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For the Intelligent Investor

Answers to questions you may not even know you have.

Taxes—Choose Your Poison: Old Tax Return versus Proposed Tax Return

This essay was originally published in Muhlenkamp Memorandum Issue 53, January 2000. Steve Forbes was campaigning to be the Republican candidate for president. One of his campaign promises was to reform the federal income tax, replacing it with a "flat" tax of 17%. Forbes proposed a similar tax plan in his 1996 bid for president (which Ron discusses in "Why I Like the Flat Tax," April 1996). The twist here is that Forbes now proposes to let the taxpayer choose which income tax return to use.

Below we have printed the tax return you would have to file should Steve Forbes be elected president and get his programs enacted. When you have completed your tax return for 1999, you might want to fill out the form to determine the difference in dollars, time, and frustration between his proposal and our current system.

Figure 7.1 Proposed Flat Tax Form for 1999 Individual Wage Tax 1999

- | | |
|--|----------|
| 1. Wages & Salary | 1. _____ |
| 2. Number of adults in family | 2. _____ |
| 3. Number of children in family | 3. _____ |
| 4. Deductions for adults
(multiply line 2 by \$13,000) | 4. _____ |
| 5. Deductions for children
(multiply line 3 by \$5,000) | 5. _____ |
| 6. Total deductions
(line 4 plus line 5) | 6. _____ |
| 7. Taxable income
(line 1 minus line 6) | 7. _____ |
| 8. Tax (multiply line 7 by 17%) | 8. _____ |



I have been a fan of Mr. Forbes's flat tax proposal since he first proposed it, partly because I believe it will foster economic growth (for the reasons I gave in last quarter's essay, "Prosperity"). But even I was surprised when I heard Steve's response to presidential candidate Gary Bauer in a recent debate. Mr. Bauer took Steve to task for dropping the mortgage interest deduction and the charitable gift deduction in his flat tax proposal. Steve replied, "We'll give you the choice, file either the flat tax form or the old 1040 forms complete with the mortgage deduction and the charitable deduction. The taxpayer can file whichever one he/she chooses." Now I've known for a long time that Steve's program would allow you to do this, and that individual choice and responsibility are at the core of all his programs, yet I was surprised when I heard a presidential candidate say that an individual taxpayer could calculate his or her taxes in multiple ways and choose the lesser tax rather than the greater tax, as is now often required.

That Steve Forbes should be the only one of six Republican candidates (all of whom favor some tax cuts) who would allow the taxpayer this choice speaks volumes about how far we are from understanding what makes a free economy work. And it means that I must find better ways of explaining the ideas in my essay "Prosperity."

Editor's Note

When Steve Forbes offered the taxpayer the choice of which tax form to use, he sent a clear, if surprising, message. He was saying it's okay if the taxpayer chooses to pay lower taxes. It seems like a rash suggestion. After all, the government needs tax revenue to function. However, he was just taking the work incentive argument to its logical conclusion. By allowing people to choose, he was placing top priority on fostering work incentive. If people work more, the economy grows. Therefore, even at lower tax rates, the government will collect higher tax revenues.

Forbes withdrew from the presidential race in February 2000. With the end of his campaign, the national spotlight moved away from the flat tax. However, its supporters remain. They are encouraged not only by the attention Steve Forbes brought to the issue in 1996 and in 2000, but also by the gains the flat tax has made outside of the United States, particularly in the former Soviet bloc countries. Estonia established a flat tax in 1994; Latvia in 1995; and Russia in 2001. Ukraine and Slovakia each adopted a flat tax in 2003.

"A key factor driving all of these countries to adopt radical tax simplification and a lowering of rates is tax evasion. They were simply unable to collect sufficient revenue under their formerly complex, high-rate tax systems. In every case, implementation of a flat tax caused collections to rise, as the benefit of evasion was reduced. (If the top rate is 50 percent, failing to report \$1 of income saves you 50 cents in taxes. But if the rate is only 13 percent,



as it is in Russia, evasion saves you only 13 cents—no longer worth the risk of getting caught for many evaders.) According to Hoover Institution economist Alvin Rabushka, inflation-adjusted personal income tax revenues in Russia rose 28 percent the first year the flat tax was in effect, and 21 percent the following year. So far this year (2003), real revenues are up about 17 percent. Revenues were flat or falling before the flat tax was imposed.”¹

¹ “Flat Tax Comeback,” by Bruce Bartlett, National Review Online, November 10, 2003.

