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Murray L. Weidenbaum

Washington University in St Louis

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Weidenbaum Center on the Economy, Government, and Public Policy – Washington University in St. Louis
Campus Box 1027, St. Louis, MO 63130.

Four Approaches to Tax Reform

by Murray Weidenbaum

April 1996

Preface

Tax reforms come in many shapes and varieties. The motivating factors for tax reform are varied. Reducing the tax burden will increase economic growth, resulting in more saving and investment. Simplifying tax preparation and reducing the role of government in people's lives are frequently cited reasons for modifying the tax code. Maintaining revenue neutrality also comes into the picture when discussions of tax reform begin. This report provides a basis for evaluating the four major alternatives being considered: the flat tax, the saving-friendly USA Tax, a national sales tax, and a value-added tax.

Several caveats can be offered:

1. None of the proposals is as simple as the proponents claim.
2. Each has substantial advantages and disadvantages.
3. All proposals to overhaul the federal tax system should be structured to raise the same revenue as the existing federal income tax. That is the way that professional analysts who have no axe to grind do their analyses.

Four Major Alternatives

Top Down — Based on Taxpayer Returns

1. Flat Tax
2. USA Tax

Bottom Up — Based on Individual Purchases

3. National Retail Sales Tax
4. Value Added Tax

1. Flat Tax

One Rate for All Income (19%)

- Generous deduction
 - \$25,500 for family of four

Postcard for Individual Taxpayers

- Tax only on wages, salaries, retirement pay
- No tax on interest, dividends, capital gains
- No itemized deductions for interest, charities, taxes, etc.



Flat Tax Form for Individuals

Form 1		Individual Wage Tax		1995
First name and initial (if joint return, also give spouse's name and initial)		Last name	Your social security number	
Home address (number and street including apartment number or rural route)			Spouse's social security number	
City, town, or post office, state, and ZIP code			Your occupation	
			Spouse's occupation	
1	Wages and Salary	1		
2	Pension and retirement benefits	2		
3	Total compensation (<i>line 1 plus line 2</i>)	3		
4	Personal allowance			
	(a) \$16,500 for married filing jointly	4a		
	(b) \$9,500 for single	4b		
	(c) \$14,000 for single head of household	4c		
5	Number of dependents, not including spouse	5		
6	Personal allowances for dependents (<i>line 5 multiplied by \$4,500</i>)	6		
7	Total personal allowances (<i>line 4 plus line 6</i>)	7		
8	Taxable compensation (<i>line 3 less line 7, if positive; otherwise 0</i>)	8		
9	Tax (<i>19% of line 8</i>)	9		

Postcard Return for Business

Same Tax Rate as for Individuals

Revenue Less Business Costs

- Expense capital outlays and other purchases
- Deduct employee compensation
- Interest and dividend income not taxed
 - Interest and dividend payments not deductible
- No deduction for health insurance or payroll taxes

Covers All Domestic Operations

- Taxes sales in U.S. *plus* exports
- Deduct all items bought in U.S. *plus* imports



Flat Tax Form for Business

Form 2	Business Tax	1995
Business name		Employer Identification Number
Street address		County
City, state, and ZIP code		Principal product
1	Gross revenue from sales	1
2	Allowable costs	
	(a) Purchases of goods, services and materials	2a
	(b) Wages, salaries, and retirement benefits	2b
	(c) Purchases of capital equipment, structures, and land	2c
3	Total allowable costs <i>(sum of lines 2(a), 2(b), and 2(c))</i>	3
4	Taxable income <i>(line 1 less line 3)</i>	4
5	Tax <i>(19% of line 4)</i>	5
6	Carry-forward from 1994	6
7	Interest on carry-forward <i>(6 percent of line 6)</i>	7
8	Carry-forward into 1995 <i>(line 6 plus line 7)</i>	8
9	Tax due <i>(line 5 less line 8, if positive)</i>	9
10	Carry-forward to 1996 <i>(line 8 less line 5, if positive)</i>	10

Advantages of Flat Tax

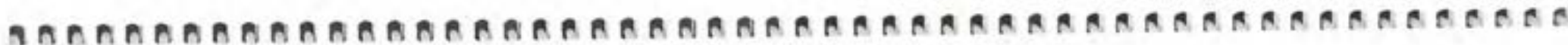
Easy to Understand

No Alternative Minimum Tax (AMT)

Eliminates All Withholding

Encourages Saving and Investment

Seems Very Simple



Disadvantages of Flat Tax

No Transition Rules (Capital Losses)

Hits States, Localities, Housing

Reduces Tax Burdens on Upper Incomes (Over \$100,000)

- and raises it on others

Encourages Imports

12 Postcards a Year

- with checks attached

Legislative Outlook

Championed by House Majority Leader Dick Armey

- Strong support in House
- Less support in Senate

Ways and Means Committee Chairman Bill Archer Wants to Tear Income Tax “Out By Its Roots”

- Flat tax still an income tax



2. USA Tax

Treats All Income Equally

- No Alternative Minimum Tax, no capital gains differentials
- Progressive rate table

Unlimited Savings Allowance

- Deduct all saving (not just IRAs, Keoghs)
- Tax-free roll-over of capital gains

Keeps Key Itemized Deductions

- Mortgage interest
- Charitable contributions
- New deduction for college tuition

Eliminates 60% of Tax Deductions

- Only fully fleshed out proposal
- Detailed transition rules

How To Prepare Individual USA Tax

Step 1. Calculate Gross Income

Step 2. Subtract Deductions

- Family exemptions
- Unlimited savings allowance
- Higher education tuition
- Mortgage interest and charitable contributions

Step 3. Calculate Initial Tax Liability (Use Rate Table)

- Deduct Social Security and Medicare tax
- Deduct withholdings



Tax Schedule for Individuals

Taxable Income	Tax Rate	After Credit*
Single		
0-\$3,200	19%	11%
\$3,200-14,400	27	19
\$14,400 and over	40	32
Married		
0-\$5,400	19	11
\$5,400-24,000	27	19
\$24,000 and over	40	32

*Credit for payroll taxes (Social Security and Medicare)

Shifts Tax Burden to Consumption

Income - Saving = Consumption

No Need to Keep Track of Individual Purchases

Maintains Fairness Via Rate Table

No Change in Tax Burden by Income Class

Within Each Income Group

- High savers pay less tax
- Big spenders pay more tax

Eliminates Social Security and Medicare Tax Burden

Transition Rules for Previously Taxed Savings



USA Business Tax

11% Cash Flow Tax Replaces Corporate Tax

- Also covers unincorporated business
- Expenses all investment and purchases
- No deduction for employee compensation

Territorial

- Rebate on exports
- Imposed on imports
- Excludes profits earned overseas
- No credit for foreign tax payments

Interest and Dividends Not Deductible

- Interest and dividend receipts not taxable

How to Calculate USA Business Tax

Base: Revenue from Sales (except exports)

Deduct: Purchases of Equipment, Products, and Services

Equals: Taxable Gross Receipts

Taxes: 11% of Taxable Gross Receipts

Minus: 7.65% Payroll Tax Paid

Equals: Tax Liability



Advantages of USA Tax

Directly Encourages Saving and Investment

Reduces Complexity and Maintains Fairness

- No need for inflation adjustments
- No advantage in shifting to or from corporate form

Transition Provisions Mean No Future Surprises

Disadvantages of USA Tax

Hard to Explain Simply

Tax Rates *Seem* to Start at Low Levels of Income

Not Widely Known



USA Tax Legislative Outlook

Only Proposal with Bipartisan Support

- Strong support in Senate (Nunn and Domenici)
- Weak support in House

May Be a Basis for Compromise

- Tax base easier to defend than flat tax
- Add features of flat tax
 - Lower rates
 - and more simplification

3. National Retail Sales Tax

Replaces Entire Income Tax System

17% Tax on Goods and Services Sold in United States (except food and medicine)

No Individual Tax Returns, No Withholding

Lifts Burden Off Saving and Investment

Simplest Tax but Few Details



How to Collect the Tax

Some Want States to Do It

- Alaska, Delaware, Montana, New Hampshire, and Oregon have no sales tax
- Coverage and exemptions vary in others

If Collected from Retailers, Requires New Collection System

How to Soften Impact on the Poor

Exempt Additional Categories of Purchases

Use Electronic “Smart Card” with Built-In Sales Tax Credit

- Based on family size

Give Every Taxpayer an Automatic Standard Refund

- Based on family size



Advantages of National Sales Tax

Easy to Understand

Shifts Tax Burden to Consumption

Simpler than Flat Tax or VAT

Virtually Eliminates Role of IRS

- In business and investment decisions

Eliminates Most Citizen Contacts with IRS

Disadvantages of National Sales Tax

Regressive and Inflationary

Imposes New Burdens on Retail Businesses

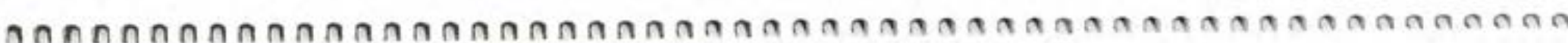
Still Need IRS for Social Security and Medicare Tax Collection

- Inevitable Revenue System

Problems with Business Purchases

- In Europe, led to VAT

"Best Tax is a Hidden Tax"



Legislative Outlook for Sales Tax

Supported by Sen. Dick Lugar

Meets Chairman Bill Archer's Requirement

Lacks Strong Congressional Base

- Liberals oppose due to regressivity
- Nonprofits oppose due to loss of tax exemption
- States and localities oppose because of tax overlap
— and adverse effect on munis

4. Value Added Tax

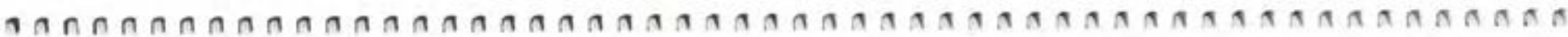
A Sophisticated Sales Tax

- Universal in Western Europe
- Widely used elsewhere

Each Enterprise Pays on Basis of Value

- It adds to goods and services it sells

Covers Imports, Excludes Exports



Advantages of VAT

Lots of Worldwide Experience with It

Promotes Exports

Avoids "Cascading" Defect of Sales Tax

Promotes Efficiency

- Costs and profits taxed equally
- Expenses investment
- Lifts tax burden off saving

Disadvantages of VAT

No Public Support in United States

New and Complicated

- Hard to cover services, especially financial

Regressive and Inflationary

- Reducing regressivity increases complexity

Unlike Europe, Would Not Be Reform of Existing Sales Taxes

Requires New Record Keeping

- Tax collection system

VAT Legislative Outlook

Favored by Former Ways and Means Chairman Sam Gibbons

- Also by capital-intensive business
- And exporters

Little Public Support

- Or congressional interest

Unlikely to Be Enacted in 1996-97

- Like Europe, national sales tax could lead to VAT

Conclusion

Strong Support for Fundamental Tax Reform

- Simplification
- Consumption based
- Reduced IRS role

Usually Takes Years to Go Through the Process

- Build up support for a specific proposal
- Go through congressional hearings and approval in 1996
- And survive possible presidential veto

"Chinese Menu" May Be Used in 1997

- Combination of flat tax and USA tax
 - Exempt saving and expense investment
 - Flatter rates — but progressive
 - Retain a few itemized deductions
 - Transition provisions to avoid large “windfall” losses