



# Flat Tax: An Overview of the Hall-Rabushka Proposal

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## Summary

The President and leading Members of Congress have stated that fundamental tax reform is a major policy objective for the 112<sup>th</sup> Congress. The concept of replacing individual and corporate income taxes and estate and gift taxes with a flat rate consumption tax is one option to reform the U.S. tax system. The term “flat tax” is often associated with a proposal formulated by Robert E. Hall and Alvin Rabushka (H-R), two senior fellows at the Hoover Institution. In the 112<sup>th</sup> Congress, two bills have been introduced that included a flat tax based on the concepts of Hall-Rabushka: the *Freedom Flat Tax Act* (H.R. 1040) and the *Simplified, Manageable, and Responsible Tax Act* (S. 820). In addition, Republican presidential candidate Herman Cain has proposed a tax reform plan that includes a modified H-R flat tax. This report analyzes the Hall-Rabushka flat tax concept. Although the current tax structure is referred to as an income tax, it actually contains elements of both an income and a consumption-based tax. A consumption base is neither inherently superior nor inherently inferior to an income base.

The combined individual and business taxes proposed by H-R can be viewed as a modified value-added tax (VAT). The individual wage tax would be imposed on wages (and salaries) and pension receipts. Part or all of an individual’s wage and pension income would be tax-free depending on marital status and number of dependents. The business tax would be a modified subtraction-method VAT with wages (and salaries) and pension contributions subtracted from the VAT base, in contrast to the usual VAT practice.

The analysis of the flat tax proposal is covered by the following four topics that sometimes overlap: broad economic issues, narrow sectorial economic issues, simplicity, and international comparisons. *First*, broad economic issues relate to economic effects of the flat tax on the entire economy: equity, efficiency, international trade, price level, interest rates, and revenue. *Second*, sectorial economic issues deal with specific industries or sectors of the total economy: differential effects on businesses, charitable organizations, housing, financial services, pensions and insurance, health care services, and state and local governments.

*Third*, tax economists, government leaders, and taxpayers are interested in the simplicity of a tax system, and the current income tax system is complex. A positive aspect of the proposed flat tax is the ease with which the individual and corporate tax systems could be integrated. But, the complexity of the current tax code is partially due to attempts to achieve greater equity or to improve economic efficiency, and there are often tradeoffs between simplicity, equity, and efficiency. It can be argued that it may be “unfair” to compare the current income tax system with some form of a “pure” consumption tax; by the time a consumption tax becomes enacted, it may become complicated. *Fourth*, there are major distinctions between recent consumption tax proposals for the United States and the current tax systems of other developed nations. Numerous aspects of the H-R flat tax proposal have not been fleshed out and many important policy issues have yet to be analyzed.

This report will be updated as issues develop, new legislation is introduced, or as otherwise warranted.

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## Introduction

The President and leading Members of Congress have stated that fundamental tax reform is a major policy objective for the 112<sup>th</sup> Congress. The concept of replacing individual and corporate income taxes and estate and gift taxes with a flat rate consumption tax is one option to reform the U.S. tax system. The term “flat tax” is often associated with a proposal formulated by Robert E. Hall and Alvin Rabushka (H-R), two senior fellows at the Hoover Institution at Stanford University. In 1981, they proposed a flat rate consumption tax. In early 1995, Hall and Rabushka published the second edition of their book titled simply *The Flat Tax*.<sup>1</sup> In 2005, Dr. Hall provided some additional insights into his flat tax proposal.<sup>2</sup> In the 1990s, much research was conducted on the flat tax because it received extensive political debate and widespread media coverage.

This report explains and evaluates the Hall-Rabushka proposal for four reasons. First, two bills have been introduced in the 112<sup>th</sup> Congress that include an H-R flat tax.<sup>3</sup> Second, Republican presidential candidate Herman Cain has proposed a tax reform plan that includes a modified H-R flat tax. Third, the Hall-Rabushka proposal concerns many issues relevant to other tax reform proposals. Fourth, unlike a number of other reform plans, the H-R proposal has sufficient detail to permit examination, although numerous aspects of the proposal have yet to be fleshed out.<sup>4</sup>

The report begins with discussions of the concept of an income tax base versus a consumption tax base, and three types of broad-based consumption taxes. Next, the justification and operation of the proposed H-R flat tax are explained. Then selected policy issues are examined, including both broad and narrow economic issues, simplicity, and international comparisons. The broad economic issues relate to the economic effects of the flat tax on the entire economy, for example, equity, efficiency, and international trade. The more narrow economic issues deal with specific industries or sectors of the total economy, such as housing or charitable organizations. Lastly, H-R flat tax proposals during the 112<sup>th</sup> Congress are described.

## Income Versus Consumption Taxation

Although our current tax structure is frequently referred to as an income tax in popular discussions, it actually contains elements of both an income and a consumption-based tax. For example, it excludes some income that goes to savings, such as pension and individual retirement account (IRA) contributions, which is consistent with a tax using a consumption base. Overall, however, the return to new investment is taxed, which is consistent with an income tax.

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<sup>1</sup> The complete citation of this book is Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Second Edition (Stanford, California: Hoover Institution Press, 1995), 152 p. (The first edition of this book was published in 1985.) In 2007, an introductory statement titled “The Flat Tax’s Silver Anniversary” and an appendix with the *Tax Reform Act of 1995* were added to the book, which is available at <http://www.hoover.org/publications/books/8329#nogo>.

<sup>2</sup> Robert E. Hall, “Guidelines for Tax Reform: The Simple, Progressive Value-Added Tax,” in Alan J. Auerbach and Kevin A. Hassett, eds., *Toward Fundamental Tax Reform* (Washington, DC: The AEI Press, 2005), pp. 70-80.

<sup>3</sup> Four bills based on the Hall-Rabushka proposal were introduced in the 111<sup>th</sup> Congress. Former House Majority Leader Richard K. Armey introduced flat tax legislation based on the Hall-Rabushka proposal, his most recent bill being introduced in the 107<sup>th</sup> Congress. His proposed flat tax bills have been frequently analyzed by economists. In 1996, presidential candidate Steve Forbes advocated a flat tax based on the H-R concept. For an explanation of his proposal, see Steve Forbes, *Flat Tax Revolution* (Washington, DC: Regency Publishing, Inc., 2005), 216 p.

<sup>4</sup> For a description of current tax reform proposals, see CRS Report R41591, *Tax Reform: An Overview of Proposals in the 112<sup>th</sup> Congress*, by James M. Bickley.

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, an individual can exercise two options with regard to his income: he can consume it or he 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.

Should the tax base be income or consumption? Is one inherently superior to the other? How do they stack up in terms of simplicity, equity, and efficiency? 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.

## **Types of Consumption Taxes**

The three general types of consumption-based taxes are a retail sales tax, a value-added tax (VAT), and a consumed-income tax.<sup>5</sup> A broad-based consumption tax, however formulated, is equal to a tax on wages plus a lump sum tax on old capital in existence at the time the tax is imposed.

### **Retail Sales Tax**

A retail sales tax (RST) is a consumption tax collected only at the retail level by vendors. A RST equals a set percentage of the retail price of taxable goods and services. Retail vendors collect the RST and remit tax revenue to the government.

### **Value-Added Tax**

The H-R flat tax can be considered a modified value-added tax. Hence, an examination of specific aspects of a VAT is particularly important in explaining the operation of the proposed flat tax.

#### ***Concept of a Value-Added Tax<sup>6</sup>***

A value-added tax is tax on the value that a firm adds to the product at each stage of production. The value the firm adds is the difference between a firm's sales and a firm's purchases of inputs from other firms. In other words, a firm's value added is simply the amount of value a firm contributes to a good or service by applying its factors of production (land, labor, capital, and entrepreneurial ability).<sup>7</sup>

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<sup>5</sup> For a comparison of the flat tax concept with other consumption tax concepts, see Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, 3<sup>rd</sup> ed. (Cambridge, MA: The MIT Press, 2004), pp. 233-271.

<sup>6</sup> For a comprehensive examination of the value-added tax, see CRS Report R41602, *Should the United States Levy a Value-Added Tax for Deficit Reduction?*, by James M. Bickley.

<sup>7</sup> These factors of production have specific meanings to an economist. Labor consists of all employees hired by the firm. Land consists of all natural resources including raw land, water, and mineral wealth. Capital is anything used in the production process, which has been made by man. The entrepreneur is the decision maker who operates the firm.

The prevailing procedure is to treat the purchase of capital inputs (plant and equipment) the same way as the purchase of any other input; that is, the purchase price is deducted at the time of purchase. This tax treatment of capital purchases is equivalent to expensing.

### ***Methods of Calculating VAT***

Three alternative methods of calculating VAT are 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 taxable 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. Under the *credit-invoice method*, a type of credit method, the firm is required to show VAT separately on all sales invoices. The firm aggregates all VAT shown on its sales invoices and calculates 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 taxable 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.<sup>8</sup>

### **Consumed-Income Tax**

A consumed-income tax would have a tax base that includes all sources of income but allows deductions for saving. This base would result in the taxation of only consumption. Taxpayers would deduct contributions to qualified savings accounts (equivalent to individual retirement accounts, with unlimited contributions permitted). All withdrawals from qualified savings accounts would be taxable at the time of withdrawal. Policymakers would have the option of applying a progressive rate structure to the level of consumed income. In contrast to a RST or VAT, each individual would be responsible for calculating his level of consumed income and paying his tax obligation.

## **Hall-Rabushka Flat Tax**

### **Justification**

Hall and Rabushka argue that replacing the existing individual income tax with their flat tax would be a major improvement for three reasons: the flat tax would be much simpler than the current income tax, consumption is a better tax base than income, and the flat tax would be much more efficient than the current income tax system.

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<sup>8</sup> For a comparison of the credit-invoice method and the subtraction method, see Itai Grinberg, “Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT,” presented at the American Tax Policy Institute Conference, Washington, D.C., February 18, 2009, 41 p.

*First*, Hall and Rabushka maintain that there is a need for tax simplification. They argue that the complexity of the current federal individual and corporate income tax systems results in excessive administrative and compliance costs.<sup>9</sup>

*Second*, Hall and Rabushka argue that a consumption tax is superior to an income tax because “individuals would be taxed on what they take out of the economy (when they spend money to consume), not on what they produce (reflected in working and saving).”<sup>10</sup> They claim that

By exempting investment from taxation, consumption taxes encourage investment and discourage spending. (Over time, each act of investment traces back to an act of saving; thus exempting investment from the tax base amounts to exempting saving.)<sup>11</sup>

*Third*, Hall and Rabushka assert that the current tax system results in an inefficient use of resources. They argue that their flat tax proposal would improve the allocation of resources, which would result in higher economic growth and a rise in living standards.

As will be discussed in more detail, some economists dispute H-R’s justifications for a flat tax.

## Operation

With a standard VAT, firms collect the tax and remit it to the government. The H-R flat tax is essentially a *modified VAT*. The H-R flat tax proposal breaks the VAT into two parts: “an individual wage tax” (to collect tax on wages and pension receipts) and “a business tax” (to collect tax on old capital).<sup>12</sup> The principal effects of the H-R flat tax are like those of a standard VAT. In 1995, Hall and Rabushka published the second (and most current) edition of their book about their flat tax proposal. Hence, their analysis utilizes data from 1991, and their presentation of their proposal is for 1995. From 1991 through 2008 and from 1995 through 2008, according to the Bureau of Labor Statistics, the consumer price index rose 58.08% and 41.27%, respectively.<sup>13</sup> Thus, these rises in the price level should be considered in examining the data in their proposal.

If a bill is proposed in the 112<sup>th</sup> Congress, based on the H-R concept it would include much higher “personal allowances” for taxpayers and dependences than proposed by H-R for 1995, as described in the subsequent sections of this report.

## Individual Wage Tax

The individual wage tax would be imposed on wages (and salaries) and pension receipts at a 19% rate. Part or all of an individual’s wage and pension income would be tax free depending on marital status and number of dependents. For tax year 1995, the personal allowance for a married couple filing jointly would be \$16,500 and the personal allowance for each dependent would be

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<sup>9</sup> For an examination of the administrative and compliance costs of the current income tax system and the flat tax, see William G. Gale and Janet Holtzblatt, “Measuring the Impact of Administrative Factors under Tax Reform,” *Proceedings of the 1998 Annual Conference of the National Tax Association*, pp. 341-349.

<sup>10</sup> Hall and Rabushka, p. 40.

<sup>11</sup> *Ibid.*, p. 41.

<sup>12</sup> Copies of tax forms for the individual wage tax and the business tax are shown in the **Appendix**.

<sup>13</sup> Bureau of Labor Statistics, *CPI Inflation Calculator*, available at [http://www.bls.gov/data/inflation\\_calculator.htm](http://www.bls.gov/data/inflation_calculator.htm).



\$4,500. Thus, for a family of four (husband, wife, and two dependents) the first \$25,500 in wage and pension income would not be taxed. All current income tax deductions would be eliminated including those for charitable contributions, mortgage interest, and state and local income and property taxes. An individual's Social Security contributions would not be deductible and his Social Security benefits would not be taxable. The current partial taxation of benefits for higher-income taxpayers would be eliminated.<sup>14</sup> H-R estimate that 80% of taxpayers do not run businesses, and consequently, they would only have to file this simple individual wage-tax form.<sup>15</sup>

## **Business Tax**

The business tax would be a modified subtraction method VAT at a 19% rate with wages (and salaries) and pension contributions subtracted from the VAT base. (Under a standard subtraction-method VAT, a firm would not subtract its wages and pension contributions when calculating its tax base.)

Except for pension contributions, all fringe benefits would be included in the firm's tax base. "The employer's [Social Security] contributions would be treated like other fringe benefits—it would not be deductible from the business tax."<sup>16</sup> Government employees and employees of nonprofit organizations would have to add to their wage tax base the imputed value of their fringe benefits, because activities of government entities and tax-exempt organizations would be exempt from the business tax.

All purchases of plant and equipment would be immediately expensed (deducted from gross income). There would be no depreciation expenses for previously purchased plant and equipment. There would be no recovery of cost of goods sold (existing inventory)—a firm selling off inventory would not be able to deduct the cost.

A standard subtraction-method VAT would rebate negative amounts of VAT that might occur when a firm's subtractions exceed its revenue—for example, when a firm invests a large amount but has low sales. Under the H-R business tax, any negative tax would be carried forward to the next year with interest paid on the carry-forward.

Self-employed individuals would *usually* find it advantageous to file both a business tax return and an individual tax return. From their business operations, they would be able to pay themselves a salary, and thus use the personal allowance to exclude some income from taxation. For example, a married couple operating a business could exclude up to \$16,500 in salary from taxation.

All owners of rental real estate would be required to file the business tax return.<sup>17</sup> "The purchase price [of rental property] would be deducted at the time of purchase, and the sale price would be taxed at the time of sale."<sup>18</sup>

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<sup>14</sup> Hall and Rabushka, p. 77.

<sup>15</sup> Ibid., p. 59.

<sup>16</sup> Ibid., p. 77.

<sup>17</sup> Ibid., p. 72.

<sup>18</sup> Ibid.

## Selected Policy Issues

The H-R tax presented policy issues that fall into four broad categories: broad economic issues, more narrow sectorial economic issues, simplicity and international comparisons.

### Broad Economic Issues

Broad economic issues concern the economic effects of the flat tax on the entire national economy. There are six: equity, efficiency, international trade, price level, interest rates, and revenue.

#### Equity

Policymakers are concerned about the distributional (or equity) effects of taxation; the proposed flat tax is no exception. A tax change has both a horizontal effect and a vertical effect on equity. Horizontal equity concerns the equal treatment of households with the same ability-to-pay. Vertical equity concerns the tax treatment of households with different abilities-to-pay. The most common measure of ability-to-pay is some measure of income, but some prefer a measure of consumption. Tax incidence usually is measured by using a one-year time period although a lifetime period sometimes is considered.<sup>19</sup>

#### *Hall-Rabushka Analysis*

Hall and Rabushka acknowledged that their proposed flat tax would cause some taxpayers to pay more taxes and some to pay less in the short run, but in the long run, they claimed that a higher rate of economic growth would cause many taxpayers who initially lost to eventually benefit.<sup>20</sup>

For 1991, H-R compared taxes on adjusted gross income consisting only of wage income with a hypothetical tax payments from the wage tax for a typical family (a married couple with 1.1 dependents). H-R concluded that currently the typical family with wage income below about \$10,000 does not pay significant individual income tax on that income and would pay no flat tax on wages. The typical family with wage income between \$10,000 and \$30,000 would pay less under the flat wage tax than they currently pay in income tax. But, the flat wage tax would be slightly higher on average for the typical family in the \$30,000 to \$90,000 range. The typical family with wage income over \$100,000 would pay less under the flat wage tax.<sup>21</sup>

But, H-R pointed out that there are limits to the preceding comparison.

The individual wage tax component of the flat tax, however, will raise less revenue than the personal income tax, and, correspondingly, the business tax component of the flat tax will raise more revenue than the existing corporate income tax.<sup>22</sup>

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<sup>19</sup> For a brief discussion of these equity issues, see CRS Report R41602, *Should the United States Levy a Value-Added Tax for Deficit Reduction?*, by James M. Bickley.

<sup>20</sup> Hall and Rabushka, p. 93.

<sup>21</sup> Ibid., p. 91.

<sup>22</sup> Ibid.

The comparison above only covered wage income. For 1991, the average tax rate on wage income under the flat tax would have been only 8.5% because personal allowances would have excluded one-half of wage income from taxation.<sup>23</sup> In contrast, for 1991, the average tax rate on wage income under the individual income tax was 10.4%.<sup>24</sup>

Because of the substantial data problems in attempting to measure the incidence of the flat tax compared to the current individual tax, H-R conclude that

We can't tell if there are any income groups who would pay significantly higher taxes, including the wage taxes they would pay directly and the business taxes they would pay indirectly. This group could not include the poor, who receive almost no business income.<sup>25</sup>

### ***U.S. Treasury's Analysis***

The U.S. Treasury analyzed the incidence of the proposed Armey-Shelby flat tax, which is based on the Hall-Rabushka concept.<sup>26</sup> The Treasury used a broad-based income concept called Family Economic Income (FEI): a concept that includes, for example, employer-provided fringe benefits and the imputed rent on owner-occupied housing.<sup>27</sup> In order for the Armey-Shelby flat tax to be revenue neutral, the U.S. Treasury maintained that a 20.8 percentage rate would have to be levied. The Treasury calculated the incidence of the change to the flat tax on eight different FEI classes. The Treasury concluded that only the highest income class (FEI of \$200,000 or more) would pay less in taxes; other classes would pay more.<sup>28</sup> These distributional effects are partially the result of assumptions concerning the incidence of different components of the flat tax.<sup>29</sup>

### ***Gravelle's Analysis***

Jane G. Gravelle, a Senior Specialist at CRS, emphasized that if a flat tax is passed, and the Federal Reserve did not change the money supply, then the flat tax would be shifted backwards onto owners of equities (old capital) and wage earners. Gravelle also assesses the lifetime and intergenerational incidence of a consumption tax:

The consumption tax tends to shift the burden to holders of old assets, who are likely to be old. The young tend to benefit if they are likely to do a significant amount of lifetime saving, but the young who do little lifetime saving can be made worse off if tax rates are much higher. Those who do little lifetime saving are likely to be the lifetime poor. At the same time, very wealthy individuals with accumulated assets who consistently pass on wealth

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<sup>23</sup> Ibid., p. 92.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid., p. 93.

<sup>26</sup> The flat tax proposal of former House Majority Leader Richard K. Armey would have repealed the earned income tax credit (EITC), thus the Treasury's study includes a repeal of the EITC. If the earned income tax credit (EITC) were repealed, there would have been an increase in taxes (loss in negative tax) for those who had an EITC in excess of their tax liability. Hall and Rabushka did not mention the EITC in their book, and consequently, whether or not their proposal included a repeal of the EITC is not known.

<sup>27</sup> For a definition of Family Economic Income, see U.S. Treasury, Office of Tax Analysis, "New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," *Tax Notes*, v. 70, no. 4, Jan. 22, 1996, p. 454.

<sup>28</sup> Ibid., pp. 453-455.

<sup>29</sup> For a presentation of these assumptions about incidence, see U.S. Treasury, Office of Tax Analysis, "New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," p. 453.

across the generations may also avoid the tax and may find their tax burdens lowered indefinitely compared to an income tax. Thus, these generational shifts probably contribute to a less progressive tax.<sup>30</sup>

Gravelle's analysis raises the issue of horizontal equity since the flat tax would shift the tax burden from the young to the old. It should also be noted that old capital and thus the old will bear a consumption tax regardless of whether the money supply is altered. Accommodating the tax with a price change will cause the burden to be shared by debt claimants—the cost of physical assets would rise resulting in the net of tax sales proceeds being fixed, but the purchasing power would fall and cause proceeds of both debt and equity holders to effectively bear the tax. If price is not changed, and there is no reason to believe it will be under the flat tax except for a minor revision to reflect the cost of fringe benefits, prices of goods will not rise, and the net of tax sales proceeds would fall by the amount of this tax. This tax will fall solely on equity since the value of outstanding debt is fixed. This tax could be very high for heavily leveraged assets that are recently purchased.

In summary, the current income tax system is progressive but the incidence of the H-R flat tax is uncertain. There is no general agreement concerning the vertical incidence of the proposed shift to the H-R flat tax—whether it would reduce or increase tax progressivity.

## Efficiency

In public finance, the more *neutral* is a tax, the less the tax affects private economic decisions; and, consequently, the more efficient is the operation of the economy.

For households, two out of three major decisions would not be altered by this hypothetical consumption tax. First, this consumption tax would not alter choices among goods because all would be taxed at the same rate. Thus, *relative* prices would not change. In contrast, other taxes, such as excise taxes, which change relative prices, would distort household consumer choices by encouraging the substitution of untaxed goods for taxed goods. A hypothetical income tax on all income would be neutral in this respect.

Second, a flat tax does not affect the relative prices of present and future consumption. In contrast, the individual income tax affects the relative prices of present and future consumption because the income tax is levied on income which is saved, and then the returns on saving are taxed.

A household's work-leisure decision, however, would be affected by a flat tax or any other tax on either consumption or income. Since leisure would not be taxed, any tax increase would fall on the returns to work. Hence, under either a consumption or an income tax the price of leisure is reduced relative to the consumption an individual could finance with an extra hour of labor.

For a firm, the flat tax would not affect decisions concerning method of financing (debt or equity), choice among inputs, type of business organization (corporation, partnership, or sole proprietorship), and goods to produce. Other types of taxes may affect one or more of these types of decisions.

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<sup>30</sup> CRS Report 95-1141, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, by Jane G. Gravelle.

Because consumption is a smaller base than income, to raise the same amount of tax revenue, a consumption-based tax would require a larger increase in marginal tax rates than would an income tax. Distortions caused by these higher marginal rates could offset (or even exceed) other neutral advantages of the flat tax. Hence, whether an income tax system or a flat tax system is more efficient is unknown.<sup>31</sup>

### *Savings*

H-R argue that taxing only consumption rather than all income (saving and consumption) would increase the savings rate. H-R predict that in consequence, a flat tax would cause an increase in the capital stock that would increase gross domestic product (GDP) by 2% to 4% within seven years.<sup>32</sup>

*National saving* consists of government saving, business saving, and personal saving.<sup>33</sup> Any tax increase or reduction in federal expenditures would be expected to reduce government dissaving, and consequently, raise national saving.<sup>34</sup> Thus, whether a flat tax increases or reduces revenue is relevant to its effect on national saving.

Another issue concerns the personal savings rate. But there is no conclusive theoretical or empirical evidence that a consumption tax will increase the savings rate and consequently the level of national savings. According to economic theory, a rise in the after tax rate of return would have two conflicting effects. *First*, each dollar saved today results in the possibility of a higher amount of consumption in the future. This relative increase in the return from saving causes a household to want to substitute saving for consumption out of current income (substitution effect). *Second*, a higher rate of return on savings raises a household's income; consequently, the household has to save less to accumulate some target amount of savings in the future (income effect). Thus, this income effect encourages households to have higher current consumption and lower current saving. These two conflicting effects mean that economic theory cannot determine the effects of the rate of return on the savings rate.

Highly stylized life-cycle models show that a flat tax would cause a substantial increase in the savings rate, but these models are extremely controversial.<sup>35</sup> These stylized models add a *third* effect for a consumption tax. Unlike a mere exclusion of tax on the return, the consumption tax allows an up-front deduction for savings, but requires the payment of tax on both principal and return when consumption occurs in the future. Thus, individuals need to save today to pay these taxes due in the future; they can do so while still consuming more today because of their large tax cuts. Thus, while the young may consume some part of their tax cut, the old reduce their

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<sup>31</sup> For an analysis of the efficiency of a pure consumption tax versus a pure income tax, see Jane G. Gravelle, "Income, Consumption, and Wage Taxation in a Life-Cycle Model: Separating Efficiency from Redistribution," *American Economic Review*, v. 81, no. 4, September 1991, pp. 985-995.

<sup>32</sup> Hall and Rabushka, p. 87.

<sup>33</sup> CRS Report RS21480, *Saving Rates in the United States: Calculation and Comparison*, by Craig K. Elwell.

<sup>34</sup> For an analysis of saving incentives, see CRS Report RL33482, *Saving Incentives: What May Work, What May Not*, by Thomas L. Hungerford.

<sup>35</sup> For example, see Don Fullerton and Diane Lim Rogers, "Lifetime Effects of Fundamental Tax Reform," in *Economic Effects of Fundamental Tax Reform*, Henry J. Aaron and William G. Gale, eds. (Washington: Brookings Institution Press, 1996), p. 321-352; and David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, "Simulating Fundamental Tax Reform in the United States," *American Economic Review*, v. 91, no. 3, June 2001, pp. 574-595.

consumption by much more, and the overall effect is to increase aggregate savings in the economy. But these stylized life-cycle models rely on somewhat idealized assumptions, such as all taxpayers having perfect information and certainty that the tax system will not change during their lifetimes. If these idealized assumptions are relaxed, then the results are not conclusive that switching from an income tax to consumption tax would increase savings.<sup>36</sup>

### ***Work Effort***

H-R maintain that their flat tax would reduce the marginal tax rate of most taxpayers. Taxpayers would have a marginal rate of either zero or 19%. H-R estimate that as a result, their flat tax would increase total hours of work in the U.S. economy by 4%.<sup>37</sup> Hence, “total annual output of goods and services in the U.S. economy would rise by about 3%, or almost \$200 billion.”<sup>38</sup>

Whether a revenue neutral flat tax increases or reduces a household’s marginal tax rate, it would have conflicting effects on the number of hours worked by that household. Households with a lower marginal tax rate would have an incentive to substitute work for leisure because of the relative rise in the value of work to leisure (substitution effect). Conversely, a household would have an incentive to reduce its hours worked because it needs to work fewer hours in order to achieve a given standard of living (income effect). For households with a higher marginal rate, the substitution effect would tend to decrease work effort but the income effect would tend to increase work effort. A household’s marginal rate affects its substitution effect but its average tax rate affects its income effect. Thus, as assessed by current economic theory, a flat tax could decrease, increase, or not change a household’s hours worked. In any case, many economists believe that, on the basis of theoretical considerations and empirical studies, the current income tax system does not significantly affect the aggregate number of hours worked.

### ***Investment***

H-R maintain that taxing all investment at a uniform rate would improve the efficient allocation of capital and raise the return on capital investment. The current system does have major distortions in the taxation of capital income such as the double taxation of corporate income, the preference for debt financing, and the favorable treatment of owner occupied housing. In addition, H-R cite an analysis by Alan J. Auerbach, an economics professor at the University of California at Berkeley, that the current tax system has a bias in investment toward equipment and away from structures, and consequently, eliminating this bias would raise gross national product (GNP) by 0.8%.<sup>39</sup>

H-R argue that currently tax-favored entities such as pension funds prefer investing in low risk activities often secured by readily marketable assets. H-R maintain that their flat tax would eliminate tax preferences including the interest deduction, and therefore, redirect investment into innovative enterprises based on new ideas.<sup>40</sup>

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<sup>36</sup> CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Jane G. Gravelle.

<sup>37</sup> Hall and Rabushka, p. 84.

<sup>38</sup> Ibid., p. 86.

<sup>39</sup> Ibid., p. 87.

<sup>40</sup> Ibid., p. 88.

But in response to all the efficiency arguments, it can be argued that it is not appropriate to compare a perfect consumption tax in concept with an imperfect real income tax system. There are steps that might improve the present system that stop short of a flat tax—for example, the current individual income tax and the corporate income tax could be integrated or, current tax preferences could be eliminated or curtailed, thus producing a more neutral income tax.

### ***Growth***

According to H-R,

Tax reform along the lines of our simple tax will influence the American economy profoundly: Improved incentives for work, entrepreneurial activity, and capital formation will substantially raise national output and the standard of living.<sup>41</sup>

H-R estimate that their flat tax would raise annual output by 6% after the economy has fully adjusted to the tax change which would be a period of seven years.<sup>42</sup> This 6% increase in output would consist of a 3% rise due to increased work effort and a 3% rise due to a combination of added capital formation and better entrepreneurial incentives.<sup>43</sup>

But H-R provide no model on which their estimate is based. As discussed in preceding sections, many tax economists do not believe that changes in the tax code can significantly affect either the savings rate or the work-leisure decision. Also, most capital accumulation models have a much longer period to return to steady state than seven years. For example, to increase net output by 3% through increased savings, the capital stock would have to increase by about 12%. Since the capital stock tends to grow at the growth rate of the economy—say 2% a year—the savings rate would have to nearly double for that seven-year period to increase the capital stock by that much.

### **International Trade**

The Hall-Rabushka flat tax is not border adjustable. That is, unlike a credit-invoice method value-added tax, for example, the H-R tax is not levied on all imports and rebated on all exports. Popular perception holds that this lack of border adjustability would increase this nation's balance-of-trade deficit. Economic theory, however, holds that border tax adjustments have little current effect on the balance-of-trade because the balance-of-trade is, in part, a function of international capital flows. Any changes in the product prices of traded goods and services brought about by border tax adjustments would usually be offset by exchange rate adjustments.

### **Price Level**

The H-R flat tax proposal would not require any change in the price level. Wage income and pension receipts are taxed at the individual level while capital income minus net investment and fringe benefits (except pension contributions) are taxed at the firm level. Thus, the flat tax

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<sup>41</sup> Ibid., p. 83.

<sup>42</sup> Ibid., p. 89.

<sup>43</sup> Ibid.



proposal would not *require* a change in the price level to prevent an economic contraction (unlike a VAT), except for the small effects due to taxing fringe benefits.<sup>44</sup>

## **Interest Rates**

Most economists believe that the H-R flat tax (or a similar proposal) would lower interest rates, but a minority of economists maintain that interest rates could rise.<sup>45</sup>

## **Revenue**

Policymakers are concerned about three aspects of a tax's revenue yield: adequacy, stability, and countercyclical effects.

### *Adequacy*

The H-R flat tax would replace the personal income and corporate income taxes. This drastic change raises the issue of the adequacy of the revenue yield. Revenue forecasting is, at best, a necessary but inexact government undertaking. Revenue forecasts of income tax revenues often have been too low or too high. Thus, there is a justifiable concern that in an abrupt transition to a flat tax the initial revenue yield could be far too low or too high compared with the amount forecasted. Any drastic unexpected decline or rise in tax revenue could be destabilizing to the economy.

### *Stability*

Consumption is more stable than personal income since people attempt to maintain their living standards during recessions (save less) and save more during periods of prosperity. Business income (and hence business income taxes) usually rises dramatically during an economic expansion, but usually declines precipitously during a recession. Because the flat tax excludes business income, it would result in more stable total tax revenues over the business cycle than an income tax system.

### *Countercyclical Effects*

The current income tax system is an automatic stabilizer; that is, without any discretionary action by policymakers, the income tax system tends to maintain aggregate demand in the economy (by reducing tax revenues) during recessions and curtailing aggregate demand (by increasing tax revenue) during booms. The countercyclical effects of a flat tax would be much weaker since

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<sup>44</sup> For a comprehensive analysis of this topic, see CRS Report 95-1141, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, by Jane G. Gravelle.

<sup>45</sup> For opposing views on the effect of a flat tax on interest rates, see John E. Golob, "How Would Tax Reform Affect Financial Markets?," *Federal Reserve Bank of Kansas City Economic Review*, v. 80, no. 4, Fourth Quarter, 1995, pp. 19-39; and, Martin Feldstein, "The Effect of a Consumption Tax on the Rate of Interest," Working Paper No. 5,397, National Bureau of Economic Research, Cambridge, Massachusetts, Dec. 1995, 31 p. An analysis of various factors affecting interest rate changes is presented in CRS Report 96-379, *The Flat Tax and Other Proposals: Effects on Housing*, by Jane G. Gravelle. (Out-of-print report available from CRS on request.)



revenues would be more stable over the business cycle. But the importance of these tax effects are diminished in the modern world of highly mobile capital.

## **Sectorial Issues**

As previously indicated, more narrow economic issues deal with specific industries or sectors of the total economy. Seven are discussed in the subsequent sections: differential effects on businesses, charitable organizations, housing, financial services, pensions and insurance, health care, and state and local governments.

### **Differential Effects on Businesses**

As noted previously, if there is no price accommodation, the general burden of the H-R flat tax will fall on wages and old capital. At a more discrete level, the business tax proposed by H-R would have differential effects among corporations depending on their financial characteristics and their industry.<sup>46</sup> Many large, established, slow-growing corporations with large depreciation expenses and high interest expenses would be collect much higher business taxes than they pay under the current corporate income tax. These corporations would be unable to deduct depreciation for plant and equipment purchased prior to the enactment of the flat tax. Also, they would be unable to deduct interest costs on their outstanding debt. Furthermore, existing inventory costs would not be recovered. Firms selling off inventory or selling assets would face a large tax burden especially if debt financed.<sup>47</sup>

In contrast, young, fast growing corporations with little debt and low depreciation expenses would collect less under the business tax than they pay under the current corporate income tax. All new investment in plant and equipment would be immediately expensed. Because of their low level of outstanding debt, the loss of the interest expense would be of little concern to these corporations.

H-R use examples to demonstrate that there would be a dramatic change in the amount of taxes collected by different corporations. According to H-R, in 1993, General Motors (GM) paid about \$110 million in corporate income taxes. In 1993, GM's interest expense and depreciation outweighed its new investment: GM had interest expenses of \$5.7 billion and depreciation deductions for past investment of \$9 billion but only about \$6 billion in new investment. Thus, under the H-R flat tax, for 1993, H-R estimate that GM would have remitted taxes of \$2.72 billion, over 24 times its actual corporate tax liability.<sup>48</sup>

In contrast, H-R examined the corporate income tax return of the Intel Corporation. In 1993, Intel paid \$1.2 billion in corporate income taxes. Intel had no debt and thus no interest expenses and invested heavily in new plant and equipment. Thus, under the proposed flat tax, Intel would have

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<sup>46</sup> For a comprehensive analysis of this issue, see Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: American Institute of Certified Public Accountants, 1995), pp. 125-149.

<sup>47</sup> This could be a quite a problem not only for many mature large corporations but also for many small businesses, farmers, and owners of rental properties.

<sup>48</sup> Hall and Rabushka, pp. 64-65.

remitted only \$277 million for 1993, less than one-fourth its actual corporate income tax liability.<sup>49</sup>

The elimination of depreciation expenses would create a special transitional problem. Managers of a business would be reluctant to purchase plant and equipment in the year before the flat tax would go into effect because they would be able to write off only one year of depreciation. If managers of this business simply waited a year, the entire investment outlay could be written off, that is, expensed. Hence, the approval of the flat tax could result in a sudden decline and then a sharp rise in investment after the flat tax was operational. Furthermore, managers of many existing businesses may consider it “unfair” to change the rules and deny depreciation expenses for past investment.

H-R offer, as an option, allowing managers of businesses to continue depreciating investments made before the introduction of the flat tax. This would require, however, a higher tax rate to offset the resulting loss in revenue, and there would be a reduction in economic efficiency.<sup>50</sup> But, the higher tax rate would be temporary, since depreciation expenses would diminish over time.<sup>51</sup> Furthermore, the flat tax would be more complicated if depreciation was permitted.

Also, the flat tax would eliminate tax preferences available to specific industries. For instance, oil producers currently receive a tax break on “intangibles” which allows them to write off most of their drilling costs. In addition, oil independents use the percentage depletion allowance to write off a percentage of their receipts. Thus, the oil producing companies probably would collect more under the business tax than they currently pay in corporate income taxes.

Hence, the financial structure and tax preferences of different industries would result in differential shifts in tax liabilities between the current corporate income tax and the proposed business tax.

## **Charitable Organizations**

Currently, taxpayers who itemize can deduct the value of contributions they make to qualifying charitable organizations.<sup>52</sup> The H-R flat tax would eliminate this charitable deduction which would likely cause charitable donations to decline. But H-R claim that the decline in charitable contributions would be small.<sup>53</sup> Their claim, however, is controversial.<sup>54</sup> For example, Professor Charles T. Clotfelter and Richard L. Schmalbeck estimated that the Armey flat tax proposal (which is based on the H-R proposal) would significantly reduce charitable contributions.<sup>55</sup>

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<sup>49</sup> Ibid., pp. 65-66.

<sup>50</sup> Ibid., pp. 78-79.

<sup>51</sup> Ibid., p. 79.

<sup>52</sup> For an examination of this tax preference, see CRS Report RL34608, *Tax Issues Relating to Charitable Contributions and Organizations*, by Jane G. Gravelle and Molly F. Sherlock.

<sup>53</sup> Hall and Rabushka, *The Flat Tax*, pp. 99-101.

<sup>54</sup> For an article on this issue, see William C. Randolph, “Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions,” *Journal of Political Economy*, v. 103, no. 4, Aug. 1995, pp. 709-738.

<sup>55</sup> Charles T. Clotfelter, and Richard L. Schmalbeck, “The Impact of Fundamental Tax Reform on Nonprofit Organizations,” in *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale (Washington, Brookings Institution Press, 1996), pp. 211-246.

## Housing

The flat tax would eliminate the mortgage interest deduction and the property tax deduction.<sup>56</sup> These deductions are controversial. Supporters argue that they promote home ownership and home improvement, which have positive spillover effects. Opponents argue that these preferences have little effect on the rate of home ownership and primarily benefit higher income families.<sup>57</sup> Furthermore, some critics claim that these preferences led to an overinvestment in housing. For example, the Competitive Policy Council, a bipartisan panel established by Congress, warned that Americans were hurting their competitiveness “by overinvesting in their houses and underinvesting in the kinds of new products and technologies that generate higher wages and salaries.”<sup>58</sup>

Hall and Rabushka argue that interest rates would decline, and consequently the loss of these tax advantages could be offset by homeowners refinancing their mortgages. H-R predict that their flat tax would reduce interest rates by “at least a fifth.”<sup>59</sup> H-R point out that in 1994 interest rates on municipal bonds were about one-sixth less than comparable taxable bonds. But H-R assert that taxable bonds also receive tax preferences; for example, if they are held in pension funds, the tax is deferred on interest income.<sup>60</sup> Hence, H-R assert that “interest rates could easily fall to three-quarters of their present levels after tax reform; rates on tax-free securities would then fall a little as well.”<sup>61</sup> H-R maintain that their flat tax would encourage new investment which could cause some rise in interest rates, therefore, “as a safe working hypothesis ... [they] assume interest rates [would] fall in the year after tax reform by about a fifth.”<sup>62</sup>

But their analysis did not incorporate the expanding influence of international movements of capital. Today’s capital markets are truly global. Owners of financial capital can quickly transfer their funds among countries in order to maximize their expected returns. Consequently, whether or not the flat tax would lower interest rates is unknown.

Hence, many families with large interest payments and property tax payments might be unable to continue making their mortgage payments. These families might be forced to sell their homes. Furthermore, the sudden elimination of these preferences might cause a sudden drop in the value of the average house.<sup>63</sup> A decline in housing values would be a loss for sellers but a benefit to buyers.

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<sup>56</sup> For an analysis of possible policy changes under fundamental tax reform concerning the mortgage interest deduction, see CRS Report RL33025, *Fundamental Tax Reform: Options for the Mortgage Interest Deduction*, by Pamela J. Jackson.

<sup>57</sup> U.S. Congressional Budget Office, *Budget Options Volume 2*, (Washington, U.S. Govt. Print. Off., August 2009), pp. 190-191.

<sup>58</sup> Steven Pearlstein, “Americans’ Investing Focus Faulted,” *Washington Post*, no. 284, September 15, 1995, p. F3.

<sup>59</sup> Hall and Rabushka, p. 94.

<sup>60</sup> *Ibid.*, p. 95.

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*

<sup>63</sup> For a view that argues that there will be serious effects, see Roger E. Brinner, Mark Lasky, and David Wyss, “Residential Real Estate: Impacts of Flat Tax Legislation,” DRI Analysis, Summary Prepared for the National Association of Realtors, Lexington, Massachusetts, May 1995, 19 p. Also, for a critical view of this DRI study, see Rebecca S. Schaefer, “Ganging Up Again at ‘Gucci Gulch’: A Look at the DRI Flat Tax Study,” *Issues and Answers*, Citizens for a Sound Economy, Aug. 15, 1995, 3 p.

H-R acknowledge that the elimination of interest deductions would result in winners and losers during transition. They state:

If Congress decides that a transition 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% of the actual interest payment, while the lender's taxable income should include 100% of the interest receipts.<sup>64</sup>

This transition option would grandfather in existing interest deductions; thus, borrowers would benefit at the expense of lenders. The proposal also would apply to new loans. For the housing industry, many homeowners would be protected from the forced sale of their homes, but mortgage lenders would suffer financially. Furthermore, this transition proposal would add complexity to the flat tax. It is important to recognize that part of the effect of H-R in discouraging demand for housing arises from the opportunities for a higher return from other investments.<sup>65</sup>

## **Financial Services**

The primary service of financial institutions (banks, savings & loan associations, credit unions, etc.) is intermediation; that is, aggregating funds of depositors and providing credit to borrowers by making loans or purchasing debt instruments. Core services provided by financial institutions are not identified by explicit fees. Instead these services are implicit in the interest spread between the rates paid depositors and the rates charged on loans to borrowers or received on purchased debt instruments. For an insurance company, the value-added is approximately equal to premiums received from policyholders for risk protection. But life insurance often includes a savings component, which is difficult to separate from risk protection.<sup>66</sup>

Hall and Rabushka claim that it would be easy to measure the value-added of financial intermediaries and insurance companies.<sup>67</sup> But, developed nations have found that it is so difficult to measure value-added of financial institutions and insurance companies that they generally exempt these businesses from their VATs.<sup>68</sup>

## **Pensions and Insurance**

Pensions are favored under current tax law because they are effectively tax exempt (treated on a consumption-tax basis). While firms would still have reasons to provide pensions, proposals that would extend this treatment to all investments would make pensions relatively less attractive, and might discourage their use. If some individuals now save more through a pension plan than they

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<sup>64</sup> Hall and Rabushka, p. 79.

<sup>65</sup> An analysis of this issue is presented in CRS Report 96-379, *The Flat Tax and Other Proposals: Effects on Housing*, by Jane G. Gravelle. (Out-of-print report available from CRS on request.)

<sup>66</sup> Charles E. McLure, Jr., *The Value-Added Tax, Key to Deficit Reduction?* (Washington: American Enterprise Institute, 1987), p. 135.

<sup>67</sup> Hall and Rabushka, pp. 74-75.

<sup>68</sup> McLure, pp. 135-138.

would on their own, overall savings could be adversely affected as well.<sup>69</sup> Currently tax-favored insurance policies (e.g., whole life insurance) would also become relatively less attractive.<sup>70</sup>

## **Health Care**

Under current law, there are numerous tax preferences for health care spending. The most significant is that “an individual is entitled to an itemized deduction for expenses paid during the tax year for the medical care of the individual, the individual’s spouse, or a dependent to the extent that such expenses exceed 7.5% of adjusted gross income.”<sup>71</sup> Under the H-R flat tax, all tax preferences for health care would be eliminated including the itemized deduction.

Under the H-R flat tax, firms would have less of an incentive to provide compensation in the form of health care for employees. Furthermore, individuals with catastrophic health care needs (in excess of 7.5% of adjusted gross income) would not receive a tax preference.

Hence, the H-R flat tax would tend to reduce the rate of growth in the demand for health care which in turn would lower the rate of inflation of health care services from what would otherwise occur.

## **State and Local Governments**

State and local governments would be affected by the proposed H-R flat tax. These effects fall into three categories: municipal bonds, deductibility of state and local taxes, and states’ tax structures.<sup>72</sup>

### ***Municipal Bonds***

Currently, interest on municipal (state and local) bonds is exempt from federal corporate and individual income taxes. This tax exemption has raised the market value of municipal bonds. As noted above, the effect of the H-R proposal on interest rates is disputed. But, if interest rates decline only slightly, or not at all, the H-R proposal would cause outstanding municipal bonds to decline sharply in value because of the elimination of the tax exemption.

The mere possibility of passage of the Armey flat tax plan, which was similar to the H-R proposal, reduced the value of outstanding municipal bonds at that time.<sup>73</sup> Many managers of

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<sup>69</sup> CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Jane G. Gravelle.

<sup>70</sup> For an overview of the taxation of life insurance products and life insurance companies, see CRS Report RL32000, *Taxation of Life Insurance Products: Background and Issues*, by Andrew D. Pike and CRS Report RL32180, *Taxation of Life Insurance Companies*, by Andrew D. Pike.

<sup>71</sup> For a comprehensive discussion of this tax preference, see Internal Revenue Service, *Publication 502—Medical and Dental Expenses*, 2010.

<sup>72</sup> An overview of the effects on the states of flat tax proposals is presented in CRS Report 95-1150, *Consumption Taxes and State-Local Tax Systems*, by Dennis Zimmerman (Out-of-print report available on request), and Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector* (Washington: American Tax Policy Institute, July 6, 1997), 78 p.

<sup>73</sup> Michael Stanton, “Correction for Possible Tax Reform Has Run Its Course, Managers Say,” *The Bond Buyer*, v. 313, no. 29,686, July 7, 1995, p. 7.

municipal bond funds blamed discussions about flat taxes for the negative cash flow which “plagued municipal bond funds throughout 1995.”<sup>74</sup> Thus, if the H-R flat tax becomes law, individuals owning municipal bonds may experience large capital losses. Furthermore, state and local governments may have to pay higher interest rates on new debt issues because municipal securities would no longer have a tax advantage over other debt issues.

Some economists dispute the wisdom of providing a tax subsidy to municipal bonds. Thus, the flat tax’s removal of the subsidy may be beneficial.

### ***Deductibility of State and Local Taxes***

Currently, individuals who itemize can deduct most state and local taxes. This is a form of revenue sharing. For example, if a state raises its income tax, individuals who itemize save on their federal income taxes an amount equal to their marginal federal income tax rate multiplied by the increase in their state income tax payments. The H-G flat tax would eliminate this tax preference. This tax preference is particularly valuable to high income individuals in high tax states such as New York. This tax preference has been controversial, and some tax economists have recommended that it be curtailed or eliminated.

### ***States’ Tax Structures***

Since the flat tax is a consumption tax, the federal government would be competing directly with states’ sales taxes, their primary revenue source. But most states also levy an income tax which is their second main source of revenue. States with income taxes generally base their tax bases on the federal income tax base, with slight variations. If the federal government replaces its income taxes then the continuation of current state income taxes would impose high compliance costs on individuals and businesses since these taxpayers would have to continue to calculate their income tax liabilities. States would also have high administrative costs. But states probably would react by dropping their taxes on net income and adopting a consumption-based tax that would piggyback on the new federal consumption tax base, thereby retaining the administrative and compliance benefits that flow from conforming to the federal tax base.<sup>75</sup>

## **Simplicity**

H-R argue that their flat tax proposal would reduce drastically the current complexity of the U.S. tax system. Tax preferences would be eliminated. Tax integration and simple returns would result from their consumption tax.

### **Integration and Measuring Capital Income**

Since new investment would no longer be taxed, the flat tax would also eliminate problems the current system encounters with measuring capital income: capital gains, attempts to distinguish

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<sup>74</sup> Jon Birger, “Tax Reform Won’t Do Much for State Funds, Moles Says,” *The Bond Buyer*, v. 313, no. 29,717, August 21, 1995, p. 6.

<sup>75</sup> CRS Report 95-1150, *Consumption Taxes and State-Local Tax Systems*, by Dennis Zimmerman. (Out-of-print report available from CRS on request).



between real and nominal income, depreciation procedures, and debt versus equity financing. A positive aspect of the proposed flat tax is the ease with which the individual and corporate tax systems could be integrated. Thus, a change that economists have long advocated for its economic efficiency could be accomplished in a simple way.

But it would be possible to levy a flat tax with an income base, simply by retaining depreciation and inventory accounting. The corporate and individual income tax systems could be integrated while retaining an income base—what makes integration simple is the flat rate.

### **Simple Returns and Other Simplicity Issues**

H-R emphasize that, because their flat tax system is simple, the two tax forms “can fit on postcards.”<sup>76</sup> The flat tax returns require little information and only a few simple calculations, but critics argue that there are numerous underlying complications.

Six additional issues are relevant to the complexity of the proposed flat rate tax. *First*, the current income tax system is complex. The federal tax code and the federal tax regulation are lengthy and continue to expand. Many taxpayers spend much time, money, and effort complying with the current income tax system. The complexity of the tax code and the fear of the Internal Revenue Service (IRS) have caused many taxpayers to pay for professional assistance.

Nina E. Olson, National Taxpayer Advocate, wrote the following:

- According to a TAS [Taxpayer Advocate Service] analysis of IRS data, individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code. And that figure does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the “tax industry” requires the equivalent of more than 3 million full-time workers.
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics data on the hourly cost of an employee, TAX estimates that the costs of complying with the individual and corporate income tax requirements for 2008 amounted to \$163 billion—or a staggering 11 percent of aggregate income tax receipts.<sup>77</sup>

The complexity of the income tax, however, should not be overstated. For example, for tax year 2008, the Internal Revenue Service reported preliminary data indicating that only 48.00 million returns out of 142.35 million returns were filed by individuals who itemized their deductions.”<sup>78</sup> Also, the complexity of the current tax code is partially due to attempts to achieve greater equity

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<sup>76</sup> Hall and Rabushka, *The Flat Tax*, p. 52.

<sup>77</sup> Nina E. Olson, Written Statement Submitted at the House Ways and Means Committee Hearing on Tax Reform, January 20, 2011, pp. 2-3. Ms Olson testified at this hearing.

<sup>78</sup> Internal Revenue Service, *Statistics of Income Bulletin*, v. 29, no. 3, winter 2010, available at <http://www.irs.gov/taxstats>.

or improve economic efficiency, and there are often tradeoffs between simplicity, equity, and efficiency.

*Second*, complexity may contribute to the gross income “tax gap”—the difference between income taxes owed and the amount voluntarily paid in a timely manner—which the Internal Revenue Service estimated is \$350 billion for 2001.<sup>79</sup> In addition, widespread tax avoidance reduces tax revenues which, in turn, necessitates higher tax rates to raise a given amount of revenue. But, enforcement efforts and late payments reduced the gross tax gap by \$55 billion for 2001. Furthermore, it can be argued that, in comparison to other developed nations, current U.S. tax compliance is satisfactory. Finally, a tax gap of unknown magnitude would occur under the flat tax.

*Third*, in comparison to the current income tax, a flat *rate* does little to reduce complexity because most taxpayers simply look up their tax liability in a table.

*Fourth*, it can be argued that it may be “unfair” to compare the current income tax system with some form of a “pure” consumption tax. By the time a consumption tax becomes enacted, it may become complicated, in part, because of lobbying by special interest groups. Furthermore, an initially simple tax may become complicated over time as it is revised.

*Fifth*, as an alternative to the flat tax, the current income tax system could be simplified by expanding the tax base which would require eliminating tax preferences and reducing marginal rates.

*Sixth*, the flat tax can, in some instances, be more complicated (rather than simpler) than the tax it replaces. For example, federal government employees and employees of non-profits would have to add to their wage base the imputed value of their fringe benefits.<sup>80</sup> Hence, a separate individual wage tax form would be necessary for these employees. The actual calculation of the imputed value of fringe benefits would be complicated. Another example is that H-R have not discussed tax issues concerning multinational corporations.

## **International Comparisons**

There are three major distinctions between recent consumption tax proposals for the United States 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 rather than as replacements for their income based taxes. Congressional proposals would replace our current income taxes with consumption taxes, rather than use consumption taxes as adjuncts to our current income based system. Despite what is sometimes claimed, the United States would thus be moving into uncharted waters.

*Second*, all developed nations with VATs, except Japan, calculate their VATs using the credit-invoice method. The H-R flat tax proposal, however, would use the subtraction method of

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<sup>79</sup> For an analysis of the tax gap, see CRS Report R41582, *Tax Gap, Tax Enforcement, and Tax Compliance Proposals in the 112<sup>th</sup> Congress*, by James M. Bickley.

<sup>80</sup> As already discussed, private businesses would pay the business tax on the fringe benefits of their employees except for pension contributions, which would be taxed at the individual level.



calculation for the business tax. The General Agreement on Tariffs and Trade (GATT Agreement) requires that for a consumption tax (including a VAT) to be rebated on exports, the tax must be levied on an item by item basis. Furthermore, the business tax is not levied on wage income. In contrast to most VATs, the business tax would not be border adjustable. Consequently, domestic firms would collect the business tax on their products sold domestically or exported but the business tax would not be collected on imported products. But, as previously discussed, economic theory has long recognized that border tax adjustments have no effect on the balance-of-trade because the balance-of-trade is a function of international capital flows.

*Third*, most other developed nations have much larger public sectors (government spending as a percentage of gross domestic product) than the United States. These countries offer a wider range of social benefits (such as national health care) in order to reduce inequality and lessen economic insecurity. Hence, these nations need greater tax revenues, and consequently, levy both broad-based consumption taxes and income taxes.

## Proposals During the 112<sup>th</sup> Congress

Proposed legislation including an H-R flat tax has been introduced in the 112<sup>th</sup> Congress. In addition, Republican presidential candidate Herman Cain has advocated a tax reform plan that includes a modified Hall-Rabushka flat tax.

### Proposed Legislation

Two bills have been introduced in the 112<sup>th</sup> Congress that include an H-R flat tax.

#### Representative Michael C. Burgess's Proposal

**H.R. 1040.** The **Freedom Flat Tax Act**, was introduced on March 11, 2011, by Representative Burgess and referred to the House Committee on Ways and Means and the House Committee on Rules.

This proposal would authorize an individual or a person engaged in business activity to make an irrevocable election to be subject to a flat tax (in lieu of the existing tax provisions). The flat tax was based on the concepts of the Hall-Rabushka flat tax proposal. This act would also repeal estate and gift taxes.

For individuals not engaged in business activity who select the flat tax, their initial tax rate would be 19%, but after two years this rate would decline to 17%. The individual flat tax would be levied on all wages, retirement distributions, and unemployment compensation. An individual's taxable income would also include the taxable income of each dependent child who has not attained age 14 as of the close of such taxable year.

The flat 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:

- \$30,320 for a married couple filing jointly or a surviving spouse

- \$19,350 for a single head of household
- \$15,160 for a single person or a married person filing a separate return

The “additional standard deduction” would be an amount equal to \$6,530 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

For individuals engaged in business activity who select the flat tax, their initial tax rate would be 19% (declining to 17% when the tax was fully phased in two years after enactment) on the difference between the gross revenue of the business and the sum of its purchases from other firms, wage payments, and pension contributions.

For those employees electing the flat tax, government employers and employers of nonprofit organizations would pay a flat tax on their employees fringe benefits, except retirement contributions, because activities of government entities and tax-exempt organizations would be exempt from the business tax.

Any congressional action that raises the flat tax rate or reduces the amount of the standard deduction would require a three-fifths (supermajority) vote in both the Senate and the House of Representatives. The effective date of the flat tax would be calendar year 2012.

### **Senator Richard C. Shelby’s Proposal**

**S. 820. The Simplified, Manageable, and Responsible Tax Act** was introduced on April 14, 2011, and referred to the Senate Finance Committee. This act is modeled after the flat tax proposal formulated in 1981 by Hall and Rabushka and would levy a consumption tax as a replacement for individual and corporate income taxes and estate and gift taxes. This proposal has two components: a wage tax and a cash-flow tax on businesses.

The individual wage tax would be levied at a 17% rate. The individual wage tax would be levied on all wages, salaries, pension distributions, and unemployment compensation. An individual’s taxable income would include taxable income of each dependent child who has not attained age 14 as of the close of the taxable year. 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 2012, the basic standard deduction would have been the following:

- \$26,810 for a married couple filing jointly or a surviving spouse
- \$17,120 for a single head of household
- \$13,410 for a single person
- \$13,410 for a married person filing a separate return

The “additional standard deduction” would be an amount equal to \$5,780 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

Businesses would pay a tax of 17% 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. State and local taxes (including income taxes) and payroll taxes would not be deductible.

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.

Government employers and employers of nonprofit organizations would pay a 17% tax on their employees’ fringe benefits, except retirement contributions, because activities of government entities and tax-exempt organizations would be exempt from the business tax.

This bill would be effective for taxable years beginning after December 31, 2011. A supermajority of three-fifths of the Members of the House or Senate would be required to (1) increase any federal income tax rate; (2) create any additional federal income tax rate; (3) reduce the standard deduction; or (4) provide any exclusion, deduction, credit, or other benefit which results in a reduction in federal revenues.

## **Proposal of Presidential Candidate Herman Cain**

Republican presidential candidate Herman Cain has advocated a tax reform plan that includes a modified Hall-Rabushka flat tax, which he refers to as an individual flat tax.<sup>81</sup> On one of his websites, Mr. Cain explains the essentials of his “9-9-9 Plan” as the following:<sup>82</sup>

- **9% Business Flat Tax**

Gross income less all purchases from other U.S. located businesses, all capital investment, and net exports.

Opportunity zones will offer deductions for the payroll of those employed in the zone.

- **9% Individual Flat Tax**

Gross income less charitable deductions.

Opportunity zones will offer additional deductions for those living and/or working in the zone.

- **9% National Sales Tax**

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<sup>81</sup> Two other Republican presidential candidates, Governor Rick Perry and Mr. Newt Gingrich, have proposed flat taxes that have major differences from the Hall-Rabushka proposal. Consequently, their flat tax proposals are not included in this report. An explanation of Governor Perry’s tax reform plan is included in his report titled *Cut, Balance & Grow*, which is available at <http://www.rickperry.org/cut-balance-grow-pdf/>. Mr. Gingrich’s tax reform plan is included in Part I: Legislative Proposals of his *21<sup>st</sup> Century Contract With America*, which is available at <http://www.newt.org/contract/legislative-proposals>.

<sup>82</sup> Mr. Cain’s website address is [https://supporthermancain.com/999/999\\_plan](https://supporthermancain.com/999/999_plan).

Unlike a state sales tax, which is an add-on tax that increases the price of goods and services, this is a replacement tax. It replaces taxes that are already embedded in selling prices. By replacing higher marginal rates in the production process with lower marginal rates, marginal production costs actually decline, which will lead to prices being the same or lower, not higher.

- **Economic Impact**

According to former Reagan Treasury official Gary Robbins, of Fiscal Associates, the “9-9-9 Plan” will expand GDP by \$2 trillion, create 6 million new jobs, increase business investment by one-third, and increase wages by 10%.<sup>83</sup>

Mr. Cain’s proposal would replace the individual income tax, the corporate income tax, payroll taxes, and the estate and gift taxes.

The Tax Policy Center (TPC) describes the three taxes proposed by Mr. Cain. Some excerpts from TPC’s descriptions are as follows:<sup>84</sup>

- **Business Tax:** This is a subtraction method value-added tax, sometimes called a business transfer tax (BTT). All businesses would pay a 9% tax on all sales minus purchases from other businesses (including purchases of investment goods).
- **Individual Flat Tax:** As described by Fiscal Associates, this is a version of the flat tax originally developed by Professors Robert Hall and Alvin Rabushka. The flat tax is a subtraction method value-added tax, similar to the BTT, with the exception that businesses may deduct wages paid and workers must report and pay taxes on their wages. With a single rate, however, it makes no difference whether the worker or the business remits the tax. The original [Hall-Rabushka] flat tax proposal would have allowed workers to claim exemptions for themselves and dependents, but the Cain proposal has no such adjustment. Another modification is that the Cain plan would allow individuals to deduct charitable contributions from the base of the flat tax.
- **National Sales Tax:** This is a retail sales tax, collected on sales to final consumers. It is imposed on all sales to households, non-profit institutions, and governments, as well as sales by the business activities of government and non-profits.

Mr. Cain’s tax proposal is still evolving and lacks sufficient details to make it operational.<sup>85</sup>

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<sup>83</sup> Fiscal Associates was contracted by Mr. Cain’s presidential campaign to write a report analyzing the proposed 9-9-9 tax plan. The citation for this report is Fiscal Associates, “Developing Consistent Tax Bases for Broad-Based Reform,” September 2011, 10 pp., available at [http://www.hermancain.com/docs/999\\_Scoring\\_Report.pdf](http://www.hermancain.com/docs/999_Scoring_Report.pdf).

<sup>84</sup> Tax Policy Center, *Herman Cain’s 9-9-9 Tax Plan*, October 18, 2011, pp. 1-2, available at <http://taxpolicycenter.org>.

<sup>85</sup> A citation of a recent analysis of Mr. Cain’s proposal is Edward D. Kleinbard, “Herman Cain’s 999 Tax Plan,” *Tax Notes* (Viewpoints), October 24, 2011, pp. 469-480.

## Conclusion

The President and leading Members of Congress have stated that fundamental tax reform is a major policy objective for the 112<sup>th</sup> Congress. The concept of replacing individual and corporate income taxes and estate and gift taxes with a flat rate consumption tax is one option to reform the U.S. tax system. The term “flat tax” is often associated with a consumption tax proposal formulated by Robert E. Hall and Alvin Rabushka, two senior fellows at the Hoover Institution. Two bills have been introduced in the 112<sup>th</sup> Congress that include a H-R flat tax. In addition, Republican presidential candidate Herman Cain has proposed a tax reform plan that includes a modified H-R flat tax.

The combined individual and business taxes proposed by H-R can be viewed as a modified value-added tax (VAT). The individual wage tax would be imposed on wages (and salaries) and pension receipts. Part or all of an individual’s wage and pension income would be tax free depending on marital status and number of dependents. The business tax would be a modified subtraction method VAT with wages (and salaries) and pension contributions subtracted from the VAT base. (Under a standard subtraction-method VAT, a firm would not subtract its wages and pension contributions when calculating its tax base.)

Hall and Rabushka argue that replacing the existing individual income tax with their flat tax would be a major improvement for three reasons: the flat tax would be much simpler than the current complex income tax, consumption is a better tax base than income, and the flat tax would be much more efficient than the current income tax system.

This report’s examination of the H-R flat tax proposal and their arguments supporting it looked at *four* topics: broad economic issues, narrow sectorial economic issues, simplicity, and international comparisons.

*The broad economic issues* concern the economic effects of the flat tax on the entire national economy. The flat tax would be shifted backwards onto owners of equities (old capital) and wage earners. The current income tax system is progressive but the incidence of the H-R flat tax proposal across income classes is unknown. The flat tax would reduce the tax burden on the young but increase it on the old.

Whether the proposed flat tax would be more or less efficient than the current income tax system is unknown. There is no conclusive theoretical or empirical evidence that the flat tax proposal would significantly affect savings, work effort, investment, or growth. A consumption base is neither inherently superior nor inferior to an income base.

The H-R flat tax would not be border adjustable. Current economic theory holds that border tax adjustments have little effect on the balance-of-trade because the balance-of-trade is largely a function of international capital flows.

The H-R flat tax proposal would not require any change in the price level. Most economists believe that the H-R flat tax would lower interest rates, but a minority of economists maintain that interest rates could rise.

Revenue forecasting is an inexact, if necessary, science; hence, there is a considerable concern that the initial revenue yield from the flat tax could be far too low or too high. Over the business cycle, total tax revenues would be more stable under a flat tax than under an income tax system.

*Narrow sectorial economic issues* concern specific industries or sectors of the total economy. The six microeconomic issues discussed were differential effects on businesses, charitable organizations, housing, financial services, health care, and state and local governments. Most of these discussions related to the elimination of an existing income tax preference.

The *simplicity* of the proposed flat tax is emphasized by Hall and Rabushka. A positive aspect of the proposed flat tax is the ease with which the individual and corporate tax systems could be integrated.

The complexity of the current tax code is partially due to attempts by policymakers to achieve greater equity or improve economic efficiency. In comparison to the current income tax, a flat rate, per se, does little to reduce complexity because most taxpayers simply look up their tax liability in a table. It can also be argued that it may be “unfair” to compare the current income tax system with some form of a “pure” consumption tax. By the time a consumption tax can be enacted it may become complicated. As an option to the flat tax, some observers maintain that the current income tax system could be simplified by expanding the tax base.

*International comparisons* of tax systems indicate that there are major distinctions between recent consumption tax proposals for the United States and the current tax systems of other developed nations. 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 rather than as replacements for their income based taxes. Notably, all developed nations with VATs, except Japan, calculate their VATs using the credit-invoice method. The H-R flat tax proposal, however, would use the subtraction method of calculation for the business tax. Finally, most other developed nations have much larger public sectors (government spending as a percentage of gross domestic product) than the United States. These nations need greater tax revenues, and consequently, levy both broad-based consumption taxes and income taxes.

It is worth noting that numerous aspects of the H-R flat tax proposal have not been fleshed out, and important policy issues have yet to be analyzed.

## Appendix. Tax Forms Under the Flat Tax

**Figure A-1. Individual Wage Tax**

<b>Form 1</b>		<b>Individual Wage Tax</b>		<b>1995</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 no.		
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 .....				
	(a) <input type="checkbox"/> \$16,500 for married filing jointly .....	<b>4(a)</b>			
	(b) <input type="checkbox"/> \$9,500 for single .....	<b>4(b)</b>			
	(c) <input type="checkbox"/> \$14,000 for single head of household .....	<b>4(c)</b>			
<b>5</b>	Number of dependents, not including spouse .....	<b>5</b>			
<b>6</b>	Personal allowances for dependents ( <i>line 5 multiplied by \$4,500</i> ) .....	<b>6</b>			
<b>7</b>	Total personal allowances ( <i>line 4 plus line 6</i> ) .....	<b>7</b>			
<b>8</b>	Taxable compensation ( <i>line 3 less line 7, if positive; otherwise zero</i> ) .....	<b>8</b>			
<b>9</b>	Tax ( <i>19% of line 8</i> ) .....	<b>9</b>			
<b>10</b>	Tax withheld by employer .....	<b>10</b>			
<b>11</b>	Tax due ( <i>line 9 less line 10, if positive</i> ) .....	<b>11</b>			
<b>12</b>	Refund due ( <i>line 10 less line 9, if positive</i> ) .....	<b>12</b>			

Source: Hall and Rabushka, *The Flat Tax*, p. 59.

**Figure A-2. Business Tax**

<b>Form 1</b>		<b>Business Tax</b>		<b>1995</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 .....				
	(a) Purchases of goods, services, and materials .....	<b>2(a)</b>			
	(b) Wages, salaries, and pensions .....	<b>2(b)</b>			
	(c) Purchases of capital equipment, structures, and land .....	<b>2(c)</b>			
<b>3</b>	Total allowable costs ( <i>sum of lines 2(a), 2(b), 2(c)</i> ) .....	<b>3</b>			
<b>4</b>	Taxable income ( <i>line 1 less line 3</i> ) .....	<b>4</b>			
<b>5</b>	Tax ( <i>19% of line 4</i> ) .....	<b>5</b>			
<b>6</b>	Carry-forward from 1994 .....	<b>6</b>			
<b>7</b>	Interest on carry-forward ( <i>6% of line 6</i> ) .....	<b>7</b>			
<b>8</b>	Carry-forward into 1995 ( <i>line 6 plus line 7</i> ) .....	<b>8</b>			
<b>9</b>	Tax due ( <i>line 5 less line 8, if positive</i> ) .....	<b>9</b>			
<b>10</b>	Carry-forward to 1996 ( <i>line 8 less line 9, if positive</i> ) .....	<b>10</b>			

Source: Hall and Rabushka, *The Flat Tax*, p. 59.



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