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Flat Tax Proposals and Fundamental Tax Reform: An Overview

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Flat Tax Proposals and Fundamental Tax Reform: An Overview

SUMMARY

President George W. Bush has stated that tax reform is one of his top priorities in the 109th Congress. On January 7, 2005, he appointed a nine member bi-partisan panel to study the "complicated mess" posed by the federal tax code and to propose options to reform the code.

Consequently, the idea of replacing our current income tax system with a "flat-rate tax" is receiving renewed congressional interest. Although referred to as "flat-rate taxes," many of the recent proposals go much further than merely adopting a flat rate tax structure. Some involve significant income tax base broadening while others entail changing the tax base from income to consumption.

Proponents of these tax revisions are often concerned with simplifying the tax system, making the government less intrusive, and creating an environment more conducive to saving. Critics are concerned with the distributional consequences and transitional costs of a dramatic change in the tax system.

Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates, but rather stem from difficulties associated with measuring the tax base.

Most of the recent tax reform proposals, such as the Shelby (S. 1040 in the 108th Congress), the English (H.R. 269 in the 108th Congress), the Specter (S. 907 in the 108th Congress), and the Tauzin (H.R. 4168 in the 108th Congress), would have changed the tax base from income to consumption. Some of these proposals are being reintroduced in the 109th Congress. As of March 21, 2005, the Linder proposal (H.R. 25) and the companion bill S. 25 (Chambliss) for a national sales tax have been introduced in the 109th Congress.

One or more of four major types of broad-based consumption taxes are included in these congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution. In addition, Representative Fattah proposed (H.R. 3759 in the 108th Congress) that the Treasury conduct a study of the implementation of a transaction fee as a replacement for all existing federal taxes on individuals and corporations.

Other tax reform proposals focus on income as the base. The Gephardt proposal would keep income as the tax base but broaden the base and lower the tax rates. Representative Crane's proposal (H.R. 1789 in the 108th Congress) would have levied a tax on the earned income of each individual as a replacement for the current individual income tax, corporate income tax, and estate and gift tax. Representative Burgess' proposal (H.R. 1040 in the 109th Congress) would have permitted each taxpayer to choose between the current individual income tax or an alternative flat tax based on the Hall-Rabushka concept. Senator Dorgan's proposal would allow most taxpayers to choose between the current individual tax system and his "short-cut" tax plan under which taxes withheld would equal the employee's tax liability.

Most Recent Developments

On March 2, 2005, Representative Michael Burgess introduced H.R. 1040, the Freedom Flat Tax Act. This bill would allow individuals to elect irrevocably to pay a flat tax as an alternative to our current income tax. In the first two years, the flat tax rate would be 19%, but in subsequent years the rate would decline to 17%.

Background and Analysis

President George W, Bush has stated that tax reform is one of his top priorities in the 109th Congress. He has appointed a nine member bi-partisan panel to study the "complicated mess" posed by the federal tax code and to propose options to reform the code. Consequently, fundamental tax reform is a major legislative issue in the 109th Congress. Fundamental tax reform has been an important issue in prior Congresses, and many past bills are expected to be reintroduced. Most proposals for fundamental tax reform would change the tax base from income to consumption.

The Relationship Between Income and Consumption

Although our current tax structure is referred to as an income tax, it actually contains elements of both an income- and a consumption-based tax. For example, the current tax system includes in its tax base wages, interest, dividends, and capital gains, all of which are consistent with an income tax. At the same time, however, the current tax system excludes some savings, such as pension and Individual Retirement Account contributions, which is consistent with a tax using a consumption base.

The easiest way to understand the differences between the income and consumption tax bases is to define and understand the economic concept of income. In its broadest sense, income is a measure of the command over resources that an individual acquires during a given time period. Conceptually, individuals can exercise two options with regard to their income: they can consume it or they can save it. This theoretical relationship between income, consumption, and saving allows a very useful accounting identity to be established; income, by definition, must equal consumption plus saving. It follows that a tax that has a measure of comprehensive income applies to both consumption and savings. A consumption tax, however, applies to income minus saving.

A consumption tax can be levied at the individual level in a form very similar to the current system. An individual would add up all income in the same way as he or she does now under the income tax but then would subtract out net savings (saving minus borrowing). The result of these calculations would be the consumption base on which tax is assessed. Equivalently, a consumption tax can also be collected at the retail level in the form of a sales tax or at each stage of the production process in the form of a value-added tax (VAT).

Regardless of the form or point where a consumption tax is collected, it is ultimately paid by the individual doing the consuming. It should be noted that consumption, in the economy as a whole, is smaller than income. Thus, to raise equal amounts of revenue in a given year, tax rates on a comprehensive consumption base would have to be higher than the tax rates on a comprehensive income base.

What Should Be Taxed?

Should the tax base be income or consumption? Is one inherently superior to the other? How do they stack up in terms of simplicity, fairness, and efficiency — the three standards by which tax systems are generally assessed? There appears to be insufficient theoretical or empirical evidence to conclude that a consumption-based tax is inherently superior to an income-based tax or vice versa.

One issue associated with the choice of a tax base is equity — how the tax burden will be distributed across income classes and different types of taxpayers. For example, a tax is "progressive" if its burden rises as incomes rise. While some types of consumption taxes can be designed to achieve any desired level of progressivity with respect to consumption alone, their progressivity with respect to income could only be approximated. Also, a consumption tax would involve a redistribution of the tax burden by age group, with the young and old generally bearing more of the total tax burden than those in their prime earning years. And the transition from an income-based tax to a consumption-based tax would have the potential for creating windfall gains for some taxpayers and losses for others.

A definitive assessment cannot be made of the effects of taxing consumption on either economic efficiency or the aggregate level of savings. Although the current tax system's distortions of the relative attractiveness of present and future consumption (saving) would be eliminated, to raise the same amount of tax revenue, a consumption-based tax would require an increase in marginal tax rates (since consumption is smaller than income). This action, in turn, would increase the current system's distortion between the attractiveness of market (e.g. purchased products) and nonmarket activities (e.g. leisure). The net effect on overall economic efficiency cannot be ascertained theoretically. In addition, economic theory indicates a consumption tax would not necessarily produce an increase in saving. The increase in after tax income might reduce saving, while the increase in the return to saving may increase it; the net result is uncertain.

A positive aspect of a consumption-based tax is the ease with which the individual and corporate tax systems could be integrated. In addition, the problems introduced by separate provisions for capital gains, attempts to distinguish between real and nominal income, and depreciation procedures would essentially be eliminated. It is doubtful, however, that a consumption-based tax would have much effect on the complexities introduced into the system to promote specific social and economic goals. Many of the same factors that influenced the design of the current income tax system would exert the same influences on the final design of a consumption tax.

Whether one prefers income or consumption, one tax rate or multiple tax rates, a critical point to remember is that the benefits to be derived from tax revision would result from defining the tax base more comprehensively than it is under current law. A tax with a base that is comprehensively defined would prove more equitable and efficient than a tax with a less comprehensively defined base.

Types of Broad-Based Consumption Taxes

Four major types of broad-based consumption taxes are included in congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert I. Hall and Alvin Rabushka of the Hoover Institution.

Value-Added Tax

A value-added tax is a tax, levied at each stage of production, on firms' value added. The value added of a firm is the difference between a firm's sales and a firm's purchases of inputs from other firms. The VAT is collected by each firm at every stage of production.

There are three alternative methods of calculating VAT: the credit method, the subtraction method, and the addition method. Under the credit method, the firm calculates the VAT to be remitted to the government by a two-step process. First, the firm multiplies its sales by the tax rate to calculate VAT collected on sales. Second, the firm credits VAT paid on inputs against VAT collected on sales and remits this difference to the government. The firm calculates its VAT liability before setting its prices to fully shift the VAT to the buyer. Under the credit-invoice method, a type of credit method, the firm is required to show VAT separately on all sales invoices and to calculate the VAT credit on inputs by adding all VAT shown on purchase invoices.

Under the subtraction method, the firm calculates its value added by subtracting its cost of taxed inputs from its sales. Next, the firm determines its VAT liability by multiplying its value added by the VAT rate. Under the addition method, the firm calculates its value added by adding all payments for untaxed inputs (e.g., wages and profits). Next, the firm multiplies its value added by the VAT rate to calculate VAT to be remitted to the government.

Retail Sales Tax

In contrast to a VAT, a retail sales tax is a consumption tax levied only at a single stage of production, the retail stage. The retailer collects a specific percentage markup in the retail price of a good or service which is then remitted to the tax authorities.

Consumed-Income Tax

Under this consumption tax, taxpayers would keep their assets in an account equivalent to a current IRA (individual retirement account). Net contributions to this account (contributions less withdrawals) would be deducted from income to determine the level of consumed-income. In contrast to a VAT or sales tax, policymakers would have the option of applying a progressive rate structure to the level of consumed-income. Each individual would be responsible for calculating his consumed-income and paying his tax obligation.

Flat Tax (Hall/Rabushka Concept)

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution. Their proposal would have two components: a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on salaries and wages; a cash-flow tax is generally a tax on gross receipts minus all outlays.) It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under a standard VAT, a firm would not subtract its wage and pension contributions when calculating its tax base. Under this proposal, some wage income would not be included in the tax base because of exemptions. Under a standard VAT, all wage income would be included in the tax base.

International Comparisons

There are two major distinctions between recent flat tax proposals for the United States that would change the tax base from income to consumption and the current tax systems of other developed nations. First, although the United States is the only developed nation without a broad-based consumption tax at the national level, other developed nations adopted broad-based consumption taxes as adjuncts to rather than as replacements for their income-based taxes. Most of the congressional proposals would replace our current income taxes with consumption taxes, rather than use consumption taxes as adjuncts to our current income-based system.

Second, all developed nations with VATs, except Japan, calculate their VATs using the credit-invoice method. Most of the current U.S. flat tax proposals, which include VAT components, however, would use the subtraction method of calculation.

Other Types of Fundamental Tax Reform

Two other types of fundamental tax reform are income tax reform and a tax plan that gives taxpayers a choice of systems.

Income Tax Reform: Base Broadening

Income tax base broadening would involve eliminating most tax preferences, increasing the standard deduction and personal exemption allowances, and reducing tax rates. House Minority Leader Gephardt’s proposal is in this category.

Option of the Current or an Alternative Income Tax System

Two proposals would give taxpayers the option of either paying taxes under the current income tax or paying a flat rate income tax. Representative Burgess’ proposal and Senator Dorgan’s proposal are in this category.

Description of Selected Proposals

Numerous flat tax (or modified flat tax) proposals are receiving the most congressional attention. Some of the proposals (the Shelby, the English, the Specter, the Tauzin, and the Linder plans) would change the tax base from income to consumption. Representative Gephardt's proposal would keep income as the tax base. Representative Crane's proposal would levy a tax on the earned income of each individual as a replacement for the current individual income tax, corporate income tax, and estate and gift tax. Representative Burgess' proposal would allow each taxpayer to choose between the current individual income tax return and an alternative individual tax return with a flat rate. Senator Dorgan's proposal would allow most taxpayers to choose between the current individual tax system and his "shortcut" tax plan under which taxes withheld would equal the employee's tax liability. Representative Fattah's proposal would require that the Treasury conduct a study of the implementation of a transaction fee as a replacement for all existing federal taxes on individuals and corporations. While some of these plans are more detailed than others, none of the proposals has the level of detail that would be required to make a plan operational. Many difficult details and transitional considerations have yet to be addressed. Some proposals have been formulated into bills introduced in the 105th, 106th, 107th, 108th, or 109th Congresses. After the heading of each proposal, the most recent bill introduced is specified by its number.

The Shelby Proposal

S. 1040 in the 108th Congress. The Tax Simplification Act of 2003 proposed by Senator Shelby was modeled after the proposal formulated in 1981 by Hall and Rabushka. This flat tax would levy a consumption tax as a replacement for the individual and corporate income taxes, and the estate and gift taxes.

As noted above, this proposal would have two components: a wage tax and a cash-flow tax on businesses. It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under this proposal, some wage income would not be included in the tax base because of deductions, while under a VAT all wage income would be included in the tax base.

Initially the individual wage tax would be levied at a 19% rate, but when the tax was fully phased in, this rate would decline to 17%. The individual wage tax would be levied on all wages, salaries, pensions, and unemployment compensation. In addition, government employees and employees of nonprofit organizations would have to add to their wage tax base the imputed value of their fringe benefits.

The individual wage tax would not be levied on Social Security receipts. Thus, the current partial taxation of Social Security payments to high income households would be repealed. Social Security contributions would continue to be taxed; that is, they would not be deductible and would be made from after-tax income. Firms would pay the business tax on their Social Security contributions. Individuals would pay the wage tax on their Social Security contributions. The individual wage tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status. For tax year 2003, the basic standard deduction would have been the following:

- $25,580 for a married couple filing jointly or a surviving spouse;
- $16,330 for a single head of household;
- $12,790 for a single person; and
- $12,790 for a married person filing a separate return.

The "additional standard deduction" would be an amount equal to $5,510 times the number of dependents of the taxpayer.

All deductions would be indexed for inflation using the consumer price index (CPI).

Initially businesses would pay a tax of 19% (declining to 17% when the tax was fully phased in after December 31, 2004) on the difference (if positive) between gross revenue and the sum of purchases from other firms, wage payments, and pension contributions. This business tax would cover corporations, partnerships, and sole proprietorships. Pension contributions would be deductible but there would be no deductions for fringe benefits. In addition, state and local taxes (including income taxes) and payroll taxes would not be deductible.

Activities of government entities and tax-exempt organizations would be exempt from the business tax.

If the business's aggregate deductions exceed gross revenue, then the excess of aggregate deductions can be carried forward to the next year and increased by a percentage equal to the three-month Treasury rate for the last month of the taxable year.

Any congressional action that raises taxes would require a three-fifth (supermajority) in both the Senate and the House of Representatives.

The English Proposal

H.R. 269 in the 108th Congress. This proposal of Representative English (Simplified USA Tax) was based on the Domenici-Nunn proposal. The *corporate income tax* would be replaced by a cash-flow business tax (a subtraction-method VAT). The gross tax base (value-added) would equal gross receipts less purchases from other firms. The tentative tax would be determined by multiplying the value-added by the appropriate tax rate. A tax rate of 8% would apply to the first $150,000 of a business' value-added, and a tax rate of 12% would apply to all of the business's value-added over $150,000. A business tax rate of 12% would apply to all imports. A credit for the 7.65% employer-paid OASDHI payroll tax (commonly called FICA or the Social Security tax) would be subtracted from the tentative tax to calculate the business's tax liability for the year.

The *individual income tax* would be replaced by a tax on consumed-income. An individual's tax liability would be calculated by (1) calculating gross income, (2) subtracting exemptions and deductions, (3) applying a progressive rate structure to the difference, and (4) subtracting a credit for the 7.65% employer-paid OASDHI payroll tax payments. Gross income would equal wages and salaries plus interest, dividends, pension receipts, and amounts received from the sale of stock and other assets. Deductions would be allowed for charitable contributions, home mortgage interest, and higher education tuition. Deductions would also be allowed for retirement-oriented 401(k) contributions and IRAs for lower income families.

The Simplified USA Tax eliminates the double taxation of savings by allowing everyone to contribute after-tax income to a USA Roth IRA, which is a universal savings vehicle. After five years, accumulated principal and earnings on principal can be withdrawn on a tax-free basis at any time and for any purpose. The federal estate and gift tax would be repealed.

The Specter Proposal

S. 907 in the 108th Congress. The Flat Tax Act proposed by Senator Specter also was modeled after the Hall-Rabushka proposal and thus is similar to that of Senator Shelby. The Specter flat rate consumption tax would replace the federal individual and corporate income taxes and the federal estate and gift taxes.

This proposal would have two components: a wage tax and a cash-flow tax on businesses. It is essentially a modified VAT, with wages, salaries, and pensions subtracted from the VAT base and taxed at the individual level.

The individual wage tax would be levied at a 20% rate on all wages, salaries, and pensions. In addition, government employees and employees of nonprofits would have to add to their wage base the imputed value of their fringe benefits. The individual wage tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status. For tax year 2004, the basic standard deduction would be the following:

- $17,500 for a joint return;
- $17,500 for a surviving spouse;
- $15,000 for a head of household;
- $10,000 for a married taxpayer filing separately; and
- $10,000 for a single taxpayer.

The "additional standard deduction" would be an amount equal to $5,000 times the number of dependents of the taxpayer. All deductions would be indexed for inflation.

Individuals would be allowed to deduct up to $2,500 ($1,250 in the case of a married individual filing a separate return) annually for charitable contributions. Individuals also would be allowed to deduct "qualified residence interest" on acquisition indebtedness not exceeding $100,000 ($50,000 in the case of a married individual filing a separate return).

The business tax would be levied at a 20% tax rate on gross revenue less the sum of purchases from other firms, wage payments, pension contributions, and the cost of personal and real property used in the business. Purchases from other firms would include capital goods. If the business's aggregate deductions exceed gross revenue, then the excess of aggregate deductions can be carried forward to the next year and increased by a percentage equal to the three-month Treasury rate for the last month of the taxable year.

This tax reform act would have become operational on January 1, 2004.

The Tauzin Proposal

H.R. 4168 in the 108th Congress. This proposal would replace the personal and corporate income taxes, estate and gift taxes and all non-trust dedicated excise taxes with a 15% national retail sales tax. Each qualified family unit would receive a sales tax rebate equal to the product of the sales tax rate and the lesser of the poverty level (adjusted for the number of dependents claimed) or the wage income of the family unit. The rebate amount would be included in each paycheck for that pay period. Any business required to collect and remit the sales tax would keep 0.5% of tax receipts to offset compliance costs. Any state choosing to do so could administer, collect and enforce the sales tax. To qualify as an "administering state," a state would have to conform its sales tax base to the federal base. Administering states could retain an administration fee equal to 1% of the amounts otherwise required to be remitted to the United States. A super majority vote of two-thirds of both Houses of Congress would be necessary to raise the sales tax rate or to create any exemptions to the sales tax.

The Linder Proposal

H.R. 25 in the 109th Congress. [A companion bill, S. 25, has been introduced in the 109th Congress by Senator Chambliss]. This proposal introduced by Representative Linder would repeal the individual income tax, the corporate income tax, all payroll taxes, the self-employment tax, and the estate and gift taxes and levy a 23% national retail sales tax as a replacement. Every family would receive a rebate of the sales tax on spending up to the federal poverty level (plus an extra amount to prevent any marriage penalty). The Social Security Administration would provide a monthly sales tax rebate to registered qualified families. The 23% national retail sales would not be levied on exports. The sales tax would be separately stated and charged. Social Security and Medicare benefits would remain the same with payroll tax revenue replaced by some of the revenue from the retail sales tax. States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee. Taxpayers rights provisions are incorporated into the act.

The Gephardt Proposal

H.R. 3620 in the 105th Congress. Unlike most proposals, this proposal would reform the current income tax base rather than changing to a consumption base. The taxable income base for individuals under this proposal included all items of income currently taxed (salaries and wages, investment income, capital gains, business profit or loss, etc.) plus employee fringe benefits (other than health insurance), employer pension plan contribution, and tax-exempt state and local interest. Social Security benefits would be included to the same limited extent as they are under current law. Deductions from gross income (called "above-the-line" deductions, as distinct from the itemized deductions taken from adjusted gross income) would be allowed for alimony paid, one-half of the self-employment tax, investment interest, and job-related expenses. The only itemized deduction allowed would be home mortgage interest. Since pension contributions would be taxable, an exclusion would be allowed from pension income for the previously taxed contributions, the way annuities are taxed under current law. Accumulated earnings under pension plans, IRAs, and life insurance policies would remain tax-deferred, as under current law. The only credits allowed would be the earned income tax credit (EITC) and the foreign tax credit.

The standard deduction and personal exemption allowances would be increased and tax rates would be decreased from current law. In addition, the "marriage tax penalty" arising from these factors would be eliminated by making the joint filer allowances and tax brackets exactly twice those of a single filer. "Head-of-household" filers, which are single individuals with dependent children, would receive allowances and the first two tax brackets halfway in between the amounts for single and joint taxpayers; the higher tax brackets are equal the single-filer brackets. There would be no separate tax rates for capital gains.

The tax-free allowances would be:

- $9,000 for a joint return;
- $6,600 for a head of household;
- $4,500 for an individual; in addition
- $2,900 for each personal exemption.

The tax rate schedule would be:

- 10% marginal rate: married (joint) $0-$46,000; head of household $0-$32,000; single $0-$23,000.

- 20% marginal rate: married (joint) $46,000-$80,000; head of household $32,000-$40,000; single $23,000-$40,000.

- 26% marginal rate: married (joint) $80,000-$150,000; head of household $40,000-$75,000; single $40,000-$75,000.

- 32% marginal rate: married (joint) $150,000-$275,000; head of household $75,000-$137,500; single $75,000-$137,000.

- 34% marginal rate: married (joint) over $275,000; head of household over $137,500; single over $137,500.

This proposal would reduce "corporate welfare" by more than $50 billion. The plan apparently retains payroll and other taxes as under the current system. The plan is said to be revenue-neutral, to allow a post-card sized tax return for some taxpayers, and to require no return at all for over one-half of individual taxpayers. It also would stipulate that future changes in tax rates could be made only by national referendum.

The Crane Proposal

H.R. 1789 in the 108th Congress. This proposal would repeal the corporate income tax, the individual income tax, the estate and gift tax, and replace these taxes with a flat rate tax of 10% on individuals' earned income. The first $10,000 in earned income would be exempt from taxation. This exemption level would be indexed for changes in the consumer price index. Earned income would be defined as the sum of wages, salaries, and other employee compensation; the amount of the taxpayer's net earnings from self-employment; and the amount of dividends that are from a personal service corporation or that are otherwise directly or indirectly compensation for services. Fringe benefits included in earned income would be valued at the cost to the employer. This proposal would establish an amnesty for all prior tax liability attributable to legal activities.

The Dorgan Proposal

S. 551 in the 107th Congress. Under the "Fair and Simple Shortcut Tax Plan," most employees would be allowed to provide employers with additional information on their W-4 (deduction) Form. For example, whether the employee is a homeowner. Single taxpayers earning up to $50,000 in annual wage income (and with nonwage income of up to $2,500) and married couples filing jointly with up to $100,000 in annual wage income (and with nonwage income of up to $5,000) could choose a "shortcut" tax plan. The employer would file the W-4 Forms with the federal government. The employer would compute family deductions, factor in a deductions for home mortgage interest and property taxes, and determine the amount of federal income tax to withhold by taking 15% of wages after deductions less the child care credit. Under this "shortcut" plan, the amount of tax withheld would equal the employee's tax liability, and consequently, the employee would not have to file a tax return. If the employee calculated that their tax liability would be less under the current income tax, she or he would have the option of filling out and filing a tax return rather than paying tax under the "shortcut" plan. Senator Dorgan stated that up to 70 million taxpayers would be relieved from having to file a yearly federal individual income tax return.

Senator Dorgan's proposal would make five other changes in the current tax code. First, the first $1 million in self-employment income would be exempt from the alternative minimum tax (AMT). Second, a taxpayer, who cannot use the shortcut method, would be allowed a tax credit for 50% of the costs (maximum of $200) of paying a preparer if the tax return is filed electronically. Third, during the first year to cover start-up costs, a business would be allowed a tax credit equal to the lesser of $1,000 or 50% of the costs of complying with the exact withholding option. Fourth, the marriage penalty would be reduced by making the standard deduction for married couples filing jointly double the amount available for single filers. Fifth, taxpayers would be offered a substantial incentive for savings and investment by exempting from taxation up to $500 of dividend and interest income for an individual and up to $1,000 for a couple.

The Burgess Proposal

H.R. 1040 in the 109th Congress. This proposal would allow taxpayers to select a flat tax as an alternative to the current income tax system. The flat tax was based on the concepts of Hall-Rabushka and is similar to the Armey flat tax proposal. The individual's selection of the flat tax would be irrevocable. In the first two years, the flat tax rate would be 19%, and in subsequent years it would fall to 17%. An individual engaged in a business activity may elect irrevocably, as an alternative to our current income tax system, to be taxed on business taxable income that equals gross sales less the cost of business inputs for business activity, wages, and retirement contributions. For the first two years, a 19% rate would apply to business taxable income, but after the first two years, this rate would decline to 17%. This act would have become effective for tax year 2006.

The Fattah Proposal

H.R. 3759 in the 108th Congress. This proposal would require the Secretary of the Treasury to conduct an in-depth study of the implementation of a transaction fee as a replacement for all existing federal taxes on individuals and corporations. This transaction fee would apply to all cash and non-cash transactions (including checks, credit cards, transfers of stocks, bonds, and other financial instruments). The fee would not apply to cash transactions of less than $500, and salaries and wages paid by employers to employees. The fee would be double, or higher than, the standard transaction fee on cash withdrawals from financial institutions. The fee would be collected by the seller or financial institution servicing the transaction. The fee would be set at least at the level to replace revenues generated under the Internal Revenue Code. A higher fee could be levied to pay for one or more of the following: elimination of the national debt over 10 years, a federal revenue sharing program with the states to support 50% of the K-16 education costs, a federal health care program providing insurance coverage for the estimated 43 million uninsured Americans, and a federal revenue sharing program supporting community and economic development investments in high poverty areas. The Secretary of the Treasury would submit to Congress the results of the study in a comprehensive analytical report not later than one year after the enactment of this act.

LEGISLATION

H.R. 25 (Linder). Fair Tax Act of 2005. To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States. Introduced January 4, 2005; referred to the Committee on Ways and Means.

H.R. 1040 (Burgess). Freedom Flat Tax Act. This bill would allow individuals to elect irrevocably to pay a flat tax as an alternative to our current income tax. In the first two years, the flat tax rate would be 19%, but in subsequent years the rate would decline to 17%. This bill would become effect in tax year 2006. Introduced March 2, 2005; referred to the Committee on Ways and Means.

S. 25 (Chambliss). Fair Tax Act of 2005. To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the states. Introduced January 24, 2005; referred to the Senate Finance Committee.

For Additional Reading

CRS Products

CRS Report RL30351. *Consumption Taxes and the Level and Composition of Saving*, by Steven Maguire.

CRS Report RL32603. *The Flat Tax and National Sales Tax: Overview of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle.

CRS Report RL32266. *Transaction Tax: General Overview*, by Maxim Shvedov.

CRS Issue Brief IB91078. *Value-Added Tax as a New Revenue Source*, by James M. Bickley.

CRS Issue Brief IB92069. *A Value-Added Tax Contrasted with a National Sales Tax*, by James M. Bickley.