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An Analysis of the Tax Burden and Compliance Costs of the Arme-y-Shelby Flat Tax

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Representative Dick Arme-y (R-Texas) and his Senate co-sponsor Richard Shelby (R-Ala.) have formally introduced legislation that proposes to replace the current federal income tax system with a "flat tax." As proposed, the plan would set the tax rate at 20 percent for two years and then reduce the rate to 17 percent in the third year of enactment.

As Figure 1 shows, if the Arme-y-Shelby

plan were enacted in 1996, it could reduce the tax-related burden for the average taxpayer by an estimated 13.5 percent (from \$7,800 to \$6,740) and increase federal tax revenues by almost \$5 billion. The reduced burden comes from the taxpayer savings that would result from reducing the high paperwork cost associated with the income tax.

The Tax Foundation estimates that the

Figure 1
Average Total Individual Tax Burden under Current Income Tax and Arme-y Flat Tax, 1996

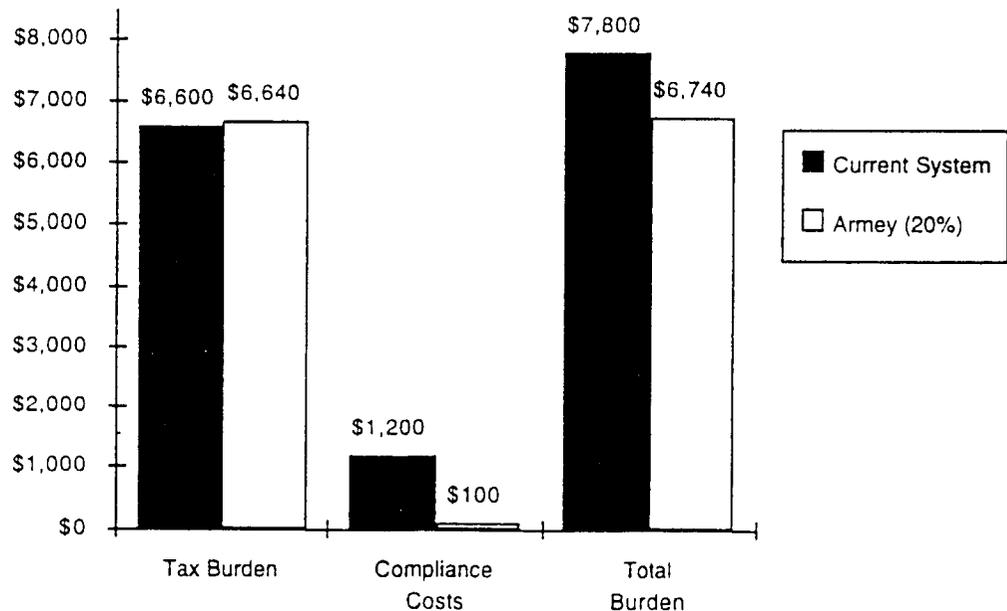


Table 1
Average Total Individual Tax Burden under Current Income Tax and Armev Flat Tax, 1996

Adjusted Gross Income	Current Income Tax System			Armev Flat Tax (20%)		
	Tax Burden	Compliance Costs	Total Burden	Tax Burden	Compliance Costs	Total Burden
\$1 under \$5,000	\$ -160	\$ 70	\$ -90	\$ 150	\$ 40	\$ 190
\$5,000 under \$10,000	-250	210	-40	470	50	520
\$10,000 under \$15,000	-150	340	190	910	60	970
\$15,000 under \$20,000	990	460	1,450	1,680	60	1,740
\$20,000 under \$25,000	2,230	590	2,820	2,490	70	2,560
\$25,000 under \$30,000	3,580	720	4,300	3,470	70	3,540
\$30,000 under \$40,000	4,950	920	5,870	5,100	80	5,180
\$40,000 under \$50,000	6,780	1,180	7,960	7,520	100	7,620
\$50,000 under \$75,000	9,770	1,630	11,400	11,460	120	11,580
\$75,000 under \$100,000	16,270	2,410	18,680	17,670	160	17,830
\$100,000 under \$200,000	27,260	4,110	31,370	27,190	250	27,440
\$200,000 under \$500,000	80,650	10,640	91,290	62,750	620	63,370
\$500,000 under \$1,000,000	225,540	25,810	251,350	142,600	1,470	144,070
\$1,000,000 or more	969,180	118,230	1,087,410	514,010	6,880	520,890
All Taxpayers	\$ 6,600	\$ 1,200	\$ 7,800	\$ 6,640	\$ 100	\$ 6,740

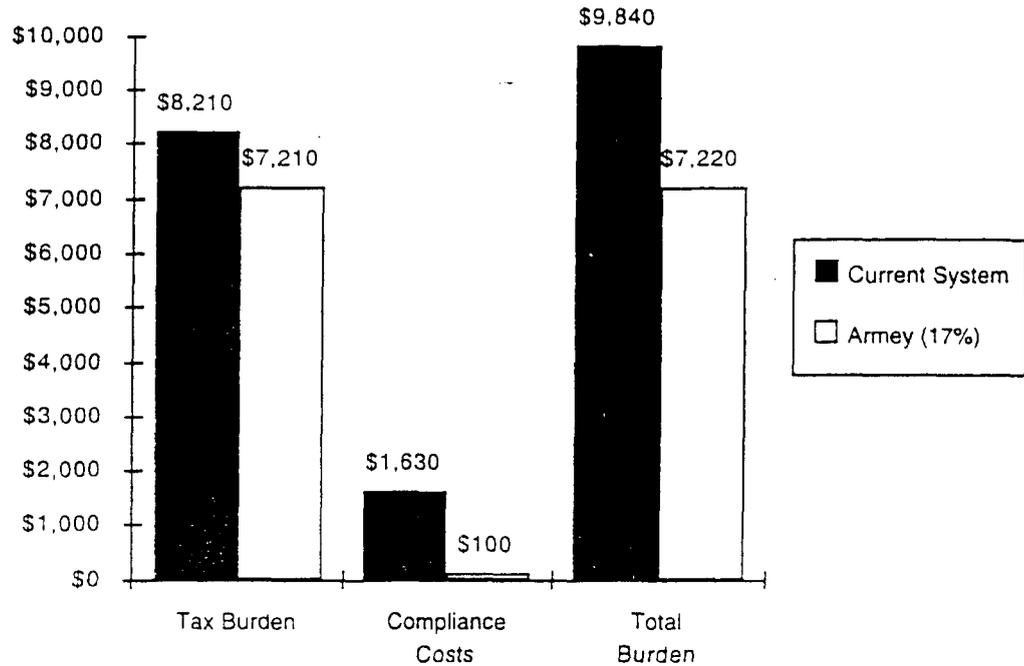
Note: Negative tax liabilities result from the refundable earned income tax credit.
Source: Tax Foundation.

Table 2
Average Total Individual Tax Burden under Current Income Tax and Armev Flat Tax, 2002

Adjusted Gross Income	Current Income Tax System			Armev Flat Tax (17%)		
	Tax Burden	Compliance Costs	Total Burden	Tax Burden	Compliance Costs	Total Burden
\$1 under \$5,000	\$ -130	\$ 70	\$ -60	\$ 120	\$ 60	\$ 180
\$5,000 under \$10,000	-210	215	-5	390	60	450
\$10,000 under \$15,000	-560	340	-220	610	60	670
\$15,000 under \$20,000	-40	460	420	1,170	70	1,240
\$20,000 under \$25,000	840	590	1,430	1,740	70	1,810
\$25,000 under \$30,000	2,250	730	2,980	2,340	70	2,410
\$30,000 under \$40,000	4,080	930	5,010	3,330	80	3,410
\$40,000 under \$50,000	5,710	1,200	6,910	5,270	80	5,350
\$50,000 under \$75,000	8,450	1,670	10,120	8,560	100	8,660
\$75,000 under \$100,000	12,940	2,430	15,370	13,520	120	13,640
\$100,000 under \$200,000	22,420	4,000	26,420	20,620	160	20,780
\$200,000 under \$500,000	68,870	10,540	79,410	50,450	350	50,800
\$500,000 under \$1,000,000	196,870	24,960	221,830	113,390	760	114,150
\$1,000,000 or more	946,760	122,640	1,069,400	441,880	3,650	445,530
All Taxpayers	\$ 8,210	\$ 1,630	\$ 9,840	\$ 7,120	\$ 100	\$ 7,220

Note: Negative tax liabilities result from the refundable earned income tax credit.
Source: Tax Foundation.

Figure 2
Average Total Individual Tax Burden under Current Income Tax and Arme y Flat Tax, 2002



Source: Tax Foundation.

cost of complying with the federal income tax system will cost individuals and businesses about \$140 billion in 1996. This high cost is tantamount to a tax surcharge on all taxpayers. A major element of the tax reform debate is the desire for a more simple tax system, and the reduced compliance costs that will accompany greater simplicity. The Arme y-Shelby flat tax could reduce the \$140 billion surcharge by 94 percent to \$8.4 billion.

The potential for such a sharp decrease in compliance costs results from the substantial change in the definition of taxable income, for both individuals and businesses, offered by the Arme y-Shelby flat tax plan. In particular, individuals, after an allowance, will pay tax only on their wage and salary income and any retirement income they receive from pension plans and individual retirement accounts. The schedule of the proposed allowances for 1996 are: \$21,400 for married taxpayers; \$10,700 for singles; \$14,000 for head of household filers; and \$5,000 for each dependent. These levels would be indexed for inflation.

To eliminate the multiple taxation of investment income, the Arme y-Shelby flat tax does not tax individuals' interest, dividend, or

capital gains income. These forms of income are taxed on the business side of the flat tax. Businesses will pay tax on the difference between the gross revenue they receive from sales of goods and services and the cost (including wages and contributions to qualified retirement plans) of producing such goods and services.

One change in the calculation of taxable income for businesses has important implications for individual taxpayers: The Arme y-Shelby flat tax eliminates the business deduction for fringe benefits, the most important of which is employer-provided health insurance. The likely effect of this tax change will be that employers convert into cash wages most of the fringe benefits they currently provide their employees.

Comparing Total Tax-Related Burdens

Table 1 provides a comparison, by income group, between the current income tax and the Arme y-Shelby flat tax, including the estimated compliance costs of each system. Because 1996 would be the first year for the

flat tax, it is assumed that only 90 percent of current fringe benefits are converted into cash wages. The tax burdens reported for both the current income tax system and the flat tax combine the direct taxes that individuals must pay the Internal Revenue Service with the burden of business taxes, which individuals also ultimately must bear. The distribution of the business tax burden here assumes that business owners and workers share the business tax burden equally, as businesses grapple with the bottom-line cost of taxation.

Business compliance costs are distributed across income groups in a manner that is identical to the distribution of business taxes. For individuals, the estimated compliance costs of the current income tax are distributed according to the average level of adjusted gross income for each income group. Individual compliance costs for the flat tax are distributed proportionately across all taxpayers.

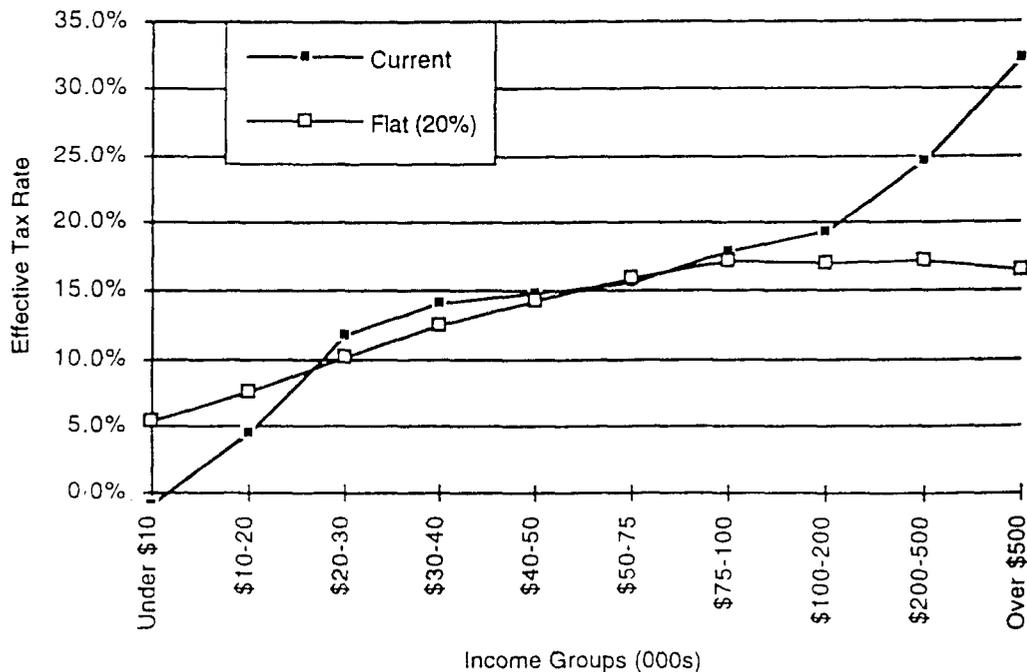
Table 2 and Figure 2 report a comparison of the current income tax and the flat tax in the year 2002. In this year, it is assumed that the flat tax is fully phased in and has added one percentage point to the economic growth rate beginning in 1997. Even with the added

growth, however, the flat tax at the 17 percent rate raises an estimated \$138 billion less than the current income tax. To raise the same amount of revenue as the income tax, the flat tax would need a rate of 19.6 percent.

However, to remedy this revenue shortfall, the Arney-Shelby legislation contains spending-cut provisions that add to the spending-cuts contained in the current budget resolution.

Figure 3 shows that the combination of lower tax burdens and lower compliance costs under the Arney-Shelby plan will provide most income groups with lower effective tax rates. The figure also shows that the flat tax creates a progressive distribution of the tax burden. However, the flat tax generates a much more proportional distribution of the tax burden than the current income tax. The major reasons for this are the elimination of the refundable Earned Income Tax Credit, which provides many taxpayers with a large negative tax liability; and the elimination of the multiple taxation of investment income — that is, capital which is initially taxed as business profits and then, after being distributed to investors in the form of dividends or capital gains, is taxed once again.

Figure 3
Distribution of Tax-Related Burden: Current Income Tax vs. Flat Tax (20% rate), 1996



Source: Tax Foundation.

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