A Primer on National Tax Reform Proposals

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America is facing a cash flow crisis that politicians suggest can be solved with tax system reform. Voters are left to consider which plan strikes the right balance between "who pays?" and "how much?" The most commonly proposed alternatives to the current federal tax structure are the Flat Tax, the Value Added Tax (VAT), and the National Sales Tax (NST).

The Flat Tax

The Flat Tax is commonly understood to be an income tax in which every taxpayer would be in the same tax bracket. However, there are two distinct approaches. Proponents of the Cash Outflow Approach argue that theirs is a highly efficient consumption tax that approximates each person's consumption—not income—taxing everyone at a uniform rate based on that estimate. Rather than requiring taxpayers to track receipts each year, this approach would rely on an indirect calculation for consumption where consumption equals income less savings: C = I - S.

For example, assume you had $100,000 in total income, and you socked away $10,000 in savings. The $90,000 difference represents your consumption, and therefore would be taxed based on the established rate. All types of income would be taxable unless they were placed in a savings or brokerage account from which the banks and brokers can report how much you deposited. Leaving saved money in your checking account unspent, or putting it under your mattress, wouldn't prevent these dollars from being taxed—the money would need to be affirmatively put in a traceable savings vehicle to qualify for exclusion.

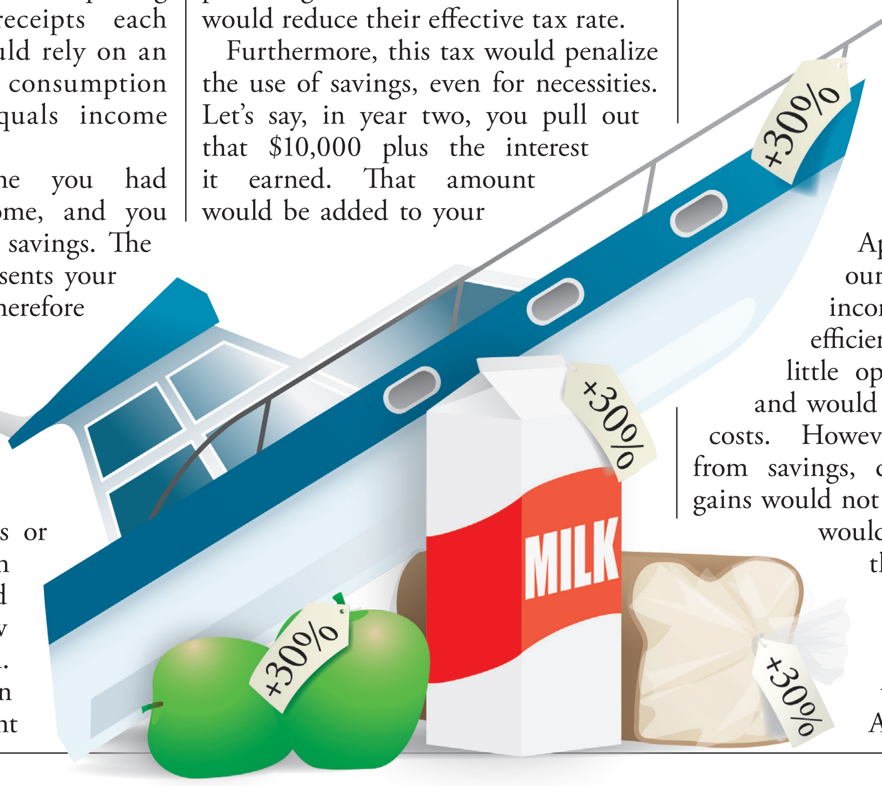
This Cash Outflow Approach encourages savings (to defer paying tax) which, in best cases, would build wealth. Additionally, the Cash Outflow Approach would streamline taxation on consumption, collecting at the individual level in a single taxable moment at the end of each year.

The "fairness" of this approach comes into question for low-income and middle-income taxpayers who consume all or nearly all of their income by necessity, yielding little or no opportunity for savings. The result would be a significant tax increase on the poor, who currently pay little or no income tax. By contrast, wealthier taxpayers are able to save a much greater percentage of their income, which would reduce their effective tax rate.

Furthermore, this tax would penalize the use of savings, even for necessities. Let's say, in year two, you pull out that $10,000 plus the interest it earned. That amount would be added to your current year income to be taxed. (This is the same idea as deductible retirement plans, but this treatment would apply to all savings). This could be a disadvantage to low and middle-income families who might pull $1,000 out of savings to cover a home repair. Should additional taxes be required when someone has to buy a new water heater?

The Tax Prepayment Approach version of the Flat Tax is an income tax that would exempt investment income (interest, dividends, capital gains) from taxation. There would be no deductions for capital losses. Furthermore, the timing of paying the tax is different in this model: all income would be taxed initially, including any amounts put into savings. For example, if your total income were $100,000, you would pay a flat tax on all $100,000 in the year it is earned. Suppose you put $10,000 in savings and, after two years, it earned $500 in interest. If you withdrew the combined amount of principal and interest, $10,500, you would pay no additional tax.

The Tax Prepayment Approach would replace our highly inefficient income tax system with an efficiency that would yield little opportunity for evasion, and would incur low enforcement costs. However, interest earnings from savings, dividends, and capital gains would not be taxed, so this again would be an advantage for the wealthy. Consider individuals whose income is derived entirely from savings: they would pay no tax. Additionally, in order to



be revenue neutral, the tax rate on low-income and middle-income families would need to increase.

Neither the Cash Outflow nor the Tax Prepayment approach solves the problem of people who report little or no income, such as tax evaders and illegal immigrants. Conversely, the VAT and the NST would result in tax scofflaws' having to pay whether they are buying a dozen eggs or a dozen Lamborghinis.

Value Added Tax (VAT)

Every developed country in the world uses a form of the Value Added Tax except for the United States. Boiled down, the VAT is a sales tax. All sales of goods and services carry a sales tax, both to businesses and consumers. The initial producer of raw materials or services collects a VAT from its customer, the product manufacturer. Then the product manufacturer collects from the distributor, who collects from the retailer who collects from the ultimate consumer. There are no sales excluded from the VAT, including labor and services. The seller collects and remits the tax, but the cost is carried through to the buyer. Businesses keep track of all VAT collected from customers and all VAT paid to vendors, and they remit the difference. If a business paid more VAT than it collected (such as if it tooled up with new equipment or had a bad year), the business could request a refund.

A strategically implemented VAT could narrow the gap between tax revenues and government spending with the least probability of creating more problems than it fixed. VAT taxes are highly efficient taxes that raise significant revenues without the market-distorting effects of an income tax riddled with deductions for various social, industrial, energy, and other policy goals. It may be easier for governments to enforce a VAT than the current income tax because all businesses are subject to the VAT in the same way. If a VAT were to be adopted, there could be a large rush by consumers to buy before the VAT added significantly to their purchase cost, which could give the economy a one-time "shot in the arm," but could also create a retail sales hangover.

With the implementation of a VAT, everything would be more expensive, so people at the low end of the economic spectrum would not be able to buy as much. The VAT would be regressive, meaning that the poor would bear a greater tax burden when they consumed than they currently pay in income tax. The income tax structure could be compensated to alleviate some of this pressure, but again, exceptions would require a higher VAT tax rate. Additionally, businesses would need to shrink their margins to compete for the consumer dollar. The higher the VAT or NST tax rate, the more consumer spending would be affected, especially if you consider that a VAT would have to be coordinated with individual states' sales taxes.

National Sales Tax

With the implementation of a National Sales Tax, only the retailer would collect tax and remit the tax to the federal government, similar to the current State Sales Tax system. This tax is different from a VAT where a tax is paid on the value added at each level of manufacturing and distribution. The National Sales Tax would be applied to the final retail sale of new goods (used goods would be exempt).

Most Americans are familiar with sales taxes, so the implementation of an NST would not be as foreign as other models. In order to replace the federal income tax system in a revenue neutral fashion, the tax rate would have to be approximately 30%, which would mean that everything we buy would cost roughly a third more than its price. An NST is the most regressive of the systems set forth in this article because all of the tax falls exclusively at the consumer level. Proponents of the NST have put forward a number of ways to exempt low-income families from the tax, but it would still hit lower and middle-income families much harder than it would hit wealthier Americans. The NST would be over and on top of the state and local sales taxes that are the lifeblood of state, county, and municipal governments. When combined with those tax rates, the effective tax rate in many parts of America would be nearly 40% on each purchase, depending on the combination of national, state, and local sales tax rates.

Some policymakers are considering adding a VAT or NST to our current tax system. In such a blended system, income tax rates for individuals and businesses would be reduced. Millions of individual taxpayers simply wouldn't need to file income tax returns anymore. If the rate on goods and services were not too high, and if most people paid less income tax, there might not be much effect on spending.

Settling on the Right Rate

The big question with the Flat Tax, VAT, or NST is what tax rate is needed to generate sufficient tax revenue. Regardless of the model chosen, total dollars channeled to the government would likely increase unless the government reduced spending. Narrowing the gap between government revenue and spending while encouraging an economy where consumers can both spend and save is the ultimate goal; one on which reasonable minds differ, to say nothing of our politicians. A consumption tax would provide an attractive, legal way for individuals to reduce their taxes owed, if the system effectively encouraged saving. However, a dramatic shift in federal taxation methods could create more problems than it solved. Satisfying the human temptation to avoid taxes could result in a black market or an underground retail economy.

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