

MuhlenkampMethods

For the Intelligent Investor

Answers to questions you may not even know you have.

Why I Like the Flat Tax

This essay was originally published in Muhlenkamp Memorandum Issue 38, April 1996. It was an election year, and Steve Forbes was making his first bid for president. He promised to energize the American economy by implementing a 17% "flat" tax (dubbed the postcard tax because it would be so simple, the tax form would fit on a postcard). This brought the idea of a flat federal income tax into the national spotlight.

The first reason I favor a flat tax is because I just did my taxes. Despite my being fairly knowledgeable about taxes and my having a fairly simple tax return, it took me the better part of a day to do it. This day's work produced nothing of value to me, to the government, or to anyone else. It didn't affect what I earn or what I pay in taxes. It was simply the time I spent in calculating the tax. And I am not alone.

Figure 6.19 Proposed Flat Tax Form -- 1996

Form 1		Federal Income Tax		1996
First Name	Last Name	Occupation	Social Security Number	
First Name of Spouse (if applicable)	Last Name	Occupation	Spouse's Social Security Number	
City		State	Zip Code	
1. Wages, Salary and Pensions			1.	
2. Personal allowance			2a.	
a. \$25,200 for a married couple filing jointly			2b. -----	
b. \$13,100 for a single person			2c. -----	
c. \$17,200 for a single head of household			3.	
3. Number of dependents, not including spouse			4.	
4. Personal allowance for dependents (line 3 multiplied by \$5,300)			5.	
5. Total personal allowances (line 2 plus line 4)			6.	
6. Taxable wages (line 1 less line 5, if a positive number; otherwise zero)			7.	
7. Tax (17% of line 6 -- multiply line 6 by 0.17)			8.	
8. Tax already paid			9.	
9. Tax due (line 7 less line 8, if positive)			10.	
10. Refund due (line 8 less line 7, if positive)				

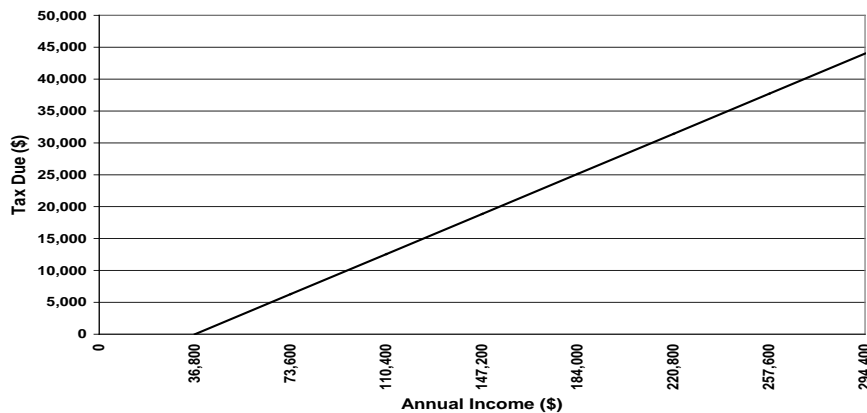


The Tax Foundation estimates that in 1994, individuals spent more than 1.8 billion hours and businesses spent more than 3.6 billion hours preparing tax returns. At the simplest level, the IRS notes proudly that it should take taxpayers “only” two hours and 42 minutes to complete the 1040EZ. The instructions for the 1040EZ are 36 pages long. Had we a flat tax, I could have filled out the Proposed Flat Tax Form in 10 minutes.

The second reason I like a flat tax is that it isn’t flat. The sales tax is a flat tax. In Pennsylvania the state sales tax rate is 6%. Someone who buys a Cadillac for \$30,000 pays 6% or \$1,800 in tax, twice the \$900 paid by someone else who buys a Chevy for \$15,000. Those who spend more pay more in taxes, at a directly proportional rate. The real estate tax is a flat tax. Each homeowner in an area pays the same rate on the appraised value of their house. Those who live in larger houses pay proportionately more.

But the flat income tax form, previously illustrated, has personal allowances on which the taxpayer pays no taxes, making it a progressive or graduated tax. A family of four with an income of \$36,800 pays no tax. A family of four with an income of \$73,600 would be exempt from paying tax on the first \$36,800, and pay 17% tax only on the remaining \$36,800. This works out to 8.5% of their total income. Similarly, a family of four with an income of \$110,400 would pay 17% on \$73,600; or 11.33% of the total, and so on; see Figure 6.20.

Figure 6.20 Results of Flat Tax on a Family of Four



Source: Muhlenkamp & Company, Inc.



But the main reason I like a flat tax is the same reason the politicians don't. When the rules are clear, it's hard for the public to cheat. It is also more difficult for the politicians to write rules making it legal for parts of the public to pay less taxes without cheating. Two hundred years ago, the authors of the *Federalist Papers* warned:

It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood.

The warning remains valid!

The sales tax is simple and straightforward in its calculations. Few people cheat on their sales tax. Real estate taxes are straightforward. Attempts to pay less real estate taxes usually focus on the appraisal, which is the part of the calculation where judgment is involved. But, when tax laws are complicated (the Federal Income Tax Code is over 10,000 pages), it pays to hire lawyers to find exceptions in the law. When tax laws are complicated, it pays to hire politicians to write exceptions into the law.

Following are several common objections to the flat tax.

- The rich won't pay enough taxes.

Folks, the truly rich don't need taxable income, they have assets. They can either live off their assets or invest in municipal bonds, which are exempt from income taxes. Income taxes don't tax the rich; income taxes tax those who are trying to get rich.

- High-income people won't pay enough taxes.

When Ronald Reagan was elected president, the top marginal tax rate was 70%. Because of the rate, many high-income people used various schemes (tax-sheltered investments, salary deferral plans, etc.) to lessen the tax bite. One day I asked two doctor clients how much time they spent being doctors and how much time they spent avoiding taxes. Their response: "We spend about a day a week avoiding taxes." What an incredible waste of time and talent.

After Reagan lowered the top tax rate, the tax avoidance schemes no longer made sense. So the doctors went back to being full-time doctors. They made more money and as a result paid more in taxes than they did before the Reagan tax cuts. So did a lot of other highly productive people, which gave us the strong economy of the 1980s. This strong economy produced tax receipts to the U.S. Treasury much higher than those of the pre-tax-cut era.

Similarly, when the minimum rate on capital gains was 20%, we told our clients to ignore taxes in their investing. More recently, with the help of George H. W. Bush's and Bill Clinton's tax increases,



ordinary income rates have climbed to 39.6% and capital gains rates are 28%. As a result, high-income earners and investors have modified their behavior, and U.S. economic growth has slowed.

- Losing the mortgage deduction will result in a decline in the value of housing.

Pure nonsense! Losing the mortgage deduction in concert with making interest income tax free would cause mortgage rates to fall to the level of municipal bond rates. The reason mortgage rates are so high is because the people who receive the interest must pay taxes on it. This same argument was made before Reagan cut tax rates. House prices didn't fall, but mortgage rates did.

- People will have less incentive to give to charities.

More nonsense. People give to charities because they believe in the charity and because they have the money, not because of the tax deduction. The same argument was made concerning the Reagan tax-rate cuts in the early 1980s. To my personal knowledge, M.I.T., Penn State, and Duquesne University each started aggressive multiyear fund drives in the early 1980s. The response was so good that each reached their original goals well ahead of schedule and increased their targets. Charitable giving as a whole reached an all-time high in the 1980s.

To find out how easy the filing of a flat tax can be, I encourage you to fill out the proposed flat tax form (see Figure 6.19) using your 1995 income. If you are interested in the views of others on the subject of flat tax, you may find one or more of the following books useful:

Flat Tax Primer: A Nonpartisan Guide to What It Means for the Economy, the Government—and You, by Douglas Sease and Tom Herman of *The Wall Street Journal*.

The Flat Tax: Freedom, Fairness, Jobs, and Growth, by Daniel Mitchell of the Heritage Foundation.

The Flat Tax: A Citizen's Guide to the Facts, by Dick Armey, House Majority Leader.

Unleashing America's Potential, by the National Commission on Economic Growth and Tax Reform.

