

HEARING OF THE JOINT ECONOMIC COMMITTEE
“RETHINKING THE TAX CODE”
NOVEMBER 5, 2003
TESTIMONY FOR SENATOR ARLEN SPECTER

Chairman Bennett and distinguished members of the Committee, I appreciate the opportunity to testify before the Joint Economic Committee today about the importance of a simple and fair tax code. In May of this year, the Senate overwhelmingly agreed to an amendment that I offered to the Jobs and Growth Tax Reconciliation bill of 2003, that this Committee should look into ways to overhaul our antiquated tax code.

The date of April 15 stabs fear, anxiety, and unease into the hearts of millions of Americans. Every year during “tax season,” millions of Americans spend their evenings poring over page after page of IRS instructions, going through their records looking for information and struggling to find and fill out all the appropriate forms on their federal tax returns. Americans are intimidated by the sheer number of different tax forms and their instructions, many of which they may be unsure whether they need to file. Given the approximately 325 possible forms, not to mention the instructions that accompany, simply trying to determine which form to file can in itself be a daunting and overwhelming task. According to the Tax Foundation, American taxpayers, including businesses, spend more than 5.8 billion hours and \$194 billion each year in complying with tax laws. That works out to more than \$2,400 per U.S. household. Much of this time is spent burrowing through IRS laws and regulations which fill 17,000 pages and have grown from 744,000 words in 1955 to over 6.9 million words in 2000. By contrast, the Pledge of Allegiance has only 31 words, the Gettysburg Address has 267 words, the Declaration of Independence has about 1,300 words, and the Bible has only about 1,773,000 words.

The majority of taxpayers still face filing tax forms that are far too complicated and take far too long to complete. According to the estimated preparation time listed on the forms by the IRS, the 2002 Form 1040 is estimated to take 13 hours and 10 minutes to complete. Moreover this does

not include the estimated time to complete the accompanying schedules, such as Schedule A, for itemized deductions, which carries an estimated preparation time of 5 hours, 37 minutes, or Schedule D, for reporting capital gains and losses, shows an estimated preparation time of 7 hours, 35 minutes. Moreover, this complexity is getting worse each year. Just from 1998 to 2002 the estimated time to prepare Form 1040 jumped 96 minutes.

It is no wonder that well over half of all taxpayers, 56 percent according to a recent survey now hire an outside professional to prepare their tax returns for them. However, the fact that only 29 percent of individuals itemize their deductions shows that a significant percentage of our taxpaying population believes that the tax system is too complex for them to deal with. We all understand that paying taxes will never be something we enjoy, but neither should it be cruel and unusual punishment. Further, the pace of change to the Internal Revenue Code is brisk – Congress made about 9,500 tax code changes in the past twelve years. And we are far from being finished. Year after year, we continue to ask the same question -- isn't there a better way?

My flat tax legislation would make filing a tax return a manageable chore, not a seemingly endless nightmare, for most taxpayers. My flat tax legislation will fundamentally revise the present tax code, with its myriad rates, deductions, and instructions. This legislation would institute a simple, flat 20 percent tax rate for all individuals and businesses. This proposal is not cast in stone, but is intended to move the debate forward by focusing attention on three key principles which are critical to an effective and equitable taxation system: simplicity, fairness and economic growth.

My flat tax plan would eliminate the kinds of frustrations I have outlined above for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete most of the 6.9 million words in the Internal Revenue Code. Instead of billions of hours of non-productive time spent in compliance with, or avoidance of, the tax code,

taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

My flat tax proposal is dramatic, but so are its advantages: a taxation system that is simple, fair and designed to maximize prosperity for all Americans. A summary of the key advantages are:

- **SIMPLICITY**: A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.8 billion hours they currently spend every year in tax compliance.
- **CUTS GOVERNMENT**: The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which have grown from 744,000 words in 1955 to 6.9 million words and 17,000 pages currently. It would also allow us to slash the mammoth IRS bureaucracy of 117,000 employees.
- **PROMOTES ECONOMIC GROWTH**: Economists estimate a growth of over \$2 trillion in national wealth over seven years, representing an increase of approximately \$7,500 in personal wealth for every man, woman and child in America. This growth would also lead to the creation of 6 million new jobs.
- **INCREASES EFFICIENCY**: Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.
- **REDUCES INTEREST RATES**: Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.
- **LOWERS COMPLIANCE COSTS**: Americans would be able to save up to \$194 billion they currently spend every year in tax compliance.
- **DECREASES FRAUD**: As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over \$120 billion in uncollected revenue annually.
- **REDUCES IRS COSTS**: Simplification of the tax code will allow us to save significantly on the \$7 billion annual budget currently allocated to the Internal Revenue Service.

The most dramatic way to show what the flat tax is to consider that the income tax form for the flat tax is printed on a postcard -- it will allow all taxpayers to file their April 15 tax returns on

a simple 10-line postcard. This postcard will take 15 minutes to fill out.

At my town hall meetings across Pennsylvania, the public support for fundamental tax reform is overwhelming. I would point out that in those speeches that I never leave home without two key documents: (1) my copy of the Constitution; and (2) a copy of my 10-line flat tax postcard. I soon realized that I needed more than just one copy of my flat tax postcard -- many people wanted their own postcard so that they could see what life in a flat tax world would be like, where tax returns only take 15 minutes to fill out and individual taxpayers are no longer burdened with double taxation on their dividends, interest, capital gains and estates.

This is a win-win situation for America because it lowers the tax burden on the taxpayers in the lower brackets. For example in the 2002 tax year, the standard deduction is \$4,700 for a single taxpayer, \$6,900 for a head of household and \$7,850 for a married couple filing jointly, while the personal exemption for individuals and dependents is \$3,000. Thus, under the current tax code, a family of four which does not itemize deductions would pay taxes on all income over \$19,850--that is personal exemptions of \$12,000 and a standard deduction of \$7,850. By contrast, under my flat tax bill, that same family would receive a personal exemption of \$27,500, and would pay tax on only income over that amount.

The tax loopholes enable write-offs to save some \$393 billion a year. What is eliminated under the flat tax are the loopholes, the deductions in this complicated code which can be deciphered, interpreted, and found really only by the \$500-an-hour lawyers. That money is lost to the taxpayers. \$120 billion would be saved by the elimination of fraud because of the simplicity of the Tax Code, the taxpayer being able to find out exactly what they owe.

This bill is modeled after legislation organized and written by two very distinguished professors of law from Stanford University, Professor Hall and Professor Rabushka. Their model

was first introduced in the Congress in the fall of 1994 by Majority Leader Richard Armey. I introduced the flat tax bill--the first one in the Senate--on March 2, 1995, Senate bill 488. On October 27, 1995, I introduced a Sense of the Senate Resolution calling on my colleagues to expedite Congressional adoption of a flat tax. The Resolution, which was introduced as an amendment to pending legislation, was not adopted. I reintroduced this legislation in the 105th Congress with slight modifications to reflect inflation-adjusted increases in the personal allowances and dependent allowances. I re-introduced the bill in this Congress on April 15, 1999--income tax day--in a bill denominated as S. 822. I then introduced my flat tax legislation as an amendment to S.1429, the Tax Reconciliation bill, the amendment was not adopted. Most recently, on May 14, 2003, I offered an amendment to the Tax Reconciliation legislation urging the Senate to hold hearings and consider legislation providing for a flat tax – this amendment passed by a vote of 70 to 30 on May 15, 2003.

Over the years and prior to my legislative efforts on behalf of flat tax reform, I have devoted considerable time and attention to analyzing our nation's tax code and the policies which underlie it. I began the study of the complexities of the tax code over 40 years ago as a law student at Yale University. I included some tax law as part of my practice in my early years as an attorney in Philadelphia. In the spring of 1962, I published a law review article in the Villanova Law Review, "Pension and Profit Sharing Plans: Coverage and Operation for Closely Held Corporations and Professional Associations," 7 Villanova L. Rev. 335, which in part focused on the inequity in making tax-exempt retirement benefits available to some kinds of businesses but not others. It was apparent then, as it is now, that the very complexities of the Internal Revenue Code could be used to give unfair advantage to some. Einstein himself is quoted as saying “the hardest thing in the world to understand is the income tax.”

The Hall-Rabushka model envisioned a flat tax with no deductions whatever. After

considerable reflection, I decided to include in the legislation limited deductions for home mortgage interest for up to \$100,000 in borrowing and charitable contributions up to \$2,500. While these modifications undercut the pure principle of the flat tax by continuing the use of tax policy to promote home buying and charitable contributions, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness and public policy -- and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult, but without them, probably impossible.

In my judgment, an indispensable prerequisite to enactment of a modified flat tax is revenue neutrality. Professor Hall advised that the revenue neutrality of the Hall-Rabushka proposal, which uses a 19% rate, is based on a well-documented model founded on reliable governmental statistics. My legislation raises that rate from 19% to 20% to accommodate retaining limited home mortgage interest and charitable deductions.

This proposal taxes business revenues fully at their source, so that there is no personal taxation on interest, dividends, capital gains, gifts or estates. Restructured in this way, the tax code can become a powerful incentive for savings and investment -- which translates into economic growth and expansion, more and better jobs, and raising the standard of living for all Americans.

The key advantages of this flat tax plan are threefold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts.

Professors Hall and Rabushka have projected that within seven years of enactment, this type of a flat tax would produce a 6 percent increase in output from increased total work in the U.S.

economy and increased capital formation. The economic growth would mean a \$7,500 increase in the personal income of all Americans. No one likes to pay taxes. But Americans will be much more willing to pay their taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My flat tax legislation will afford Americans such a tax system. Thank you.

2003 Individual Tax Return

Form 1	Individual Wage Tax	2003
Your first name and initial (if joint return, also give spouse's name and initial)		Your social security number
Home address (number and street including apartment number or rural route)		Spouse's social security number
City, town, or post office, state, and ZIP code		

1.	Wages, salary, pension and retirement benefits	1 _____
2.	Personal allowance (enter only one)	
	-- \$17,500 for married filing jointly	
	-- \$10,000 for single	
	-- \$15,000 for single head of household	2 _____
3.	Number of dependents, not including spouse, multiplied by \$5,000	3 _____
4.	Mortgage interest on debt up to \$100,000 for owner-occupied home	4 _____
5.	Cash or equivalent charitable contributions (up to \$2,500)	5 _____
6.	Total allowances and deductions (lines 2, 3, 4 and 5)	6 _____
7.	Taxable compensation (line 1 less line 6, if positive; otherwise zero)	7 _____
8.	Tax (20% of line 7)	8 _____
9.	Tax withheld by employer	9 _____
10.	Tax or refund due (difference between lines 8 and 9)	10 _____

A variety of specific cases illustrate the fairness and simplicity of this flat tax:

CASE #1 -- Married couple with two children, rents home, yearly income \$35,000:

Under Current Law:

Income	\$35,000
Four personal exemptions	\$12,000
Standard deduction	\$ 7,850
Taxable income	\$15,150
<u>Tax due under current rates</u>	<u>\$ 1,676</u>
Marginal rate	11.1%
Effective tax rate	4.8%

Under Flat Tax:

Personal allowance	\$17,500
Two dependents	\$10,000
Taxable income	\$7,500
<u>Tax due under flat tax</u>	<u>\$1,500</u>
Effective tax rate	4.3%

Savings of \$176

CASE #2 -- Single individual, rents home, yearly income \$50,000.

Under Current Law:

Income	\$50,000
One personal exemption	\$ 3,000
Standard deduction	\$ 4,700
Taxable income	\$42,300
<u>Tax due under current rates</u>	<u>\$ 7,774</u>
Marginal rate	18.4%
Effective rate	15.5%

Under Flat Tax:

Personal allowance	\$10,000
Taxable income	\$40,000
<u>Tax due under flat tax</u>	<u>\$8,000</u>
Effective rate	16.0%

***Increase of \$226 ***

CASE #3 -- Married couple with no children, \$150,000 mortgage at 9%, yearly income \$75,000:

Under Current Law:

Income	\$75,000
Two personal exemptions	\$ 6,000
Home mortgage deduction	\$13,500
State & local taxes	\$ 3,000
Charitable deduction	\$ 1,500
Taxable income	\$51,000
<u>Tax due under current rates</u>	<u>\$ 7,573</u>
Marginal rate	14.8%
Effective tax rate	10.1%

Under Flat Tax:

Personal allowance	\$17,500
Home mortgage deduction	\$9,000
Charitable deduction	\$ 1,500
Taxable income	\$47,000
<u>Tax due under flat tax</u>	<u>\$9,400</u>
Effective tax rate	12.5%

Increase of \$1,827

CASE #4 -- Married couple with three children, \$250,000 mortgage at 9%, yearly income \$125,000:

Under Current Law:

Income	\$125,000
Five personal exemptions	\$15,000
Home mortgage deduction	\$22,500
State & local taxes	\$5,000
Retirement fund deductions	\$6,000
Charitable deductions	\$ 2,500
Taxable income	\$74,000
<u>Tax due under current rates</u>	<u>\$13,783</u>
Marginal rate	18.6%
Effective tax rate	11.0%

Under Flat Tax:

Personal allowance	\$17,500
Three dependents	\$15,000
Home mortgage deduction	\$9,000
Charitable deduction	\$2,500
Taxable income	\$81,000
<u>Tax due under flat tax</u>	<u>\$16,200</u>
Effective tax rate	13%

Increase of \$2,417

**ANNUAL TAXES UNDER 20% FLAT TAX FOR
MARRIED COUPLE WITH TWO CHILDREN FILING JOINTLY**

Income	Home Mortgage*	Deductible Mtg Interest	Charitable Contribution*	Personal Allowance (w/ children)	Taxable Income	Marginal Tax Rate	Taxes Owed
<27,500					0	0%	None
30,000	60,000	5,400	600	27,500	0	0%	None
40,000	80,000	7,200	800	27,500	4,500	2.3%	900
50,000	100,000	9,000	1,000	27,500	12,500	5.0%	2,500
60,000	120,000	9,000	1,200	27,500	22,300	7.4%	4,460
70,000	140,000	9,000	1,400	27,500	32,100	9.2%	6,420
80,000	160,000	9,000	1,600	27,500	41,900	10.5%	8,380
90,000	180,000	9,000	1,800	27,500	51,700	11.5%	10,340
100,000	200,000	9,000	2,000	27,500	61,500	12.3%	12,300
125,000	250,000	9,000	2,500	27,500	86,000	13.8%	17,200
150,000	300,000	9,000	2,500	27,500	111,000	14.8%	22,200
200,000	400,000	9,000	2,500	27,500	161,000	16.1%	32,200
250,000	500,000	9,000	2,500	27,500	211,000	16.8%	42,200
500,000	1,000,000	9,000	2,500	27,500	461,000	18.4%	92,200
1,000,000	2,000,000	9,000	2,500	27,500	961,000	19.2%	192,200

* Assumes home mortgage of twice annual income at a rate of 9% and charitable contributions up to 2% of annual income