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A Proposal to Simplify Our Tax System

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Despite recent progress in lowering rates, the tax system remains a disgrace. It is in dire need of simplification and reform. The tax system is inordinately big, filling volumes of codes, complicated by hundreds of credits, exemptions and special provisions. Many taxpayers need expensive professional help to fill out their returns. Each act of the Congress complicates the system further. Widespread evasion is apparent on interest, dividend and other forms of household or professional income. Tax shelters are commonplace. Estimates of the size of the underground economy range from tens of billions of dollars to several hundred billion. In short, we have a system that fosters contempt for the law, and simultaneously discourages productive economic activity.

We have recently worked out the details of a simple income tax, imposed at a low *uniform rate on a comprehensive measure* of income. The tax would be founded on the following principles:

1. *All income should be taxed only once*, as close as possible to its source.
2. All types of income should be taxed at the same rate.
3. The poorest households should pay no income tax.
4. Tax returns for both households and businesses should be simple enough to fit on a postcard or on a single page.

A major problem with the current system is its helter-skelter taxation of business income. Corporate income is taxed first under the corporate tax and again under the personal tax on dividends. Income from proprietorships and partnerships often evades tax, or is taxed lightly. We propose a single business tax on all types of income other than wages.

The Current Range of Rates

A uniform rate of 19% would replace the current range of rates. The current rates now stretch from actual subsidy of highly leveraged tax shelters with large interest deductions to rates as high as 80% that are imposed on income earned by stockholders.

The proposed new 19% business tax applies equally to all forms of business—corporate, partnership, professional, farm and rentals and royalties. The base for the tax is gross revenue less purchases of goods and services and compensation paid to employes. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions are permitted for depreciation, interest or payments to owners in any form.

Even for a multibillion-dollar corporation, the business tax return would fit easily on a single page. It would look like this:

1 Gross revenue from sales

Costs

2 Purchases of goods and materials
3 Compensation paid to employes
4 Other direct costs
5 Total costs (lines 2,3 and 4)
6 Net Revenue (line 1 less line 5)
7 Purchases of capital equipment and structures
8 Taxable income (line 6 less line 7)
9 Tax (19% of line 8)
10 Tax carry-forward from losses in previous years
11 Net tax (line 9 less line 10)
12 Tax payment (amount on line 11 if positive)
13 Carry-forward to next year (amount on line 11 if negative)

porate income tax in 1980 of $64 billion. Despite a much lower tax rate, the extra revenue comes from the much wider tax base, including unincorporated business, and from taxing business income at the source.

Under the simple tax system, all business income would be taxed only once, at its source. Household receipts of interest, dividends and capital gains would be after-tax income. Though wealthy households might receive large amounts of these types of income, it is important to understand that the taxes on such income have already been paid. Taxing business income at its source has the important practical benefit of taxing the large amounts of interest and dividend income that escape taxation under the current system.

With comprehensive taxation of business income, taxation of capital gains should be eliminated at the level of the individual. The value of a security or other interest in a business is the capitalized value of its after-tax income, and so already embodies the appropriate tax when business income is taxed at its source.

000A Individual Compensation Tax 1981

1	Compensation (including fringe benefits) as reported by employer	1
2	Other wage income, including pensions paid directly by employer	2
3	Total compensation *(line 1 plus line 2)*	3
4	Personal allowance	
	(a)☐$5,000 for married filing jointly	4(a)
	(b)☐$3,000 for single	4(b)
	(c)☐$4,500 for single head of household	4(c)
5	Number of dependents, not including spouse	5
6	Personal allowances for dependents *(line 5 multiplied by $600)*	6
7	Total personal allowances *(line 4 plus line 6)*	7
8	Taxable compensation *(line 3 less line 7)*	8
9	Tax *(19% of line 8)*	9
10	Tax withheld by employer	10
11	Tax due *(line 9 less line 10, if positive)*	11
12	Refund due *(line 10 less line 9, if positive)*	12

Individual tax returns would fit on a postcard.

In place of the hodge-podge of investment incentives in the tax system now, we propose the use of straightforward first-year write-off of all business investment. First-year capital recovery is a great simplification over the complicated depreciation deductions and investment credits in present law.

The net revenue of U.S. business in 1980 was $803 billion. Under the new business tax we are proposing, capital recovery allowances would have been $317 billion, leaving net taxable business income at $486 billion. A tax rate of 19% would have yielded $92 billion; that would be about half again the revenue from the actual corporate income tax in 1980 of $64 billion.

Our simplified tax system also includes a comprehensive tax on the earnings of individuals.

Most income in the U.S. is compensation for work. In the proposed tax, compensation is broadly defined as anything of value received by workers from employers, including cash wages and salaries, the market value of fringe benefits and contributions to public and private pension plans.

A Set of Personal Allowances

To limit the tax burden of poor families, we propose a set of personal allowances. Taxes would be 19% of compensation in excess of the following allowances:

Married Couple	$5,000
Single	3,000
Single head of household	4,500
Each dependent	600

Except for the personal allowances, no deductions of any kind would be permitted, including interest deductions.

The individual tax return for the compensation tax would look very much like the illustration accompanying this article. It would fit on a postcard.

In 1980, total compensation in the U.S.—including fringes and pension contributions—was $1,596 billion. We estimate that personal allowances in 1980 would have been $420 billion, leaving taxable compensation of $1,176 billion. At a rate of 19%, tax revenues would have been $223 billion. By comparison, the personal income tax in 1980 yielded about $255 billion.

At the outset, the simple income tax, with common flat rates of 19% on business income and compensation, would raise revenue equal to about 12% of GNP, the same as the current combination of corporate and personal income taxes. Though our system would stabilize revenue as a fraction of GNP, it would probably produce more revenue than the government needs to maintain existing programs.

Low marginal tax rates would draw economic activities from the underground economy into the formal market, where they are recorded as part of GNP. Businesses and individuals would spend less time worrying about the tax consequences of their actions and concentrate instead on earning higher incomes. On these grounds, we believe that the revenue needs of the federal government could be met with tax rates as low as 16% or 17%, rather than the 19% needed to reproduce current revenue at current levels of GNP.

The benefits of tax reform are not merely economic. The complexities of the federal tax system now foster contempt for government and make petty criminals out of a large fraction of the population. A simplified tax with low marginal rates would help restore confidence in government and would support the basic honesty of the American people.

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