
The Case for a Flat Tax

Dick Armey

Texas Republican Dick Armey, majority leader of the U.S. House of Representatives, grew up on a North Dakota farm. When he first ran for Congress in 1984, he was an economics professor and department head at the University of North Texas in Denton. He holds a bachelor's degree from Jamestown College, a master's degree from the University of North Dakota, and a Ph.D. from the University of Oklahoma.

As the 1994 election approached, he announced that he was running for majority leader—even though his party wasn't yet in the majority—and has been in the position ever since.

Representative Armey spoke to a November 1999 Center of the American Experiment forum, one of a series led by Distinguished Senior Fellows Vin Weber—who once called Armey a one-man think tank in cowboy boots—and Tim Penny on issues raised in the Minnesota Policy Blueprint, published by American Experiment in early 1999.

When I got this invitation to speak, I was scared that y'all wanted me to tell you what Minnesota's taxes should be, and I didn't really want to do that. I'm from a right-to-work state where we don't have an income tax, and I think you all up here ought to leave it just the way it is. We'll welcome as many of you as we can to Dallas.

In Texas, we're very proud that we don't have an income tax, and we seem to get along just fine without it. Some states have both an income tax and a sales tax. An interesting experiment is going on right now in Tennessee, which has a sales tax and no income tax. The governor is trying to move away from the sales tax and into an income tax, and is having a little bit of trouble.

Too Many Squawks

In 1994 I found myself fed up with the federal tax system and decided that somebody had to do something to change it. I spent six months, from January to June, studying the options. I wanted to go back to the fundamentals, and I started with this premise: irrespective of your political philosophy, government is necessary.

Next, governments must fund themselves, and the way they do it is to levy taxes. There ought to be some governing principles by which taxes are levied, like Adam Smith's axioms of taxation in *Wealth of Nations*, and I started to reiterate some of them, and to mix them up with my own thinking.

I would argue that a tax code has no legitimate objective other than to raise money. Any other purpose is a corruption—corruption being, in my mind, using an instrument for a purpose other than that for which it is intended. I get that from my grandpa, a carpenter. A hammer is for hammering, a saw is for sawing; you don't use your tools for purposes other than what they're intended for or you wreck the tools. So I reject using a tax code for the purpose of either social engineering or income redistribution.

My favorite tax axiom from *Wealth of Nations* is that as you raise money through a tax code, you should strip the down off the goose with the least amount of squawking. Today, we spend more time, energy, and resources complying with our federal income tax code than what is spent on the production of every car, truck, and van produced in the United States. That's

too many squawks. We have something like, I believe, \$200 billion worth of compliance costs because our tax code is so complex.

In 1998 the IRS hot line gave out over 8 million wrong answers. The Clinton administration's reaction was to have the IRS answer the phone on Saturday, too. It struck me that that was a fairly inadequate response. One definition of insanity is doing more of the same thing and expecting a different result.

The fact of the matter is, our tax code is incomprehensible. Every year, *Money* magazine gives a set of tax data to forty preparers, who arrive at forty different answers—and the IRS can never say which is the right one.

Obviously, when you've got that much confusion, that much compliance cost, that many hours of energy spent complying with the tax code, you are stripping the down off the goose with too many squawks. We ought to avoid that; it ought not to be a miserable, painful experience.

Our tax code as we know it today is also anti-family—it causes you to hate your brother-in-law. You know that your brother-in-law has some tax gimmick that he's using but not telling you about it. We have a sense of distrust, suspicion, envy, resentment born out of these complexities. Everybody's got a break but me, right? This is a high motivation to cheat.

Cheating on taxes is encouraged by the complexities in two ways. First, there is a tendency for people to believe that there's a break in the tax code for everyone but me; therefore,

I'm justified in giving myself a break. The second common impulse is that taxes are so complex, no one can figure them out anyway, so cheaters won't be caught. Someone who feels justified and doesn't anticipate getting caught is more likely to do the wrong thing.

The final fundamental that I went back to is the fact that all taxes are paid by people, and all taxes are paid out of income. This takes you back to Economics 101—probably one of your favorite courses—when you differentiated between assets and cash flow. The fact of the matter is, you're going to pay your taxes each year out of your flow of income. No matter how you disguise it, it's going to be people paying taxes.

It's on that basis that I maintain a strong predilection for the income tax as opposed to a sales tax or many other taxes. It keeps the structure of your tax code tied to the fundamental truths of income, earning, and tax payment.

Simple, Visible, Neutral, and Fair

Next I set some requirements for a tax code.

Taxes should be simple and obvious to the people who pay them. People who are paying a share of the cost of government should be able to see clearly and precisely what their share of the cost of government is.

The current tax code is a complex exercise in government by disguise; it's a deceptive government practice. We structure taxes in such a way as to give you the illusion that people other than yourself—businesses, foreigners—are paying the taxes. These illusions in the

tax code create in a lot of people a sense of free ridership.

From my point of view as a conservative free-market economist who believes that the government that governs least governs best, these deceptive government practices built into the tax code give people a predilection to vote for more big government, because they think they're getting it for nothing.

So, taxes should be simple, obvious, and visible. In fact, in my first iteration of the flat tax in 1994—it was really a reiteration; I didn't invent it, I just rediscovered it—one of the things I thought about and one of the things I'm now going back to is to cancel withholding. I want you to sit down at your kitchen table on the first of every month and as you write checks for your Sears bill, your electric bill, your house payment, I want you to also write a check to the federal government. I want you to realize each and every month, inescapably, that you pay more in taxes than you do for food, shelter, and clothing combined.

One spring my son said to me, "Hey, dad, I've got great news. I'm getting a check from the IRS!" I saw my son, the apple of my eye, whom I had raised the best I could—though he had not realized his full potential to resent the government—liking the IRS. That was because of the system of withholding, which makes taxes invisible.

And I want the tax code to be neutral. I don't want anybody to base either a family decision or a business decision on tax law rather than on family values or economic and financial considerations. On the family side,

the most obvious thing is the marriage penalty. Here's our social engineering: a home mortgage deduction so you'll be encouraged to buy your own home, and a marriage penalty so you'll live in it out of wedlock. Does that make sense? Both are unjustified.

Should you make a decision about where to invest your capital, about whether to save, consume, or invest, or about how to invest, based on the tax code or on the economics of the propositions in front of you? It is wasteful and inefficient to base those decisions on extraneous considerations.

I want a tax code to be fair, and this is the big challenge that I face as an advocate of a flat tax. I'm challenging America to accept what I will characterize as an American definition of fairness. We Americans are like a bunch of economists on the question of fairness. We know it, understand it, and love it in theory, but we don't want to see it in practice. I'm really trying to force this issue.

Is it fair, Mr. and Mrs. America, to treat everybody exactly the same as everybody else? That's what I insist on in the flat tax. We should have a tax code that gathers every dollar's worth of income that is brought into the economy in any annual accounting period and taxes it one time—and one time only—at the exact same rate as every other dollar's worth of income. There should be no differentiation based upon the manner in which that income is earned, whether it's through the provision of labor or the provision of capital.

I am offended by some of the artificial constructs that have so much currency in today's political discourse, like the false distinction between earned and unearned income. The fundamental definition of that is, if you earned it the way I did, it's earned; if you earned it another way, it's unearned. When you accept as the definition of fairness treating everyone the same, then you're saying capital earnings are taxed one time and one time only. No double taxation: no capital gains tax, no death tax. This offends a lot of people.

The single rate is important. If you want to eliminate complexity, you must have a single rate; much of the complexity comes from the notion of multiple rates. Sam Donaldson just couldn't grasp this. I said, "Sam, since you make ten times as much money talking about what I do as I make doing it, you should pay ten times as much in taxes as I do." That's fair.

Finally, the tax code should not discourage economic growth. The current tax structure, with its double taxation, discourages the two driving engines of growth, savings and investment.

Rediscovering the Flat Tax

As I was establishing these principles, I looked at everything that was out there at the time. In 1994 there was the Nunn-Domenici plan, and after about a month and a half of studying it, I concluded that nobody understood it, including Nunn and Domenici. This plan isn't long for this earth, I thought to myself, and it wasn't.

The other idea that seemed to have a lot of legs under it—a lot of people were and still are talking about it—is a national sales tax as a substitute for a national income tax. For a variety of reasons, I rejected the idea of a national sales tax. I would characterize it today as the most multifaceted pipe dream in current, ongoing public policy discourse. I see advocacy of a national sales tax as a reincarnation of that fellow who used to travel through Kansas with a wagon full of bottles that would cure your ingrown toenails, make your hair grow back, take care of black leg in the herd, and help you find oil on your land. There are zillions of false promises, none of which comply with empirical observation about what's really happening in the world.

Ultimately, I found myself being led back to rediscovery of the flat tax as created by Professors Hall and Rabushka at the Hoover Institution in the early 1980s. I ran for Congress arguing for the flat tax in the middle 1980s. And then tax reform in 1986 put a damper on everybody's spirits.

One of the things I also realized recently is that it doesn't matter under this current system whether you increase taxes or decrease taxes; either way, you make the code more complex. We have to get away from that.

Here's the structure I put together, basically following the leadership of Hall and Rabushka. A family takes its total earnings, deducts a generous family allowance, multiplies the remainder by 17 percent, and that's its tax liability. You know what your taxes are, and you know what your brother-in-law's taxes

are. No gimmicks for you, no gimmicks for him. No itemized deductions. No death taxes, no capital gains taxes. We don't tax your interest earnings, so if you happen to be a saver, you can do whatever you want with your IRA.

If you're a business, you take your total earnings, your total gross receipts, deduct your legitimate business expenses, including both capital and inventory, to get to net earnings, then multiply that by 17 percent, and you pay your gross business taxes. That is the tax on the contribution that comes from capital. When after-tax business earnings are distributed, we don't tax them a second time.

A lot of people are unhappy about that; they think somehow that's giving a break to the rich. But today, without basis adjustment, people actually pay capital gains taxes on what are, in fact, capital losses. We talk about a preferential capital gains tax rate without ever acknowledging the empirical fact that today we have a prejudicial capital gains tax rate under the best of circumstances. We're just trying to get to neutrality.

Will It Happen?

A flat tax fulfills all my requirements for a tax system. But can I pass it into law?

I sat down and looked at what I had in 1994—we opened the debate on June 17 with a Wall Street Journal editorial—and I knew that I had to be prepared to spend the next ten years of my life talking to America about this.

There is a very large, well-funded, highly focused coalition of forces opposing the flat tax. I call them the

tax complexity professionals, and a great many of them make their living in Washington, D.C.—the only city in America that makes its living off the rest of the nation. When America beats Washington, we will make the flat tax the law of the land.

How long will it take to get this done? The advent of the Republican majority helps some, but I think it's going to take a Republican president with a Republican majority to complete the job. I was brought to this realization when I was sitting in the White House in 1995. President Clinton got excited about reducing the capital gains tax—you could see his energy—and all of a sudden, Vice President Gore literally pulled him back in his seat and said, in rather disciplinary terms, "Mr. President! That's Democrat theology." It struck me that the two objectives of current tax policy—income redistribution and social engineering—are instrumental to the Democratic Party's conceptual framework. The objectives of a flat tax are not going to be embraced by the Democratic Party.

Will it get done by 2004? My wife and I sat down and talked it over. Susan has never wanted me to be in Congress—to this day she doesn't want me to be in Congress—but we agreed that I would not retire until we make this the law of the land.

I told that story to Dick Gephardt, and the next day I had ninety-four Democratic cosponsors!

Newt Gingrich and I were wondering about it, and Newt was saying that "by 2004" is a lot of time. "Well,

Newt," I said, "it's really more of a worry to you than it is to me, because between now and then might come the Rapture, in which case you'd have to do it on your own."

We try to have a little fun, and we keep working on it.

Following his talk, Representative Arme y talked with American Experiment senior fellows Tim Penny and Vin Weber and took questions from the audience.

Tim Penny: I want to pick up where you left off in terms of the politics of this and talk more specifically about the stars that need to align in the presidential election and the way this issue plays out in this year's campaign. And what groups might help deliver more congressional support, particularly across party lines?

Dick Arme y: I think there are fans of the notion in both parties. There are two sources of confusion out there, one political and one substantive. The first is Steve Forbes picking up the flat tax and running with it in 1996, and he's running with it again. There's a tendency for people to say that Forbes ran on the flat tax and didn't win with it. I would argue that he did better than anybody should have expected him to have done because he was running on it. He did particularly well in Florida and Arizona, among senior citizens, precisely because of that.

But it complicates the matter, just because no candidate wants to appear to be emulating another candidate's

position. From the point of view of national public policy discourse, I felt that Forbes pushed it out front too early. One of Armeý's axioms is that you never put a good idea in harm's way, and, of course, politics is very harmful to good ideas.

The substantive factor is that there are a lot of people who are enamored with the idea of a national sales tax. So you find yourself in this contest: flat tax or sales tax? I know I want to get rid of what I've got, but which do I want? Eventually we're going to have to force this issue through the legislative process, and the question is who comes to the floor with a proposition on which more people are more afraid to go home having voted no than to stay in Washington having voted yes. My job is to build that momentum.

Vin Weber: Let me raise a question that a lot of people raise when they talk about this. People are pretty sympathetic, I think, to the philosophy you laid out, and generally to the idea of lower taxes and flat taxes. But I often hear from people that we got rid of most of the loopholes and cut the rate down to 28 percent back in 1986, and a few years later the loopholes were still gone but the rate started moving right back up again.

Why should we not have that same concern about the flat tax—especially since you're going to retire right after it's enacted and there will be no one to protect it?

Dick Armeý: You are right to raise this issue, and what happened in 1986 is very instructive for us. This is not a policy for the timid; you do the whole

thing or you don't do it at all. If you do it halfway, you'll be back in the same loop. I'm very stubborn about this.

People say they love the flat tax, but they all want their favorite little provision, the most popular of which is the home mortgage deduction. It's like saying you want to go to heaven, but you don't want to die. We've got to kill this code altogether, and that means everything dies with it.

Now, you ask yourself, do you want a new tax code in which you don't need the cherished home mortgage deduction, or is the home mortgage deduction an essential part? You can't do it halfheartedly. A home mortgage deduction is not necessary or productive in the flat tax world, and it's the first string by which you'll unravel any gain you make. And then, too, we build in a requirement for a two-thirds vote of both the House and the Senate for increasing the rate, lowering the family deduction, adding a second rate, or restoring any of the exemptions.

Since I brought up the home mortgage deduction, let me just remind you of a couple of things. An amazingly small number of tax filers—something like 17 percent—claim the home mortgage deduction, but what struck me as most remarkable is that less than 50 percent of home owners file the home mortgage deduction. So, in fact, it's not prevalent.

My brother-in-law immediately started to whine about his home mortgage deduction, and I told him to try it for himself. File it today's way and then file it my way, and see if you're not better off.

Tim Penny: Would you talk about the distribution of the tax burden under your approach as compared to current law, and factor in as a secondary question how the payroll tax would shift the relative burden?

Dick Arme y: The payroll tax, of course, is neutral. We don't touch that.

Right now, contrary to popular mythology, the overall burden of the income tax is borne by the highest income groups. The flat tax would take away all of the loopholes, and the tax burden on the highest income groups with the most complex income structures would increase. Take about 10 million low-income Americans off the tax rolls on the bottom end, and you get to a configuration where you have to be at around 50 percent or more of your income in the 28 percent bracket or higher with a lot of itemized deductions in your current filing in order to be a loser. Almost without exception, if you file with a standard deduction today, you gain in the flat tax world.

The other thing that happens is that the flat tax does away with the earned income tax credit. That takes out a lot of complexity and enforcement effort, but it will be attacked from the left as an increase in taxes on the poor. The attack is going to focus on the question of whether it is fair.

John Shriner: I have a slightly broader question. The presidential candidates spend all their time telling us what cookies they're going to give away, buying votes, and they say nothing about the responsibilities that ought to be the individual citizen's.

Years ago, Governor Rockefeller of New York talked about the insatiable demand for government services. Our unique governor has been doing that: He spoke tartly to a single mother at a rally on the Capitol steps. And in out-state Minnesota, he has said that the state will help with the farm crisis, but farmers have to pick up and help themselves.

Why don't the presidential candidates talk about more than cookies?

Dick Arme y: It's hard for me to explain what presidential candidates do. I've never been a fan of politics—sooner or later, it makes a horse's rear out of everyone.

Candidates work hard at complying with public expectations. The Clinton administration has its finger on the pulse daily with the highest technology possible. In one sense, we really do have a representative government. At the outset of the last presidential election, the issue wasn't the president's character but the character of the American people, who said the president's behavior was acceptable to them.

What you and I demand from candidates, as constituents whose votes they seek, defines them more than they will define themselves if we leave them to their own devices. Their job is to find out who we want them to be and be that person. That's what they do. I don't say it's dignified, but that's what politics is all about.

Jerry Teeson: What happens to the gas tax and the other taxes that we pay if we adopt a flat tax?

Dick Arme: Just reforming the income tax and making it an honest, fair system is job enough. The flat tax is not designed to take care of anything else.

There's a fellow down in Houston who says that if you'll just accept his 25 percent national sales tax, you can get rid of all other taxes. By the time you get to the truth of that matter, it would probably be a 30 percent national sales tax.

We also need to make the effort to hold certain revenues to their dedicated purposes: highways, Social Security, airports. When we have a gasoline tax that is used for road construction, we are getting the discipline back in the system that holds those revenues to their dedicated purposes. If we do that, we will suffer the dedicated tax with some degree of—what should I say?—voluntary compliance. But if you feel your gasoline taxes are being squandered on everything but roads, you resent them.

Elwood Caldwell: Under the flat tax that you propose, what would be the effect on municipal bond interest, both on municipal fund-raising and on those who have structured their retirement income or their estates around that tax exemption?

Dick Arme: Municipal bonds would lose their current advantage. The differential between munis and corporate bonds would disappear, and they would arrive at a bond rate that is more comparable to today's muni rate. The Kansas City Federal Reserve did a study: the flat tax would give you a 25

percent reduction in interest rates.

I believe that that would cause municipalities to be much more disciplined and discerning in terms of the areas they fund, because without the bonus points, their projects would have to be more rigorously justifiable to bond purchasers in contrast to alternatives. People will buy some bonds out of a sense of civic responsibility and duty, but I think the long-term result would be enhanced discipline in municipal decision making.

Jim Van Houten: I think the incremental tax rate is somewhere between 25 and 30 percent, which means, because people in Minnesota can deduct their state income taxes to calculate their U.S. taxes, that people in Dallas and other taxpayers are paying between 25 and 30 percent of Minnesota income taxes. What do you think would happen to the differential between state income tax rates if there were no longer a deduction for state income taxes?

Dick Arme: I'm not sure what to tell you. That's simply not a problem I've studied from an empirical point of view, or even speculated about.

Vin Weber: You'd certainly put pressure on states like Minnesota to shift their funding to property taxes and sales taxes and other sources of revenue, wouldn't you?

Dick Arme: Again, I don't know. The federal income tax deductibility of state income taxes really is just that spoonful of sugar that you expect to make the medicine go down. We in

Texas might bemoan the fact that we can't deduct state income tax at the federal level, but nobody will stand up and scream against replacing the sales tax with an income tax faster than a Texan.

Joan Calott: When the Democrats take a position or attack a position—on tax fairness, say—they seem to stay on message. They have one voice, they are well-researched, and they put their proposition across to the people over a period of time. The Republicans, on the other hand, don't ever seem to be on message. They back off very quickly, and they seem not to have any PR support to their message whatsoever. If you want this program, don't you have to learn to get together and sell it?

Dick Arme y: There's some good news and some bad news in your observations, none of which do I argue with. Republicans tend to be free thinkers. We're pretty independent-minded people. Trying to round up Republicans is like trying to keep cats on a flatbed truck.

Tim may see it differently, but it appears that the Democrats tend to be more conforming. I'm not sure that it always feels that way in the Democratic Party.

Tim Penny: It's easier for us to put together coalitions because, since we believe in more government, everybody gets a piece.

Dick Arme y: That's interesting, because John Kenneth Galbraith—I can't spend an hour and a half in a public forum without saying something

disparaging about John Kenneth Galbraith—wrote so disparagingly about what he called bureaucratic symbiosis. Well, the Democrats managed somehow to create that, so that the different factions in your alliance will bend to agree with each other. We don't do that. We're always at each other's throats. We aren't as bold and premeditated about our politics as the Democrats.

Tim Penny: The Contract with America was pretty bold and premeditated.

Vin Weber: On tax policy, I think your observations are right, but it falls somewhat short of an absolute law of nature. In 1980, Ronald Reagan and the Republican Party were very united and pretty successful in marketing the Kemp-era tax cut, which, in fact, became law. There was a big effort there. There were economists who were supportive, were organized for it, and there was a big marketing effort. Jack Kemp had been talking about it for four years. So it's not impossible.

Dick Arme y: Jack Kemp and others talked about it, and it got legs under it when a president was pushing it. That's what you need. But in the end, the idea is bigger than the man, bigger than the moment, and if the idea is right, it will prevail eventually. But it will take discipline and hard work to get it done, because the forces of resistance—well-funded, highly motivated, highly focused people—defend the established order.

Tim Penny: Another Texan was strong for the sales tax and then

ultimately cobbled together the 1999 tax reduction package, but Chairman [Bill] Archer of the Ways and Means Committee is going to be heading home after this term in Congress. How about the next chairman?

Dick Armey: Well, we don't know who that next chairman will be, and it's not altogether clear that Chairman Archer might not be in some high and strategically placed position.

Tim Penny: Another Texan at Treasury? Is that what you're suggesting?

Dick Armey: It could happen. But while I didn't create the flat tax, I was the guy who brought it back to the national debate. I have a responsibility to the idea. One of my jobs now is to find a way to convince America to stop this flirtation with the national sales tax. And especially Republicans. I don't want Republicans advocating a national sales tax because when somebody wants to have both, sometime in the future, I don't want my party being quoted as saying this is such a hot idea. The biggest worry is that you get both. We can't have both.

Catherine Besonen: You talked about the family allowance. What factors would determine the family allowance? Would it be graduated based on income or a flat amount?

Dick Armey: Once you build the structure, the tax rate and the family allowance are where you make adjustments. We combined the 17 percent rate with a family allowance structured to get rid of the marriage penalty. The numbers are something like \$12,200

per individual, \$24,400 for a married couple, and \$5,500 per child. It turns out that a family of four gets, I think, \$35,400.

The idea was that you have to give the individual, the married couple, the family an allowance that is realistically aware of their obligation to the family first. And try to hold that at an amount that would enable you to set the tax rate at something less than 20 percent. You adjust those two factors within the structure. And you eliminate bracket creep and the marriage penalty.

Vin Weber: This whole question about what we should do with the tax code, like a lot of other big questions—Social Security and things like that—becomes more meaningful in this apparently daunting era of budget surpluses. I'm told that it's entirely conceivable that the next estimate could show us with three and a half, four trillion dollars in surplus. That's a huge increase, even from the numbers we're talking about right now. We may have the option of doing various things that we ought to do anyway but doing them with less pain than might be attached to them if we had to cope with a deficit. This idea that has been around for a while and that you've been promoting single-handedly might just accelerate faster than a lot of people think.

Tim Penny: I buy into that. Based on everything that's happened since the attempt at tax reform and simplification in the mid-1980s, we know that whether taxes are going up or down, every tax bill just seems to add layers of complexity to the system.

Two key issues that would broaden the support for a flat tax, particularly among Democrats, are fairness in terms of relative tax burden and how this interplays with payroll taxes. The payroll tax is a regressive tax—it falls most heavily on low-income workers because it hits everyone from the first dollar. Whether the family deduction or other exemptions at the front end help to compensate for that is another mathematical equation you're going to have to build into this plan in order to bring more Democrats on board.

Dick Armev: With respect to the payroll taxes, it's time for us to decide

whether these are in fact retirement assessments that are going to be connected to and tied to your investments, or if we are just going to put them down as a tax. That is another important question, and one we will address.

The relative share of the tax burden as it falls in different income categories is always going to be a tough problem. In the end, on the fairness question, you will either be for the flat tax or against it based upon whether or not you find this an acceptable definition of fair. That's going to be the final bridge for all of us. n