Economic Insights

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Tax Reform: An Opportunity To Increase Our Saving

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Increasing the amount of saving and investment is a common goal of two of the major tax overhaul plans now being discussed on Capitol Hill and across the nation — the flat income tax and the consumption tax.

It's no secret that economic growth and increases in our standard of living require more capital. Increases in the quantity and quality of the nation's capital stock depend on incentives to save and invest. In fact, many economists believe saving is now more important than ever before and that capital formation financed by domestic savers is virtually the only route left to increase the capacity of the economy to expand.

One of the most forceful advocates of this position is Robert E. Lucas, Jr., of the University of Chicago, winner of this year's Nobel Prize in economics and arguably the most influential economist of the late 20th century. In a review of supply side economics, Lucas wrote:

"When I left graduate school, in 1963, I believed that the single most desirable change in the U.S. tax structure would be the taxation of capital gains as ordinary income. I now believe that neither capital gains nor any of the income from capital should be taxed at all.... Supply side economics [is] a term associated in the United States with extravagant claims about the effects of changes in the tax structure on capital accumulation. The analysis I have reviewed supports these claims: Under what I view as conservative assumptions, I estimated that eliminating capital income taxation would increase the capital stock by about 35 percent....The supply side economists...have delivered the largest genuinely free lunch that I have seen in 25 years in this business, and I believe that we would have a better society if we followed their advice."

Lucas is not alone in these views. His voice is simply the most prominent of those professional economists who argue for more favorable treatment of capital income and, by extension, saving in the tax code.

Increasing the amount of saving and investment is a common goal of two of the major tax overhaul plans now being discussed on Capitol Hill and across the nation—the flat income tax and the consumption tax. Earlier this year, we had the opportunity to host House Majority Leader Dick Armey for a lecture in Dallas and House Ways and Means Committee Chairman Bill Archer for a lecture at our Houston Branch. In this issue of *Economic Insights*, we present excerpts from Congressman Armey's remarks on his flat tax proposal and Congressman Archer's address outlining a consumption tax.

To provide further insight on reforming the tax system, we include remarks from Arthur Hall of the nonpartisan Tax Foundation, who spoke at our public policy conference this year. He brings to light compelling evidence of a problem in serious need of solution.

I hope you enjoy our second issue of *Economic Insights* and gain additional perspective on the important and timely issue of increasing our nation's ability to save and invest. ■

> **“The basic goals of the Armey flat tax are honesty, simplicity and fairness.”**
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> **—Rep. Dick Armey**
> House Majority Leader

The following is an edited excerpt from Congressman Dick Armey’s address on his flat tax proposal at the Federal Reserve Bank of Dallas on April 18, 1995.

As some of you may have noticed, there’s a new political star on the horizon. It is not a nova. It is not a person. It is an idea that I believe will someday be a compelling force in Washington, D.C.: the flat tax, or more specifically, the Armey flat tax.

People often ask me, “What’s the difference between your flat tax and Congressman Gephardt’s flat tax or Jerry Brown’s flat tax from a couple of years ago?” The difference between me and Gephardt and me and Jerry Brown is that my tax is flat, and I mean it. My motto for the flat tax is stay flat or die.

The basic goals of the Armey flat tax are honesty, simplicity and fairness. One of the most heartwarming things I have experienced in listening to people across this country talk about the flat tax is that everybody wants to be treated exactly the same as everybody else. That’s fairness. That’s what the flat tax is all about. Moreover, I want to make sure all income is included by broadening the tax base. Right now, the tax code misses hundreds of billions of dollars worth of income. Seems to me that’s not fair.

With the Armey flat tax, I want to encourage a growing economy—in particular, by getting government out of the way of the essential growth activities. As Adam Smith said, the road to economic progress is through abstinence and capital accumulation, abstinence being saving. What I want to do is promote saving and investment and growth, but in the private sector, not the government.

For individual taxpayers, I would do that by saying interest earned is not a taxable form of income. Dividends are not taxable to the individual. Capital gains are not taxable to the individual. And the inheritance tax would cease to exist. Incidentally, in addition to ending interest as a taxable form of revenue to the individual, I would also end interest as a deductible expense.

On the business side, employers would pay their flat tax based on gross receipts less legitimate business expenses, which would determine net income. One expense that would no longer be legitimate is employer-provided health insurance, which, by the way, is the reason that too many Americans have too much of the wrong kind of health insurance. Under the Armey flat tax, if an employer provides $5,000 worth of health insurance, they don’t get to write that off as a business expense. Instead, all income is taxed, whether it’s spent on health care or anything else. That is consistent with the underlying philosophy of the flat tax—that every dollar of income should be taxed. By leveling the playing field and treating health care benefits like other income, we can expect health care consumers to be more cost-conscious, which will lead to a more efficient use of health care dollars.

As for business expenses such as capital outlays, under the Armey plan, an employer would be able to expense all capital purchases at the time of purchase. You go out and buy a new piece of equipment and write it off on the day you buy it. In today’s world, the march of science, engineering and technology is so fast that what you bring on line today is probably going to be obsolete six months from now. If you can expense it immediately, you can stay ahead or at least stay current with the march of technology. I think this is an extraordinarily important innovation in the tax code. If you want wages to go up, productivity must go up. Productivity goes up when people have access to more sophisticated application of science and engineering knowledge through the purchase of new capital.

Once an employer pays its flat tax on net earnings, that’s the only time those earnings would be taxed. In other words, you pay the tax at the source of all the earnings. When those earnings are distributed to the owners of the business enterprise, through dividends or through capital gains or through interest on bonds, those earnings would not be taxed a second time. It’s insidious to tax the same income twice. The Armey flat tax eliminates that.

I believe that with this kind of a tax code, we can broaden the base so that we treat everybody fairly and tax all of their income only once, and we can provide incentives for saving and investment. Also, with the Armey flat tax, we can eliminate the 560 million hours a year that are now devoted to reporting taxes. It’s a tragedy that we spend more time reporting taxes in America today than we spend producing all the cars, trucks and vans combined.

Now, people keep asking me, “Dick, why don’t you take the flat tax to Washington?” Well, I don’t want the Armey flat tax in Washington for at least another year. It needs to have so much compelling force behind it that people don’t dare talk back to it. My plan is for the flat tax never even to be taken up seriously by a committee. Rather, in about a year, I would like to have someone bring his comprehensive tax reform bill to the floor of the House for a vote. And when they do, I will go and ask the Rules Committee if they would give me the opportunity to offer the Armey flat tax as a substitute. And if I’m right about America, the Armey flat tax will win. ■

"A tax on income is a tax on work."

—**Rep. Bill Archer**
Chairman of the
House Ways and Means Committee

The following is an edited excerpt from Congressman Bill Archer's address on his consumption tax proposal at the Houston Branch of the Federal Reserve Bank of Dallas on August 29, 1995.

In the 23 years I have served on the House Ways and Means Committee, we have been through innumerable exercises of reforming the U.S. income tax. In each instance, we have ended up with a worse income tax than we had before. The motives have been good, the goals have been good, but I am convinced, after going through all of this for the past 23 years, that you can't fix the income tax. I think you can flounder and you may think you have improved it for a while, but it will eventually get back to being the counterproductive mechanism it is today.

On the day after the November 1994 election, when I held my first press conference as chairman of Ways and Means, I threw a bombshell out publicly and said, "I want to tear the income tax out by its roots so that it can never grow back again. And I want to replace it with a tax on consumption." A tax on income is a tax on work. We should not be taxing work efforts; we should be taxing people when they spend their money. I think we should have a tax system that meets the following four criteria.

First, it should be as simple as possible. Today, the current income tax system costs a minimum of $300 billion a year for compliance. That's the conservative estimate. *Fortune* says it is $600 billion a year for compliance. That's not revenue raised for the government; that's the cost for compliance. Some of the brightest minds in this country devote their entire lifetimes to figuring out how to deal with the tax code. They produce nothing of real worth. Those minds could be channeled into productive effort that would increase the fruits of our labor. That is extremely important. Consider this: Americans file 130 million tax returns every year. We can reduce that to a few million.

Second, we should have a tax code that gives the greatest possible incentive for people to save. Sitting on the Ways and Means Committee over the last many years, liberal, moderate and conservative economists have come before us, and rarely do they agree on anything. But they do agree that we have a shortage of savings in the United States. The tax code is a major barrier to savings. Without savings, you don't have capital, you don't have investment, you don't have job creation, and you don't have improvement in the standard of living.

Third, the way we tax should get at the underground economy. The GAO testified before our committee that there is $120 billion a year in unpaid taxes in the illegal underground economy. As of last year, 44 percent of the purchases in this country were not made by check or credit card so that you have a written record. So we are losing $120 billion a year, and that offloads onto those of us who pay our taxes. You are paying 15 percent more in taxes because of the people who aren't paying their taxes, and that doesn't include illegal economic activities.

Fourth, and perhaps most importantly, we need a tax system that allows us to remove the cost of government from the price of our products that are exported and charge the cost of government to the price of products that are imported. That's called border adjustability. The income tax is a cost of doing business that can't be removed from the price of exports. It is built into the price of our products that are sold overseas, making them less competitive. By taxing at the point of sale in the United States, our exports would escape taxation, and imports would be taxed.

So, how do we accomplish these goals? Let me go through the four criteria one by one and compare a broad-based consumption tax, which I advocate, with a flat tax, such as the one advocated by my colleague Dick Armey.

Simplicity

Although much simpler than the tax code we have today, a flat tax would still make you file an income tax return. About 130 million returns would still have to go into the IRS every year, and you would still have to keep records to support each one. If we instead tax the consumption of goods and services, individuals would not file returns.

Savings

The flat tax takes a giant step toward helping savings, and I support that. But a tax on the consumption of goods and services is a zero tax on savings, not a 17–20 percent tax coming out of your paycheck.

Income Lost to the Underground Economy

The flat tax would reduce the tax rate from 40 percent to 17–20 percent. But if you are paying zero percent today, there still wouldn't be much incentive to start paying taxes. However, if you are in the underground economy and you buy anything in the open marketplace, you'll pay your fair share if there is a tax on the consumption of goods and services.

Border Adjustability

No income tax can be border adjustable. A tax on the consumption of goods and services is adjustable at the border within the terms of GATT. America would become a sponge for savings. Interest rates would decline dramatically, and the cost of buying a home would go down as a result. Overseas, we would blow our competition out of the water.

Going to a national consumption tax is ambitious and it's bold. But I think the results are well worth the effort. ■

“Complying with the entire federal tax system costs Americans $200 billion annually.”

—Arthur P. Hall
Senior Economist, Tax Foundation

The following is an edited excerpt from Arthur Hall’s address on simplifying the tax code presented at the Dallas Fed’s public policy conference on June 23, 1995.

All of the currently proposed tax reform plans have identical goals. They seek to eliminate the biased tax treatment of saving and investment and to simplify the process of complying with the federal tax system. The Tax Foundation estimates that complying with the entire federal tax system costs Americans $200 billion annually. The rules and regulations for the federal income tax alone account for $140 billion of this cost. The cost of compliance, which adds nothing to national output, is tantamount to a tax surcharge on all taxpayers. One way to comprehend the magnitude—and economic waste—of the $140 billion federal income tax surcharge is to imagine putting every vehicle sold by General Motors in 1994 onto ships and dumping them into the ocean. If Congress were to replace the current federal income tax with any one of the predominant alternative plans currently being discussed on Capitol Hill, it could dramatically reduce America’s tax-related burden without necessarily sacrificing a dime of federal tax revenue. ■

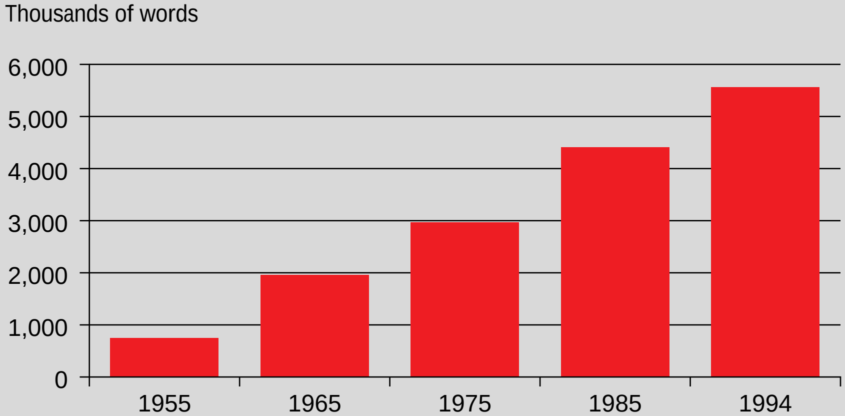
Estimated Cost of Corporate Income Tax Compliance By Company Asset Size

Asset size[1] (Thousands of dollars)	Compliance cost as a percentage of assets	Estimated compliance cost
$ 1,000	.74	$ 7,400
25,000	.40	100,000
50,000	.40	200,000
100,000	.40	400,000
250,000	.14	350,000
500,000	.10	500,000
1,000,000	.09	900,000
2,000,000	.08	1,600,000
3,000,000	.08	2,400,000
4,000,000	.04	1,600,000
5,000,000	.04	2,000,000
7,500,000	.05	3,750,000
$10,000,000	.03	3,000,000

[1] Excludes financial and life insurance firms.

SOURCE: Tax Foundation.

Growth of the Income Tax Code (Laws and Regulations)



SOURCE: Tax Foundation.

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