
ESSAY: WHY I FAVOR A “FLAT TAX”

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. 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 “Form 1” below in ten 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 sales tax rate is 6%. Someone who buys a Cadillac for \$30,000 pays 6% or \$1800 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, illustrated above, 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 chart below.

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.

There are several common objections to the “flat tax” including:

1. 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.

2. HIGH INCOME PEOPLE WON'T PAY ENOUGH TAXES. When Ronald Reagan was elected President, the top marginal tax rate was 50%. 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

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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 1980's. 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 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.

3. 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.

4. 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 80's. To my personal knowledge, M.I.T., Penn State, and Duquesne University each started aggressive multi-year fund drives in the early 80's. 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 80's.

To find out how easy the filing of a "flat tax" can be, I encourage you to fill out "Form 1" 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 House Majority Leader Dick Armev.

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

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

NOTES

RAISING THE MINIMUM WAGE

Congress is once again discussing the question of raising the minimum wage. I'm in favor of such a raise only if the coverage is extended to include baby-sitters.

SURVEY COMING

We are currently sending out over 15,000 copies of the Muhlenkamp Memorandum each quarter to interested readers all over the globe. Included are some readers who are not clients or shareholders. In the hope of learning more about your interests and concerns, we will send surveys to some of you. When you receive the survey, we ask you to take a few minutes to fill it out and return it to us.

ADMINISTRATIVE CHANGES CLOSE TO COMPLETION

As we informed our shareholders in February, the new custodian bank for the Muhlenkamp Fund is Star Bank, N.A. of Cincinnati, Ohio. All future investments for Muhlenkamp Fund accounts should be sent to the following address: Muhlenkamp Fund, P.O. Box 799, Cincinnati, OH 45264-0799.

Recently, American Data Services was chosen to act as the transfer agent and accountant for the Muhlenkamp Fund. We are currently making the transition and hope this move will provide our shareholders with better service on their accounts. This move will also allow us to offer our shareholders an Automatic Investment Plan. All future redemption requests for the Fund should be sent to the following address: Muhlenkamp Fund, c/o American Data Services, 24 West Carver St., Huntington, NY 11743.

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Note: We have had many requests for extra copies of Ron Muhlenkamp's "Maxims", since they were first published in 1991. We include them here for your enjoyment.

Basic Financial Maxims I Want My Kids to Know

- There is no free lunch.
- There's no free income either.
- The essentials in life are cheap. Only the luxuries are expensive.
- A bad product is always a bad deal. Don't buy a car or appliance with a poor service record. Don't buy a house with a cracked foundation.
- A good product can be a bad deal if the price is wrong. How do you know a good price? Shop around and be willing to walk away from any "deal".
- The purpose of insurance is to protect against financial disaster. Any loss that is non-financial cannot be remedied by insurance. Any loss that is not a disaster does not require insurance.
- Financial products are simply agreements written on paper. Although written in English, they are written by lawyers and designed so you won't read them. Read them anyway, and read them again, and again, until you understand them.
- The price of borrowing money is interest and worry. Keep all borrowing below the worry point, and don't borrow to buy things that depreciate; you will lose on both ends.
- Don't rely on appreciation of the asset. If the price is too high, wait. It's too high for everyone else as well, and they will realize it in due time. The public tends to extrapolate trends long after the financial justification is gone. Read our essay "Houses Don't Make Money".
- Any agreement has two parties; the other person will be working for himself. Figure out whether he is working for or against you. Always check one level deeper and follow-up.
- The assumptions that you make consciously won't hurt you. The assumptions you take for granted — what "everybody knows" — will kill you. Always check the assumption behind the assumption you make.
- If it's complicated it is probably a bad deal.
- If you don't understand it, it is a bad deal. Don't buy any product or service from someone who can't or won't explain it to you in terms you understand.
- Don't confuse income and wealth. Income can end with a dismissal notice or a change in interest rates.
- Don't confuse wealth with the current price of an asset. People get carried away with prices - up and down.
- Don't count on Social Security. The benefits you receive will be a small fraction of what your grandparents now receive.
- People think of inflation as prices going up. It's not. It's the value of money going down.
- There are no guarantees, there are only guarantors. The phrase "It's Guaranteed" requires the response: "By Whom?"
- Only the Ten Commandments were written in stone. All other laws are at the whim of politicians who will change them in response to current pressures.
- When you change the rules a little, you change the game a lot.
- Convenience is usually expensive. Ignorance is deadly.
- "Collectibles" are faddish. They come and go. When everyone knows it's a "collectible" the game is over.
- You can't spend yourself rich. You've spent a lot of time and effort to make a buck pretax. The money you don't spend is worth more than the money you earn — it's after tax.
- Fund your IRA every year — early if possible. Invest in an equity or total return mutual fund. Equity returns compounded over long periods are truly amazing.