THE FLAT TAX

Simple, Efficient, Fair. Or Is It?

by William G. Gale

The U.S. tax system remains continually, and deservedly, under attack. Many people find taxes too complex. Analysts blame the tax system for depressing saving, entrepreneurship, and economic growth. Few people believe it to be entirely fair or transparent.

Members of both political parties have put forth plans to overhaul the current tax system. The best known is the "flat tax." Conceived by Stanford economist Robert Hall and political scientist Alvin Rabushka in the early 1980s, the flat tax has been given legislative form in the past few years by Rep. Richard Armey (R-TX) and Sen. Richard Shelby (R-AL).

The flat tax would replace taxes on personal and corporate income and estates. Households would pay taxes on wages and pension income in excess of substantial personal and child allowances. Businesses would pay taxes on their sales less their wage and pension payments, input costs, and capital purchases. No other income would be taxed, no other deductions allowed. Businesses and individuals would face the same flat tax rate.

Proponents have made strong claims for the flat tax: it would be so simple that the tax form could fit on a postcard; it would take tax considerations out of people's economic decisionmaking, thereby increasing efficiency and revitalizing the economy; it is a fair and airtight system.

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IN THEORY AND PRACTICE

In theory, the flat tax is, indeed, a clever, principled approach to changing the nature of federal taxation. Whether it could satisfactorily meet the competing demands placed on the tax system—fairness, simplicity, growth—and the transition to the real world is an open question.

Just What Is the Flat Tax?

The flat tax is not an income tax, but a consumption tax. The simplest form of consumption tax is a tax on retail sales. If we switch to a consumption tax, why not just adopt the simplest?

Implementing a national retail sales tax would be problematic for several reasons. First, it would be regressive. Poor households consume a much greater share of their income than do other households. Taxing their total consumption would be a large burden, especially compared with the current income tax system, which channels money to many poor working households via the earned income tax credit. In addition, as the sales taxes that now exist in 45 states have shown, it is often hard to distinguish business-to-business sales from business-to-household sales. But if each sale from business to business is taxed, the eventual product is taxed several times, resulting in "cascading," a problem that encourages firms to integrate vertically and also creates capricious redistributions of tax burdens across goods and people. Most important, though, a retail sales tax with a rate high enough—well over 30 percent—to replace existing federal taxes would be very hard to enforce. European countries that have tried to raise significant revenue by retail sales taxes have found that they become unadministrable at rates as low as 10–12 percent. They have therefore shifted to a different form of consumption tax, a value-added tax (VAT).

A sales tax and a VAT differ in the point at which they are exacted: a sales tax, on the final sale price; a VAT, at each stage of production. Under a VAT, each business pays a tax on the difference between gross revenues from all sales (including business-to-business sales) and the cost of materials, including capital goods. Thus it pays taxes on wages, interest, and profits, the sum of which represents the value added by the firm in providing goods and services.

The VAT avoids cascading because sales between businesses wash out. The baker who sells bread to the grocer pays VAT on the sale, but the grocer deducts the purchase in calculating his VAT. The VAT is also easier to enforce. One reason is that the seller, in trying to decide whether to report a transaction to the tax authorities, knows that the buyer will file the transaction with the tax authorities to claim the deduction for funds spent.

Like the sales tax, however, the VAT is regressive. Governments can address that problem by exempting from taxation, say, the first $20,000 of consumption by sending each family a check for $5,000 (assuming a 25 percent tax rate). But financing such transfers requires higher tax rates. Targeting the transfers to the poor would mean that rates would not have to be raised as much, but it would require all households to file information on income, thus sacrificing some of the simplicity gain.

The flat tax is a VAT, with two adjustments that help address the regressivity problem. First, businesses deduct wages and pensions, along with materials costs and capital investments. Second, the wages and pensions that businesses deduct are taxed at the individual (or household) level above a specified exemption. Dividing the VAT into two parts, one for businesses and one for households, makes possible the family exemptions that can ease the burden of the consumption tax for lower-income households.

How Does the Flat Tax Differ from the Current System?

Today's federal "income" tax is actually a hybrid between an income and a consumption tax. A pure income tax would tax all labor earnings and capital income, whether realized in cash, in kind, or accrued. But the current system does not tax certain forms of income, such as employer-provided health insurance or accrued gains on unsold assets. And it taxes some income more than once: in the case of corporate earnings, once at the corporate level and again at the individual level when distributed as dividends. It also taxes some items not properly considered income, such as the inflationary components of interest payments and realized capital gains. The flat tax would not tax capital income—such as interest, dividends, and capital gains—at the household level, or financial flows at any level. On the other hand, most saving—in pensions, IRAs, and so forth—is already taxed as it would be under a consumption tax.

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Unlike the flat tax, the current income tax also permits dozens of allowances, credits, exclusions, and deductions. Taken together these "loopholes" reduced personal tax collections by some $1.3 trillion in 1993, about 50 percent of the actual tax base. Eliminating them all would make it possible to reduce tax rates across the board, or set rates as low as 13.5 percent.

The income tax is graduated: its six rates—0, 15, 28, 31, 36, and 39.6 percent—rise with taxable income. Multiple tax rates increase progressivity, but raise compliance and administrative costs and the importance of the deductions. A deduction that matters little when the tax rate is 10 percent is of much more consequence when the rate is 40 percent.

But the biggest differences between the existing system and the flat tax arise not because of large inherent differences in the underlying tax base. In fact, if the flat tax allowed firms to deduct investment expenditures over time, in accordance with the economic depreciation of their assets, instead of allowing them to deduct all investment expenses the year they are made, the flat tax would then be a flat income tax.

Rather, the key point is that the differences arise because, in response to a variety of political pressures, the existing tax system has strayed from a pure income tax structure. Indeed, perhaps the crucial question about the flat tax is how it would respond to those same pressures if it were to move from idea to reality.

The Armey-Shelby flat tax proposal features a $31,400 exemption for a family of four and a 20 percent tax rate. After two years the exemption would rise to $33,300 and the rate would fall to 17 percent. (The low tax rate is possible because the proposal is not "revenue neutral"; that is, it combines tax reform with a tax cut.)

But in recent years, different variants of the flat tax have begun to take on some features of today's income tax. Sen. Arlen Spector's (R-PA) proposal would reinstate the mortgage and charity deductions. So would Pat Buchanan's, which would also tax at least some capital income at the household level. The Kemp Commission favored deductions for payroll taxes and for mortgage interest and charity. Robert Dole voiced a wish to protect deductions for mortgages, charity, and state and local taxes.

These cracks in the flat tax armor, appearing long before serious legislative action takes place, suggest that the pressures that led to an impure income tax are likely to affect the flat tax as well.

Political and Economic Dilemmas in Tax Reform

Richard Armey, like some other advocates of the flat tax, candidly links his proposal to big tax cuts (although he does not specify how he would cut government spending to make up for the lost revenue). Because it is misleading to compare a plan that simultaneously reforms the tax structure and cuts taxes with the existing system, I will lay out the issues raised by the flat tax without the confounding effects of tax reduction.

Tax reform that collects the same amount of revenue in a new way will necessarily redistribute tax burdens among taxpayers. Those who stand to lose often try to prevent reform or to secure "transition relief" to avoid or delay the full brunt of the new law. The flat tax embodies this problem in stark form, because it proposes a single rate on businesses and on household money wages above a threshold, with no deductions and no transition relief.

The biggest transition problem for the flat tax involves business. Under the current system, businesses may deduct depreciation, the loss of value of capital assets over their useful lives, in computing taxable business income. Under the flat tax, businesses can deduct the full value of the asset the year it is purchased. The practical problem is what to do about assets that have not been fully depreciated when the new tax takes effect.

The pure flat tax would allow no deductions for depreciation on existing assets. But companies that lose their existing depreciation deductions will claim unfair treatment. And the stakes are high. In 1993, corporations claimed $363 billion in depreciation deductions, unincorporated businesses about one-third that.

Similarly, under the current system many businesses have net operating losses that they can carry forward as offsets against future profits. And businesses' interest payments are deductible because they are a cost of earning income. The flat tax would disallow both the carryforwards and the deduction for interest payments. Firms that depend on those provisions will press for transition relief under the flat tax.

Flat tax advocates have already acknowledged the need for transition relief. The Kemp Commission, for example, recommended that policymakers "take care to protect the existing savings, investment, and other assets" during a transition to a new tax system. But these political concessions carry a big price tag. Transition relief will reduce the size of the tax base and therefore require higher tax rates on the rest of the base. Policymakers will have to choose: the more transitional relief they provide, the less efficient the new tax system.

What about the Existing Deductions?

Many prominent features of the income tax have long been a part of American economic life. The original (1913) income tax allowed deductions for mortgage interest and for state and local income and property taxes. Deductions for charity and employer-financed health insurance followed by 1918.

A pure flat tax would scrap these longstanding provisions. Without question, doing so would hurt the affected sectors of the economy. That, after all, is one of the points of tax reform: using the tax code to subsidize these sectors has channeled too many of society's resources to them. Removing the subsidy would make for a more efficient overall allocation of resources across sectors. But the affected groups are not likely to see things that way.

Under current tax law, for example, owner-occupied housing enjoys big advantages over other investments. Homeowners may deduct mortgage interest and property taxes without being required to report the imputed rental income they receive as owners. These deductions increase demand for owner-occupied housing and boost the price of housing and land. By treating owner-occupied housing and other assets alike, the flat tax would reduce the relative price of housing. Estimates of how much range widely, but even declines as low as 5–10 percent would hurt homeowners and could affect lending institutions through increased defaults.

Confronted with these realities, is Congress likely to end the tax advantages of owner-occupied housing? Perhaps not. But retaining the mortgage interest deduction means that tax rates would have to be higher to replace revenue lost from the deduction.

The same story would unfold with each of the other long-standing deductions. Under the flat tax, health insurance would no longer be deductible by businesses and would become taxable at the flat tax rate. Jonathan Gruber and James Poterba calculate that the change would boost the price of health insurance by an average of 21 percent and reduce the number of people who are insured by between 5.5 million and 14.3 million people. Pressure to keep the deduction would be strong. But if Congress were to retain it, the flat tax base would shrink, and rates would have to rise to maintain revenues.

Likewise, terminating the charitable contributions deduction would reduce charitable giving—and at a time when cuts in government spending are being justified on the grounds that private philanthropy should pick up the slack. But retaining the deduction means a higher tax rate to maintain revenues.

Flat Tax Trade-Offs: How Much?

In short, the flat tax is unlikely to be adopted in its pure form. What are the budget implications of various policy changes to the pure flat tax structure?

By my calculations, the Armey-Shelby plan with a 17 percent rate would have raised $138 billion less in 1996 than the current system. Even a 20 percent rate, which Jack Kemp referred to as the maximum acceptable flat tax rate in press conferences after the Kemp Commission report was released, would result in a shortfall of $29 billion. Allowing businesses to grandfather existing depreciation deductions—one form of transition relief—would raise the required rate to 23.1 percent. Allowing deductions for mortgage interest payments, as well as transition relief, would raise the required rate to 24.4 percent. If the deduction for employer-provided health insurance were also retained, the rate would rise to 26.5 percent. Adding in deductions for charitable contributions, individual deductions of state and local income and property tax payments, and the earned income tax credit would raise the rate to 29 percent. With all these adjustments, a tax rate of 20 percent would generate a revenue loss of well over $200 billion. Even with a flat tax rate of 25 percent, the revenue loss would be just over $100 billion.

Finally, retaining current payroll tax deductions for businesses would raise the required rate to 32 percent. The revenue shortfall, at a 20 percent tax rate, would be a whopping $280 billion a year. Even at a 25 percent tax rate, the revenue shortfall would be about $163 billion.

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Politicians might find it hard to support a flat tax with these rates, since more than three-quarters of taxpayers now face a marginal tax rate of 15 percent or less, and less than 4 percent pay more than 28 percent on the margin. On the other hand, capping the rate at 20 percent or 25 percent would generate large losses in tax revenues that might also be hard to support.

One thing is clear. The flat tax is considered a simple tax with a relatively low rate in large part because it eliminates, on paper, deductions and exclusions that no Congress has dared touch.

The Flat Tax and Economic Growth

Retaining existing deductions and providing transition relief will also eat into the economic growth that flat tax advocates claim the tax will spur.

The most complete economic model that generates realistic estimates of the impact of the flat tax on growth, developed by Alan Auerbach of the University of California, Laurence Kotlikoff of Boston University, and several other economists, finds that moving from the current system to a pure, flat rate, consumption tax, with no exemptions, no deductions, and no transition relief or other adjustments, would raise output, relative to what it would have been under the income tax, by 6.9 percent after the first 2 years, 9 percent after 9 years, and almost 11 percent in the long run. These are remarkably large gains, but they vanish as the tax plan becomes more realistic.

For example, if the personal exemption is set at $9,000, somewhat less than the $11,000 personal exemption in the Armey-Shelby plan, and transition relief is provided for existing depreciation deductions, the economy would grow by only 0.6 percent over 2 years, 1.8 percent after 10 years, and 3.6 percent in the long run. Adding exemptions for children (which the Armey plan now provides) would drive these estimates to zero. Adding transition relief for interest deductions and retaining the earned income credit and deductions for mortgages, health insurance, taxes paid, and charity would reduce growth further. Thus, implementing realistic versions of the flat tax could even slow economic growth.

Tax Reform in the Real World

Good tax reform requires discipline. It is not hard to look at the U.S. tax code and see the need for a simpler, cleaner tax. But it is hard to look at the 1997 Taxpayer Relief Act, passed by Congress and signed by the president, and believe that the political system has the discipline to pass broad-based fundamental reform. After all, there is nothing—other than political forces and views of social equity—stopping our political leaders right now, or in any other year, from passing legislation that would broaden the tax base, close loopholes, and reduce tax rates. Those political forces and views of social equity will not vanish when the flat tax is passed. As one congressman noted, "You can't repeal politics."

The flat tax is a simple and thoughtful response to many of the problems in today's tax system. But tax reform is not a free lunch: we can't get everything we might want.

There are two ways out of this quandary. One would start with the flat tax proposals and make them less pure. For example, holding personal exemptions at about their current level would generate added revenue. And coupling the lower exemption levels with a two-tier tax rate system (similar to the 15 percent and 28 percent brackets that now apply to the vast majority of taxpayers) would raise revenue, enhance progressivity, and maintain many benefits of the flat tax.

The less radical alternative would be to start with the existing income tax system and simplify, streamlining the tax treatment of capital income, reducing the use of the tax code to run social policy, and reducing and flattening the rates. That would be an extension of the principles developed in the Tax Reform Act of 1986. Either alternative would place the resulting system somewhere between the current tax system and the flat tax on simplicity, efficiency, and equity—the three primary issues under debate.

The flat tax is an important advance in tax policy thinking and represents a thoughtful approach to several problems in the tax code and the economy. But removing the entire body of income tax law and starting over with a whole new system is a monumental task. We should approach the issue with our eyes open concerning the likely benefits, costs, and practical issues that would arise in adopting a flat tax. n