mutual fund balance after he retires, without paying any more tax. Under the current tax, he gets a tax deduction up front but has to pay tax on the entire amount he takes out when he retires. These two approaches differ only in the timing of the tax payment; they are economically equivalent because the accumulated earnings make the later tax payment in the current system enough larger than the up-front

| Form 2 Business Tax  |  | 1998    |
|--|--|---------|
| Business name<br>Seymour Krankheit, MD                                 | Employer identification number<br>97-01469 |         |
| Street address<br>1948 Prospect Road                                   | County<br>Dallas                           |         |
| City, state, and ZIP code<br>Dallas, Texas 83045                       | Principal product<br>Medical Services      |         |
| <b>1</b> Gross revenue from sales.....                                 | <b>1</b>                                   | 567,163 |
| <b>2</b> Allowable costs   | <b>2(a)</b>                                | 87,997  |
| (a) Purchases of goods, services, and materials.....                   | <b>2(b)</b>                                | 55,874  |
| (b) Wages, salaries, and pensions.....                                 | <b>2(c)</b>                                | 36,448  |
| (c) Purchases of capital equipment, structures, and land.....          | <b>3</b>                                   | 180,319 |
| <b>3</b> Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>4</b>                                   | 386,844 |
| <b>4</b> Taxable income (line 1 less line 3).....                      | <b>5</b>                                   | 73,500  |
| <b>5</b> Tax (19% of line 4).....                                      | <b>6</b>                                   | 0       |
| <b>6</b> Carry-forward from 1997.....                                  | <b>7</b>                                   | 0       |
| <b>7</b> Interest on carry-forward (6% of line 6).....                 | <b>8</b>                                   | 0       |
| <b>8</b> Carry-forward into 1998 (line 6 plus line 7).....             | <b>9</b>                                   | 73,500  |
| <b>9</b> Tax due (line 5 less line 8, if positive).....                | <b>10</b>                                  | 0       |
| <b>10</b> Carry-forward to 1999 (line 8 less line 5, if positive)..... |  |         |

Figure 3.6 Dr. Krankheit's Business-Tax Form

payment under the flat tax to exactly offset the time value of money.

Our third example, Sally Vendeuse, works as a manufacturers' representative—she is a traveling saleswoman. Her gross revenue on line 1 consists of the commissions she earns (see figure 3.7). Her allowable costs would include all of her travel expenses and the costs of taking her customers to lunch. On line 3c, she would deduct the full cost of a car she bought for business use. She could have paid herself a salary of any amount she chose. If she were single, she would want to pay herself at least \$9,500 to take advantage of the personal allowance in the wage tax, but her husband earns a salary as a teacher, so there would be no benefit to paying herself a salary.

Samuel Agricola is a farmer in Iowa (see figure 3.8). His gross revenue would be the total amount he receives from the sale of the corn and other crops he grows. In 1995 it fell a little short of what he paid to his suppliers and workers, so the government would let him take the \$4,459 carry forward against future taxes, when the normal profitability of the farm returns.

#### INVESTMENT INCENTIVES

Almost all experts agree that the high rates of the current tax system significantly impede capital formation. The government's solution to the problem has been to pile one special investment or saving incentive on top of another, creating a complex and unworkable maze of regulations and tax forms. Existing incentives are ap-

| <b>Form 2 Business Tax</b>                       |   | <b>1998</b>                                |
|--|---|--|
| Business name<br>Sally Vendeuise                 |   | Employer identification number<br>15-13255 |
| Street address<br>903 S. Ashland                 |   | County<br>Lancaster                        |
| City, state, and ZIP code<br>Lancaster, PA 02351 |   | Principal product<br>Sales services        |
| <b>1</b>   | Gross revenue from sales.....                                 | 101,008                                    |
| <b>2</b>   | Allowable costs   |  |
|  | (a) Purchases of goods, services, and materials.....          | 12,896                                     |
|  | (b) Wages, salaries, and pensions.....                        | 0  |
|  | (c) Purchases of capital equipment, structures, and land..... | 27,445                                     |
| <b>3</b>   | Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | 40,341                                     |
| <b>4</b>   | Taxable income (line 1 less line 3).....                      | 60,667                                     |
| <b>5</b>   | Tax (19% of line 4).....                                      | 11,527                                     |
| <b>6</b>   | Carry-forward from 1997.....                                  | 0  |
| <b>7</b>   | Interest on carry-forward (6% of line 6).....                 | 0  |
| <b>8</b>   | Carry-forward into 1998 (line 6 plus line 7).....             | 0  |
| <b>9</b>   | Tax due (line 5 less line 8, if positive).....                | 11,527                                     |
| <b>10</b>  | Carry-forward to 1999 (line 8 less line 5, if positive).....  | 0  |

Figure 3.7 Sally Vendeuise's Business-Tax Form

| Form 2 Business Tax  |  | 1998    |
|--|--|---------|
| Business name<br>Samuel Agricola                                       | Employer identification number<br>53-89617 |         |
| Street address<br>Rural Route 2  | County<br>Keokuk                           |         |
| City, state, and ZIP code<br>Gibson City, Iowa 60436                   | Principal product<br>Corn                  |         |
| <b>1</b> Gross revenue from sales.....                                 | <b>1</b>                                   | 347,872 |
| <b>2</b> Allowable costs   |  |         |
| <b>(a)</b> Purchases of goods, services, and materials.....            | <b>2(a)</b>                                | 197,357 |
| <b>(b)</b> Wages, salaries, and pensions.....                          | <b>2(b)</b>                                | 107,490 |
| <b>(c)</b> Purchases of capital equipment, structures, and land.....   | <b>2(c)</b>                                | 66,496  |
| <b>3</b> Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | <b>3</b>                                   | 371,343 |
| <b>4</b> Taxable income (line 1 less line 3).....                      | <b>4</b>                                   | -23,471 |
| <b>5</b> Tax (19% of line 4).....                                      | <b>5</b>                                   | -4,459  |
| <b>6</b> Carry-forward from 1997.....                                  | <b>6</b>                                   | 0       |
| <b>7</b> Interest on carry-forward (6% of line 6).....                 | <b>7</b>                                   | 0       |
| <b>8</b> Carry-forward into 1998 (line 6 plus line 7).....             | <b>8</b>                                   | 0       |
| <b>9</b> Tax due (line 5 less line 8, if positive).....                | <b>9</b>                                   | 0       |
| <b>10</b> Carry-forward to 1999 (line 8 less line 5, if positive)..... | <b>10</b>                                  | 4,459   |

Figure 3.8 Samuel Agricola's Business-Tax Form

pallingly uneven. Capital projects taking full advantage of depreciation deductions and the deductibility of interest paid to organizations exempt from income tax may actually receive subsidies from the government, rather than being taxed. But equity-financed projects are heavily taxed. Investment incentives severely distort the flow of capital into projects eligible for debt finance.

Our idea is to start over, throwing away all the present incentives and replacing them with a simple, uniform principle—treating the total amount of investment as an expense in the year it is made. The entire incentive for capital formation is on the investment side, instead of the badly fitting split in the current tax system between investment incentives and saving incentives. The first virtue of this reform is simplicity. Businesses and government need not quarrel, as they do now, over what is an investment and what is a current expense. The distinction doesn't matter for the flat tax. Complicated depreciation calculations, carrying over from one year to the next and driving the small-business owner to distraction, will vanish from the tax form. The even more complicated provisions for recapturing depreciation when a piece of equipment or a building is sold will vanish as well, to everyone's relief.

Expensing investment has a much deeper rationale than simplicity. Every act of investment in the economy ultimately traces back to an act of saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving. Consumption is what people take out of the economy; income is what people con-

tribute. A consumption tax is the exact embodiment of the principle that people should be taxed on what they take out, not what they put in. The flat tax, by expensing investment, is precisely a consumption tax.

Expensing investment eliminates the double taxation of saving, another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save and again when the savings earn a return. With expensing, the first tax is abolished. Saving is, in effect, deducted in computing the tax. Later, the return to the saving is taxed through the business tax. Although economists have dreamt up a number of ways to eliminate double taxation of saving (involving complicated record keeping and reporting by individuals), the technique exploited in our flat tax is by far the most straightforward.

The easiest way to show that expensing investment is a consumption tax arises when someone invests directly in a personally owned business. Suppose a taxpayer receives \$1,000 in earnings and turns around and buys a piece of business equipment for \$1,000. Under the flat tax, there is a tax of \$190 on the earnings but also a deduction worth \$190 in reduced taxes for the equipment purchase. On net, there is no tax. The taxpayer has not consumed any of the original \$1,000. Later the taxpayer will receive business income representing the earnings of the machine, which will be taxed at 19 percent. If the taxpayer chooses to consume rather than invest again, there will be a 19 percent tax on the consumption. So the overall effect is a 19 percent consumption tax.

Most people, however, don't invest by directly purchasing machines. The U.S. economy has wonderfully developed financial markets for channeling savings from individual savers to businesses who have good investment opportunities. Individuals invest by purchasing shares or bonds, and the firms then purchase plant and equipment. The tax system we propose taxes the consumption of individuals in this environment as well. Suppose the same taxpayer pays the \$190 tax on the same \$1,000 and puts the remaining \$810 into the stock market. For simplicity, suppose that the share pays out to its owner all the after-tax earnings on equipment costing \$1,000. (That assumption makes sense because the firm could buy \$1,000 worth of equipment with the \$810 from our taxpayer plus the tax write-off worth \$190 that would come with the equipment purchase.) Our taxpayer gets the advantage of the investment write-off even though there is no deduction for purchasing the share. The market passes the incentive from the firm on to the individual investor.

Another possibility for the taxpayer is to buy a bond for \$810. Again, the firm issuing the bond can buy a \$1,000 machine with the \$810, after taking advantage of the tax deduction. To compete with the returns available in the stock market, however, the bond must pay the same returns as a stock selling for the same price, which in turn is equal to the after-tax earnings of the machine, so it won't matter how the taxpayer invests the \$810. In all cases, there is effectively no tax for saved income; the tax is payable only when the income is consumed.

In our system, any investment, in effect, would have the same economic advantage that a 401(k), IRA, or Keogh account has in the current tax system. And we achieve this desirable goal by reducing the amount of record keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their Form 1040s and then report the distributions from the funds as income when they retire. Moreover, proponents of the cash-flow consumption tax would extend these requirements to all forms of saving. Our system would accomplish the same goal without any forms or record keeping.

#### CAPITAL GAINS

Capital gains on rental property, plant, and equipment would be taxed under the business tax. The purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale. Every owner of rental real estate would be required to fill out the simple business- tax return, Form 2 (figure 3.2).

Capital gains would be taxed exclusively at the business level, not at the personal level. In other words, our system would eliminate the double taxation of capital gains inherent in the current tax system. To see how this works, consider the common stock of a corporation. The market value of the stock is the capitalization of its future earnings. Because the owners of the stock will receive their earnings after the corporation has paid the business tax, the market capitalizes after-tax earnings. A

capital gain occurs when the market perceives that prospective after-tax earnings have risen. When the higher earnings materialize in the future, they will be correspondingly taxed. In a tax system like the current one, with both an income tax and a capital gains tax, there is double taxation. To achieve the goal of taxing all income exactly once, the best answer is to place an airtight tax on the income at the source. With taxation at the source, it is inappropriate and inefficient to tax capital gains that occur at the destination.

Another way to see that capital gains should not be taxed separately is to look at the national income accounts. Gross domestic product, the most comprehensive measure of the nation's command over resources, does not include capital gains. The base of the flat tax is GDP minus investment, that is, consumption. To include capital gains in the flat-tax base would depart from the principle that it is a tax on consumption.

Capital gains on owner-occupied houses are not taxed under our proposal. Few capital gains on houses are taxed under the current system—gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death. Excluding capital gains on houses makes sense because state and local governments put substantial property taxes on houses in relation to their values. Adding a capital gains tax on top of property taxes is double taxation in the same way that adding a capital gains tax on top of an income tax is double taxation of business income.

## BANKS AND INSURANCE COMPANIES

Banks, insurance companies, and other businesses that bundle services with financial products present a challenge to any tax system. Here is the problem: Suppose a depositor has a balance of \$1,000 in a personal account, averaged over the year. At market interest rates, the depositor should earn at least \$40 in interest, and this interest income would be taxable. But the bank bundles services with the basic function of borrowing from the depositor and offsets the price of the services against interest payments. The services include processing deposits, clearing checks, preparing statements, providing automatic teller services, and even free safe deposit boxes. By deducting the prices of the services and paying only the remainder as interest, the bank is, in effect, letting the depositor deduct the prices of the services. The government is the loser. Proper accounting would require that the depositor report the entire amount of interest as income and not deduct the prices of the services. Note that this problem only arises when the depositor is not a business—a business would be entitled to deduct the prices of the services.

At first, it may seem that the flat tax would solve this problem effortlessly. The interest the bank pays its depositors would not be taxed under our system. But the problem arises in another place—the application of the business tax to the bank itself. Take a simple example, a bank that bundles so many attractive services that none of its accounts pay any interest. The bank invests all its depositors' money in bonds. The bank would have no

revenue on line 1 of its business-tax Form 2. Remember that line 1 reports income from the sale of goods and services and does not include financial income. The bank would report, however, all the costs of providing its services on lines 2a, 2b, and 2c—paper, computer services, wages and salaries, and purchases of equipment. The bank would appear to operate at a loss year after year. In the case of an actual bank, which does sell services to its customers, the problem would still exist, though it would be less conspicuous. A bank would appear to generate less taxable income that it really does, as a result of bundled services.

Banks are a problem in any tax system. The solution is to require that banks report the price of the services they provide to depositors. The price is easy to measure—it is the difference between the market interest rate and the lower rate that the bank pays on accounts that have bundled services. For example, when the interest rate on Treasury bills is 5 percent and checking accounts are paying 2 percent, the price of the bundled services is the difference, 3 percent of the balance in the account. Line 1 on a bank's Form 2 should include the valuation of all bundled services on this principle.

Bank loans present a similar challenge. A loan is actually a financial transaction bundled with services provided by the bank. The value of the services generates about a 3 percentage point margin between the pure interest rate and the lending rate. Again, line 1 of a bank's Form 2 should include the value of services associated with loans.

Our last example is Form 2 for the First National

Bank of Rocky Mount, Virginia (see figure 3.9). The profit-and-loss statement for the bank shows only \$452,000 in income other than interest income. But after imputing 0.80 percentage points of service value to all its deposits (other than very large certificates of deposit that are essentially purely financial instruments) and 2.98 percentage points of service value to its loans, its income is \$4,660,000 in total. Its flat tax of \$259,000 is below its actual 1993 tax of \$471,000, mainly because of the lower rate.

Taxation of life insurance companies should follow the same principle—they should report extra income on line 1 of Form 2 whenever they pay less than the market rate of interest to their policyholders.

The principle appears in our proposed flat-tax law in a general way: Under the business tax, the revenue from any service provided in connection with a financial transaction must be augmented by the difference between the market interest rate and the actual rate paid as part of the transaction.

#### IMPORTS, EXPORTS, AND MULTINATIONAL BUSINESS

With the North American Free Trade Agreement and the growth of trade throughout the world, U.S. companies are doing more business in other countries and foreign companies are increasingly active here. Should the U.S. government try to tax American-owned business operations in other countries? Should it tax foreign operations in the United States? These are increasingly

| Form 2 Business Tax                                 |   | 1998   |
|---|---|--|
| Business name<br>First National Bank of Rocky Mount |   | Employer identification number<br>54-0962185 |
| Street address<br>249 Franklin Street               |   | County<br>Franklin County                    |
| City, state, and ZIP code<br>Rocky Mount, VA 24151  |   | Principal product<br>Banking                 |
| <b>1</b>  | Gross revenue from sales.....                                 | 4,660,000                                    |
| <b>2</b>  | Allowable costs   |  |
|   | (a) Purchases of goods, services, and materials.....          | 974,100                                      |
|   | (b) Wages, salaries, and pensions.....                        | 2,272,900                                    |
|   | (c) Purchases of capital equipment, structures, and land..... | 52,000                                       |
| <b>3</b>  | Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....    | 3,299,000                                    |
| <b>4</b>  | Taxable income (line 1 less line 3).....                      | 1,361,000                                    |
| <b>5</b>  | Tax (19% of line 4).....                                      | 258,590                                      |
| <b>6</b>  | Carry-forward from 1997.....                                  | 0  |
| <b>7</b>  | Interest on carry-forward (6% of line 6).....                 | 0  |
| <b>8</b>  | Carry-forward into 1998 (line 6 plus line 7).....             | 0  |
| <b>9</b>  | Tax due (line 5 less line 8, if positive).....                | 258,590                                      |
| <b>10</b>   | Carry-forward to 1999 (line 8 less line 5, if positive).....  | 0  |

Figure 3.9 First National's Business-Tax Form

controversial questions. Under the current tax system, foreign operations of U.S. companies are taxed in principle, but the taxpayer receives a credit against U.S. taxes for taxes paid to the country where the business operates. Because the current tax system is based on a confused combination of taxing some income at the origin and some at the destination, taxation of foreign operations is messy.

By consistently taxing all business income at the source, the flat tax embodies a clean solution to the problems of multinational operations. The flat tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from the sales of products within the United States plus the value of products as they are exported would be reported on line 1 of the business-tax Form 2. Only the costs of labor, materials, and other inputs purchased in the United States or imported to the United States would be allowable on line 2 as deductions for the business tax. Physical presence in the United States is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the United States. Its costs would include the actual amount it paid for its imports, valued as they entered the country (this would generally be the actual amount paid for them in the country of their origin). Its revenue would be the actual receipts from sales in the United States. Second, consider an exporter selling goods produced here to foreigners. Its costs would be all the in-

puts and compensation paid in the United States, and its revenue would be the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the country. Third, consider a firm that sends parts to Mexico for assembly and brings back the final product for sale in the United States. The value of the parts as they leave here would count as part of the revenue of the firm, and the value of the assembled product when it was returned would be an expense. The firm would not deduct the actual costs of its Mexican assembly plant.

Under the principle of only taxing domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the flat tax, all income throughout the world would be taxed once and only once. Because the basic principle of the flat tax is already in use in the many nations with value-added taxes, a U.S. flat tax would harmonize nicely with those foreign tax systems.

Application of the wage tax, Form 1 (figure 3.1), in the world economy would follow the same principle. All earnings from work in the United States would be taxed, irrespective of the worker's citizenship, but the tax would not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The United States, with a low tax rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the flat tax would not tax the over-

seas earnings of American workers and businesses, there is no reason to fear an exodus of economic activity. On the contrary, the favorable tax climate in the United States would draw in new business from everywhere in the world.

#### SOCIAL SECURITY

We are not disposed to tackle in this book the enormous topic of reforming the Social Security system. The Social Security tax is second only to the personal income tax in federal revenues, but we have not made proposals for changing that tax. It is worth pointing out, however, 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. Its history shows that we are perfectly capable of keeping a tax flat.

The interaction of Social Security with the flat tax would work in the following way: The employer's contribution would be treated like other fringe benefits—it would not be deductible from the business tax. Here we are departing from the existing system, where the employer's contribution is deductible. As at present, the employee's contribution would be included in taxable income under the wage tax. 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.

## THE TRANSITION

In this book, the bulk of our effort is devoted to laying out a good, practical tax system, and we have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of our ideal. One area where the political process is likely to complicate our simple proposal is the transition from the current tax to the flat tax, with the most attention drawn to depreciation and interest deductions. In both cases, taxpayers who made plans and commitments before the tax reform will cry loudly for special provisions to continue the deductions.

Congress will face a choice between denying taxpayers the deductions they expected before tax reform or granting the deductions and raising the tax rate to make up for the lost revenue. Fortunately, this is a temporary problem. Once existing capital is fully depreciated and the existing borrowing paid off, any special transition provisions can be taken off the books.

*Depreciation Deductions*

Existing law lets businesses deduct the cost of an investment on a declining schedule over many years. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year write-off prescribed in the flat tax. No business will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they

thought they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1992, total depreciation deductions under the personal and corporate income taxes came to \$597 billion. At the 35 percent rate for most corporations (which is close to the rate paid by the individuals who are likely to take deductions as proprietors or partners), those deductions were worth \$209 billion. At the 19 percent flat rate, the deductions would be worth only \$108 billion.

If Congress chose to honor all unused depreciation from investment predating tax reform, it would take about \$597 billion out of the tax base for 1995. To raise the same amount of revenue as our 19 percent rate, the tax rate would have to rise to about 20.1 percent.

Honoring past depreciation would mollify business interests, especially in industries with large amounts of unused depreciation for past investment but little prospect of large first-year write-offs for future investment. In addition, it would buttress the government's credibility in tax matters by carrying through on a past promise to give a tax incentive for investment. In contrast, however, the move would require a higher tax rate and a less efficient economy in the future.

If Congress did opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue is temporary. Within five years, the bulk of the existing capital would be depreciated and the tax rate should be brought back to 19

percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

### *Interest Deductions*

Loss of interest deductions and eliminating interest taxation are two of the most conspicuous features of our tax reform plan. We will discuss the important economic changes that would take place once interest is put on an after-tax basis in the next chapter. During the transition, there will be winners and losers from the change, and Congress is sure to hear from the losers. Congress may well decide to adopt a temporary transitional measure to help them. Such a measure need not compromise the principles of the flat tax or lessen its contribution to improved efficiency.

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows deductions for interest on outstanding debt, it should also require taxation of that interest as income of the lender. If all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition than depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses,

the lender must treat the interest as taxable income. But the borrower's deduction should be only 90 percent of the actual interest payment, while the lender's taxable income should include 100 percent of the interest receipts.

Under this transitional plan, borrowers would be protected for almost all their existing deductions. Someone whose personal finances would become untenable if the mortgage-interest deduction were suddenly eliminated can surely get through with 90 percent of the earlier deduction. But the plan builds in an incentive for renegotiating the interest payments along the lines we discussed earlier in this chapter. Suppose a family is paying \$10,000 in annual mortgage interest. It could stick with this payment and deduct \$9,000 per year. Its net cost, after subtracting the value of its deduction with the 19 percent tax rate, would be \$8,290. The net income to the bank, after subtracting the 19 percent tax it pays on the whole \$10,000, would be \$8,100. Alternatively, the family could accept a deal proposed by the bank: The interest payment would be lowered to \$8,200 by rewriting the mortgage. The family would agree to forgo its right to deduct the interest, and the bank would no longer have to pay tax on the interest. Now the family's cost will be \$8,200 (instead of \$8,290 without the deal), and the bank's income will be \$8,200 (instead of \$8,100 without the deal). The family will come out \$90 ahead, and the bank will come out \$100 ahead. The deal will be beneficial to both.

One of the nice features of this plan is that it does not make any distinctions between old borrowing, exist-

ing at the time of the tax reform, and new borrowing, arranged after the reform. Lenders would always require that new borrowers opt out of their deductions and thus would offer a correspondingly lower interest rate. Otherwise, the lender would be saddled with a tax bill larger than the tax deduction received by the borrower.

As far as revenue is concerned, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised the right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear and we would be left with the pure flat tax.

#### VARIANTS OF THE FLAT TAX

In this chapter, we have set forth what we think is the best flat tax. But our ideas are more general than this specific proposal. The same principles could be applied with different choices about the key trade-offs. The two most important trade-offs are

- *Progressivity versus tax rate.* A higher personal allowance would put an even lower burden on low- and middle-income families. But it would require a higher tax rate.
- *Investment incentives versus tax rate.* If the business tax had less than full write-off for purchases of capital goods, the tax rate could be lower.

Here are some alternative combinations of allowances and tax rates that would raise the same amount of revenue:

| <i>Allowance for<br/>Family of Four</i> | <i>Tax Rate</i> |
|---|-----------------|
| \$12,500                                | 15%             |
| 22,500                                  | 19%             |
| 34,500                                  | 23%             |

The choice among these alternatives depends on beliefs about how the burden of taxes should be distributed and on the degree of inefficiency that will be brought into the economy by the corresponding tax rates. We will have more to say about the inefficiency issue in the next chapter.

Here are some alternative combinations of investment write-offs and tax rates that would raise the same amount of revenue:

| <i>Equipment<br/>Write-Off</i> | <i>Structures<br/>Write-Off</i> | <i>Tax Rate</i> |
|--------------------------------|---------------------------------|-----------------|
| 100%                           | 100%                            | 19%             |
| 75%                            | 50%                             | 18%             |
| 50%                            | 25%                             | 17%             |

The choice among these alternatives depends on the sensitivity of investment/saving to incentives and on the degree of inefficiency brought by the tax rate.