

House Budget Committee Hearing on Tax Reform
Congressman Michael C. Burgess
Prepared Testimony
October 6, 2004

First, I want to thank Chairman Nussle for holding this important hearing today. As a long-time supporter of fundamental tax reform, I believe that this is one of the most important issues that Congress will face in the next few years. I would also like to thank the Chairman for the opportunity to testify before you to explain my voluntary flat tax proposal.

Ten years ago, when I was a private citizen living in North Texas, I thought the flat tax made a lot of sense. It meets the criteria by which all tax systems should be evaluated - it is fair, simple, transparent, and efficient, thereby promoting economic growth today. I will discuss how the flat tax meets each of these important criteria, but first I would like to explain how the Freedom Flat Tax works.

The Freedom Flat Tax Act

In April 2003, shortly after coming to Congress, I introduced H.R. 1783, The Freedom Flat Tax Act, which would establish a voluntary flat consumption tax. It is simpler, fairer, more transparent and more efficient than the current income tax code. The flat tax concept is simple - there are two components, the individual wage tax and the business tax.

Individuals pay a flat rate on their wage and pension income, and there will be no deductions. H.R. 1783, however, would allow for the following personal exemptions:

- \$24,600 for a married couple filing jointly;
- \$15,700 for a single head of household;
- \$12,300 for a single person; and,
- \$5,300 for each dependent.

A family of four, for example, would not be subject to the flat tax until their combined income reached \$35,400, which is 194% above the 2002 federal poverty level of \$18,244. Thus, the flat tax system is slightly progressive because the exemptions ensure that lower wage earners do not pay any federal tax until they reach a certain threshold, after which they pay the flat rate of 17%.

It is important to note that the marriage penalty is repealed under the flat tax because the exemption for a married couple filing jointly is twice that of a single person.

Businesses would pay a flat rate on the total costs of taxed inputs subtracted from total sales; only employee wages and pensions will be tax deductible - this ensures that income is only taxed one time. Under H.R. 1783, both the business and individual tax rates are 19 percent, but would decline to 17 percent after the initial two years of participating.

Unlike past flat tax proposals - The Freedom Flat Tax Act allows taxpayers to choose if and when to opt into a flat tax system. That is because I do not believe that we should penalize those who have made investments based on the market-distorting tax code. It would be like changing the rules in the middle of the game. My flat tax plan allows taxpayers to transition to the flat tax system on their own timetable.

Now that I have explained the mechanics of my flat tax proposal, I'd like to discuss the advantages to the flat tax system. Why would anyone want to opt into the flat tax system?

Fair

First, it is fair – no matter how much money you make, what kind of business you are in, or whether or not you are married, you will be taxed at the same low rate as every other taxpayer.

The tax code should strive to be fair both vertically and horizontally. The flat tax system has vertical fairness because it taxes everyone at the same rate, while ensuring that the tax burden does not fall too heavily on lower wage earners.

The tax code should also have horizontal fairness, and that is best illustrated by what I call the “Clinton paradox,” which I encountered in 1993. 1993 was the year that Congress increased the tax rate, retroactive to the first of the year. By some quirk of fate, former President Clinton and I earned almost an identical amount that year. But when it came time to pay to the federal government, President Clinton paid just over 20 percent, and I paid over 30 percent. Why should such a discrepancy exist? What is the benefit for the country when we are taxed at different rates on exactly the same income? Currently, simplicity and fairness in taxes are sacrificed for the sake of pursuing a social agenda.

But a social agenda is not the purpose of the federal income tax code. That is why the Freedom Flat Tax Act does not allow credits or deductions, which means that people who earn the same wages pay the same amount in taxes, thus the flat tax has horizontal fairness.

Congressman English's Simplified USA Tax, however, does allow deductions for home mortgage interest, charitable donations, and secondary education. My concern is that allowing deductions now allows additional deductions in the future. Look what has happened since the 1986 tax reform, during which a large number of deductions were repealed. Over time, many of those deductions have been restored, which has added complexity to the code.

Simplicity

A major advantage of the flat tax is its simplicity – a tax system so simple that you can understand it without a CPA. By eliminating tax credits and deductions, abolishing multiple layers of taxation, and eliminating the complex depreciation schedules for businesses, the flat tax will simplify the tax code. The flat tax will allow families and businesses to take back the more than 6 billion hours per year that they currently spend to

comply with the income tax. Some simple arithmetic is all that is needed to determine your tax liability each year. The flat tax has the ability to give time back to families because it is easy to understand and easy to comply with.

The Simplified USA Tax, by contrast, is more complicated than the flat tax for individual taxpayers because it allows several deductions and has several tax brackets.

The FairTax, on the other hand, is very simple for individual taxpayers - after they get over the sticker shock - but is extremely onerous for businesses, especially small businesses. That is because the Fair Tax would require small businesses to become the tax collector. I am concerned that this would serve as an additional tax on mom-and-pop shops and would discourage entrepreneurs from starting new small businesses.

Transparent

It is important that the tax system be transparent - otherwise the government can easily raise rates, as they have done in Europe with the VAT tax. With a flat tax, you will easily be able to tell how big a bite the federal government takes out of your income each year. After some simple and brief subtraction, you simply pay 17% percent of your wages above your personal exemptions. And because everyone pays the same rate, it would be obvious to all Americans if it was raised.

The FairTax, in contrast, is less transparent than it would appear at first glance. Although the FairTax would be separately stated on each receipt, to determine your total federal tax liability, you'd have to add up all your receipts from the whole year. That means saving receipts from every trip to the grocery store for milk, every latte from Starbucks, every newspaper, or magazine, etc.

Efficient/Pro-Growth

An efficient tax code is one that does not cost a lot. The current system is clearly not efficient - according to the CATO Institute, collecting the income tax costs the federal government 10-20% of all tax revenue collected. That is a lot of deadweight in the tax code.

The flat tax will encourage economic growth by easing the burden on the taxpayer and entrepreneurs by reducing the cost and time spent on tax forms. A flat tax would be much less costly, saving taxpayers more than \$100 billion per year and reducing tax compliance costs by over 90%, according to one estimate by The Tax Foundation, a non-profit, non-partisan 501(c)(3) educational organization. This savings will give people and businesses more money to spend, ultimately boosting take-home pay, spurring the economy and creating jobs.

The flat tax will especially benefit small businesses, which today create the majority of new jobs and account for half of the economy's private output, by allowing for major simplification and the immediate expensing of capital equipment.

Multiple layers of taxation on savings and investment discourage taxpayers from adding to the capital stockpile for our economic engine. The flat tax encourages economic growth by ensuring that income is only taxed one time.

I would like, at this point, to raise my concern that under the FairTax there is a very real possibility that business purchases would be double taxed. The FairTax would ostensibly give businesses a rebate on business-to-business purchases in order to avoid double taxation, but the rebate would be very difficult to implement. Businesses, like individuals, would have to save all of their receipts - for everything from office supplies to raw materials - every year. Most large companies would not be hurt by this requirement; it would be the Main Street businesses to suffer. These are the same mom-and-pop shops that would now have to collect taxes under a national retail sales tax.

Perhaps my most serious concern with the FairTax is that it would discourage economic growth. By only taxing new goods, the Fair Tax creates an incentive to purchase used goods. To buy a used couch or a new couch does not seem like it would be all that significant to the economy, but imagine the ramifications if only new houses and new cars are taxed. We tax what we want less of, and I am concerned that taxing only new goods would discourage new production and ultimately shrink the economy.

Political Dimension

It is my belief that the flat tax is better than the Simplified USA Tax and the FairTax because it is fundamental tax reform that is achievable.

Unlike other tax proposals, the flat tax would not require repealing the 16th Amendment to the Constitution. If we cannot get 2/3 of the House and Senate to agree to protect marriage, it is doubtful that we could get 2/3 to vote to repeal the 16th Amendment.

I believe that the flat tax is achievable because we are already on the glide path after the 2001 and 2003 tax cuts. The Bush tax cuts allowed for bonus expensing for capital equipment, abolished the marriage penalty, reduced the multiple layers of taxation, reduced capital gains taxes and lowered rates.

To conclude, the American people deserve a tax system and a government that rewards them for their hard work. It is time for Congress to give that to them and I believe that the flat tax is the best way to achieve this goal.