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SUBJECT: MAXTAX or Alternate Maximum Tax Proposal

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I. Background

More than a decade after passage of the Tax Reform Act of 1986, fundamental tax reform remains a national agenda item. It remains so because a growing number of economists, lawmakers, and taxpayers view the current tax system as inequitable, inefficient, administratively complex, and a hindrance to economic growth. They believe the U. S. income tax system is fundamentally flawed, and cannot be fixed by partial reforms or code modifications. What is needed, they argue, is a shift in the basis of taxation, from the current multi-rate income tax to a single tax rate that applies to income from all sources.

Broadening the tax base and switching to a simple flat-rate tax, it is argued, reduces the complexity and unfairness resulting from the many exemptions, credits, loopholes and deductions of the current income tax system, and permits a lower single tax-rate. Compliance costs are thereby reduced, and the present disincentives to investing and saving are removed. Economic growth is encouraged through greater saving and the enhanced reward for work.

As one might guess, the switch to a consumption tax is not seamless. There are, for example, critical dislocation and transition issues to address. Ronald Pearlman, in *Economic Effects of Fundamental Tax Reform*, September 1996, points out that elaborate transition rules are part and parcel of every major tax bill. As discussed in greater detail below, transition provisions dealing with the treatment of "old capital," is necessary if "fairness" is to be preserved. There are also important concerns as to the effect of a switch on the housing sector, financial institutions and charitable organizations.

To a large extent, Stephen Moore's "Max Tax or Alternative Maximum Tax" (MAXTAX) proposal is a way of side stepping these complex transitional issues. To bridge the transitional gap, he simply allows taxpayers to self-elect whether to be taxed under a flat tax rate or the current income tax structure. As he states, "every taxpayer can choose between the current income tax system *or* an alternative post maximum tax with a flat rate of 25 percent of gross income." (CATO, "The Alternative Maximum Tax," January 28, 1997).

Under Moore's proposal, gross income is defined as the sum of wages and salaries, pensions, capital gains, dividends, interest income, gifts and bequests, and government benefits. This income definition is similar to the one used in the Arme-y-Shelby Flat Tax proposal, but unlike the latter, the MAXTAX allows a credit for payroll taxes. In the proposal, corporations are also permitted to choose between the 25 percent flat tax and the current corporate rules. Wages, dividend payments and capital expenditures are credited against revenues in arriving at corporate

taxable income. Corporations, however, must comply with the current "alternative minimum tax." rule.

II. Policy Issue

The simplicity of the MAXTAX choice is extremely appealing and is attracting a growing number of supporters. In fact, the virtues of the "Alternative Maximum Tax" are extolled in a recent editorial article of the *Wall Street Journal* (November 25, 1997). It is presented as the practical solution to the current impasse on tax reform and the way of installing a national consumption tax.

The key issues for policymakers are: (a) Will the MAXTAX proposal live up to its supporters' claims and, (b) Are there substantive drawbacks with implementing an "Alternative Maximum Tax" scheme. The next section addresses these twin questions as the Pros and Cons of the MAXTAX proposal are discussed.

III. Policy Implications of MAXTAX Proposal

From Stephen Moore's perspective, the MAXTAX is the mechanism by which we move to a flat tax. Thus, the benefits to be derived from the MAXTAX are the same as those ascribed to the flat tax. And, since the arguments favoring consumption taxes are well known, they are not rehearsed here. Instead, the following five topics are discussed: (1) Tax simplification and administration costs, (2) Transitional problems, (3) Stability of tax rates and revenues, (4) Equity issues, (5) The effect on state and local governments.

A. Tax Simplification and Administration Costs

There is little doubt that the touted "single-page" MAXTAX filing form is less complicated for those electing to file under this alternative. That does not mean, however, that the filing process itself is simplified, or the cost of administration is less. First, for many individuals, they do the calculations at least twice in order to establish which tax approach produces the smallest tax liability. Depending on their sources of income, additional calculations may occur as taxpayers contemplate the how the decision impacts future tax years. As discussed below, state income tax considerations may solicit still more calculations.

Second, and perhaps more importantly, the cost of administrating two taxing systems can not be less expensive than tracking one. For example, fairness dictates that both groups of taxpayers face the same auditing and compliance procedures. Providing this parity merely complicates and increases tax administration costs. Joel Slemrod, *Economic Effects of Fundamental Tax Reform*, provides a crude measure of this higher cost. He calculates that total administrative and compliance costs for the personal and corporation income taxes are about \$75 billion. Adopting a flat tax could reduce those costs by one-half, or conversely adding it to the current system could add an additional \$37.5 billion.

Third, the requirement that taxpayers who elect to use the 25 percent flat tax option must stick with it in subsequent filings, only intensifies the monitoring and compliance aspects of tax administration. This also raises the question as to what happens when a person changes their marital status. For example, in the case of divorce can the individuals elect to return to the income tax, or are they simply stuck with the early decision regardless of their changed circumstances. Last, because earnings, dividends, and interest income are taxable *only* at the individual level, the matching of 1099s and other disclosure filings is critical. There are significant problems with the current system in this regard and the cost and importance of improving this process should not be minimized.

B. Transitional Problems

As noted above, the MAXTAX in essence ignores the question of transitional equity. That is, the inequities that arise from changes in tax laws. To illustrate the point, under the flat tax, all new savings are deductible and the entire amount of any savings withdrawals or proceeds from asset sales are taxed. Hence, there is no need to distinguish between principal and interest or between gains and basis. Under the current income tax, a distinction between gains and basis is maintained because only the former is subject to taxation. Thus, if an individual elected the 25 percent flat tax, viewed from an income tax perspective, these assets are overtaxed because the gain as well as the basis is taxed. These assets are also overtaxed from the flat-tax perspective, since no deduction was received when the original investment was made. Thus, without transitional relief, "old capital" is penalized under the 25 percent flat tax.

A similar problem arises with respect to the 25 percent flat tax option for corporations. A Corporation with large depreciation deductions would not opt for the flat tax due to its larger tax liability. Further, it would stick with the corporate income tax unless they received a "transition basis deduction" for their remaining basis. A new corporation, on the other hand, faced with the same capital outlays would in all likelihood elect the flat tax, since capital investment is expensed under the latter tax. Once again, "old capital" is penalized.

Sidestepping these transitional equity issues has its advantages. First, as Stephen Moore stresses, the inherent complexities in fashioning transition rules have stymied efforts to initiate a consumption-based tax. Second, while horizontal inequities would exit, individuals and corporations are able to elect the most advantageous tax alternative. In this regard, their tax liabilities may be reduced, but they are no worse off under the MAXTAX than under the income tax. Third, denying transition relief to owners of "old capital" reduces the transitional cost to the treasury thereby facilitating a lower single tax rate.

C. Stability of Tax Rates and Revenue

An obvious question to raise is what effect does the MAXTAX proposal have on tax revenues. Unfortunately, there is no discussion of this important fiscal issue, and it is unclear if the proposal is revenue neutral. The omission under cuts the merits of the proposal and must be addressed.

There are serious revenue problems with MAXTAX, even if we assume that the 25 percent flat-rate tax is revenue neutral. This occurs because the tax base is unstable and the flat-tax rate must be adjusted to maintain a given level of tax revenue. If the MAXTAX supporters are correct, each

year the number of individuals and corporations electing the flat-tax grows. Taxpayers make the switch to the flat tax, it is argued, because it is simple to calculate and it reduces their tax liability. The tax savings, however, reduce the revenue yield to the treasury below the level projected with the income tax. To compensate for the reduced yield, marginal income tax rates and/or the flat-tax rate must be raised. Since the revenue shortfall is known only after the fact, rate adjustments are made the following year.

The foregoing disequilibrium condition has some additional ominous implications. Given that individuals must stick with the flat-tax option once it is selected, annual adjustments would be strongly resisted. In essence, they undercut the individual's original decision and are contrary to the flat-tax principle. If this is true, the additional revenue must come from higher rates on the income tax filing group. Of course, with each additional increase in the income tax rates, the more attractive the 25 percent option becomes to those remaining in the income-filing group. This in turn results in shrinking pool of income taxpayers upon which the marginal rates can be raised. Thus, tax rate and revenue stability is a significant problem irrespective of the revenue-neutral question.

D. Equity Issues

Similar to the tax revenue issue, no serious attempt is made at examining the distributional or equity implications of the MAXTAX. It is suggested, however, that by providing a credit for the "regressive payroll tax" the MAXTAX "lowers the marginal tax rate for virtually all taxpayers." The latter statement is a slight overstatement, but it is largely correct. In 1994, 68.3 percent of the federal income tax filers had an AGI of less than \$100,000 (*Statistical Abstract of U.S.*, 1997, Table 532). With the payroll tax applicable to earnings up to \$62,000, the lion-share of these taxpayers would thus benefit from the MAXTAX. This still begs the question, however, of the affect of MAXTAX on the distribution of tax liabilities.

An overall indication of the equity effects of the MAXTAX is provided in a recent study by the U. S. Treasury Department (*Tax Notes*, January 22, 1996). The study estimated the revenue and distributional impacts of the Arney-Shelby Flat Tax proposal. As noted previously, the MAXTAX is very similar to the latter proposal. The Treasury found that replacing the current individual and corporate income taxes (including the EITC) and estate and gift taxes with a revenue-neutral 20.8 percent flat-rate tax essentially benefited upper income families. More specifically, families with incomes of \$200,000 or more would enjoy a 28.1 percent reduction in federal income taxes whereas families with incomes less than \$200,000 would experience an increase in their federal taxes ranging from 70.7 percent to 5 percent. Based on this finding, the rich will opt for the flat rate and the poor will stick with the income tax. As discussed above, the payroll tax credit to some extent mitigates the Treasury's projected increase, particularly for those with income less than \$35,000.

E. Effects on State and Local Governments

The foregoing discussion essentially dealt with the direct effects of the MAXTAX on individuals, corporations and the treasury. State and local governments are also impacted by the MAXTAX since 36 states use the filer's federal tax return for computing state income taxes. More

specifically, 25 states use adjusted gross income (AGI), eight states use federal taxable income (TI), and three states use federal tax liability for determining state income tax base.

The MAXTAX option has a two-fold impact in these states. First, the tax base for the state income tax is dramatically altered by this change. For those electing to file under the 25 percent flat tax their state liability is increased since previously untaxed sources of income are now taxable and previously excludable deductions are non-deductible. The final revenue impact depends on the number of individuals filing under the option and the extent to which their taxable incomes change. Second, the gain to the state is obviously a loss to individual taxpayers. In response, disenchanted tax taxpayers in states like Minnesota and South Carolina (TI based states) with relatively high marginal tax rates may pressure state legislatures to restructure their rates and brackets. The dual filing system also introduces horizontal inequities, which further complicates the issue for state policymakers.

As a method of dealing with these complications, states may move to adopt their own definition of AGI or TI. In doing so, they undermine a major advantage of the linked state-federal definitions for income tax bases-administrative efficiency. Thus, the simplicity gained at the national level may be offset to some degree by greater reporting requirements at the state level.

Finally, if the interest on tax-exempt bonds becomes taxable, states and local governments will bear part of that cost. In the long run, their cost of borrowing will rise since the preferential treatment of government bonds is removed. The effect of this change on national revenues is a bit fuzzy since individuals with large holdings may not opt for the MAXTAX.