legislator than an alternative set of plans with fewer preferences or lower expenditures. The essence of this over-expenditure argument is this: each majority coalition, in aiming for passage of its own measure, takes the taxes paid by citizens represented by non-coalition members as given. In totaling the costs and benefits of each project, the coalition includes the costs to its members but not the costs to nonmembers. Because not all of the costs are considered, the coalition votes for more of the public good than is needed by society.

Transition Problems

Every tax system develops its own inertia, in the sense that people who make long-term decisions based on the present system argue that it is unfair to change the rules mid-game. More than this, however, the economic system works to dissipate any special benefits of the tax system by adjusting relative prices. The result is that individuals who gain little or no special tax advantage from the current tax system can nevertheless be seriously hurt by tax reform. The result is a wrenching problem for tax reformers: how do we treat these "innocent bystanders" who get caught by the change?

For example, take the deductions for mortgage interest and local property taxes, which are surely among the most popular tax preferences in the current system. When these deductions were enacted, homeowners undoubtedly gained a direct benefit in the form of lower taxes. But these people will eventually sell their homes, and at the time of the sale the circumstances of the buyer will be different than before. The buyer can deduct mortgage interest and property taxes, and this means he will be willing to pay a higher price for the house. The seller knows this, and will accordingly raise the price of the house to try to capture some of this increased willingness to pay. As a result, the new buyer will give up some of this tax benefit to the original owner in the form of higher house prices; economists say that the tax benefit has been *capitalized* into the price of the house. In fact, under certain market conditions, house prices will rise to eliminate the entire tax benefit; in other words, the present value of the stream of future reductions in taxes will be just equal to the increase in house prices. Under more likely conditions, some but not all of the tax benefit will be capitalized away from the new homebuyer.

Now, suppose that the government institutes a pure flat tax that would eliminate this tax preference. The citizen who just bought a home sees this as unfair to him, because he made his plans based on the old system. Although he may not receive large benefits from the loopholes, the loss of the loophole will cost him dearly. Tax reformers cannot turn back the clock; the tax reform would not be raising the taxes of those who gained from the old system—those are the original homeowners who have turned their tax benefits into cash.

Some tax reformers have suggested a gradualist approach in which a new tax system would be phased in gradually. While such an approach would smooth the process somewhat, it would not eliminate the basic problem of dealing with individuals hurt by the reforms. Sooner or later, the affected groups would bear the burden of higher taxes. It has also been suggested that these individuals be "grandfathered" into the tax system, so that, for example, all homeowners at the time of the tax reforms receive a special exemption or deduction. But this approach could significantly reduce the tax base under the new tax system (thus raising marginal rates), and it would cause horizontal inequity between those who managed to receive the aid and later homebuyers who failed to obtain tax relief.

Conclusion

Because of these political and economic forces, we ought to expect tax reform to be incremental rather than an abrupt adoption of bold, new plans. It is not enough to introduce new schemes, as tax reform requires shifts in political opinions and alignments. Since these shifts in loyalties come slowly and through much negotiation and confrontation, it is unlikely that a pure flat tax, or any sort of sweeping tax reform, can be adopted in unmodified form. To formulate realistic alternatives, tax reformers must understand the conflicts, and the compromises, inherent in the current system.

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economic commentary

Flat Taxes and the Limits to Reform

by Paul Gary Wyckoff

Although Congress and the administration are always talking about tax reform, there is currently heightened interest in new, all-inclusive approaches to the problem. According to Rudolph Penner, director of the Congressional Budget Office, "The prospects for radical tax reform are brighter than ever."[1] In his State of the Union message on January 25, 1984, President Reagan called for the Treasury Department to make a comprehensive study of ways to make the income tax more simple, more efficient, and more equitable. Treasury Secretary Donald T. Regan has indicated that the department will probably recommend some sort of modified flat tax system in its report. The administration is not alone in its interest in flat taxes; each major party has formulated a detailed and comprehensive modified flat tax proposal and has introduced it in Congress. This *Economic Commentary* examines the nature of flat taxes, the inadequacies in the present system that they would remedy, and the reasons why the alluring goal of a pure flat tax is difficult to achieve. In the process, the article illustrates the economic principles against which tax policy can be measured and the political realities of the tax decision-making system.

What's Wrong with the Current System?

The current attack on the personal income tax comes from both sides of the ideological spectrum, but everyone agrees that the loopholes in the tax — the numerous credits, deductions, exclusions, and exemptions— are the crux of the problem.[2] Although each side values both equity and efficiency, liberals tend to stress equity objections to the loopholes, while conservatives tend to stress efficiency considerations. Liberals argue that the current system is inequitable on two counts. First, the system violates the principle of *horizontal equity*, which demands that individuals in comparable economic circumstances bear the same tax.[3] It has been argued, for example, that through investment tax credits and accelerated depreciation, taxpayers earning their income from investments may pay less tax than those who receive wage and salary income, even if both groups have the same total income and hence the same command over economic resources. Second, liberals argue that the current system also fails the test of *vertical equity*, which states that persons in different circumstances ought to pay different amounts of tax based on their ability to pay. This complaint crystallized during the 1984 presidential debate over the proportion of Vice President Bush's 1983 income paid in taxes; Walter Mondale claimed that tax loopholes allowed the relatively wealthy Vice President to lower his taxes to unreasonably low levels.

Conservatives contend that the present tax system is inefficient. They see the system as a *leaky bucket* that draws resources from the well of economic activity; every time the bucket dips into the well and carries off money for use by the government, resources are lost through the leaks.[4] This waste occurs because (1) individuals in the economy are encouraged to produce less than otherwise, and (2) the economy ends up producing the wrong kinds of goods in the wrong quantities.

As an example of the first type of inefficiency, conservatives argue that, because of all the special provisions in the tax code, tax rates are higher than they need otherwise be. Since they reduce the after-tax rewards to economic activity, these higher tax rates encourage people to work and save less. The result is a less productive economy than without the loopholes. By comparison, the second source of inefficiency is more subtle in its impact on economic welfare. Loopholes encourage people to alter their behavior so as to move them from heavily taxed to lightly taxed activities. For example, the exemption for employer-paid fringe benefits, such as health and life insurance, encourages people to take more of their total "income" in

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1. See *Fortune*, June 11, 1984, p. 97.

2. A tax *credit* is a provision that allows the taxpayer to reduce his total tax bill after he has figured his tax base (in this case, his income from various sources) and has applied the appropriate tax rate against that base. A tax *deduction* offsets (or reduces) the citizen's tax base — for example, the taxpayer might be allowed to reduce his taxable income by some portion of the amount he paid for medical care. A tax *exemption* or *exclusion* is an item that could, under a comprehensive tax plan, be considered as part of the citizen's tax base but, for one reason or another, is not counted in the base for tax purposes. For example, income from state and local government bonds is not counted as income for purposes of the federal income tax.

the form of these benefits rather than as wages. Similarly, the deductions for mortgage interest and local property taxes give people an incentive to move out of rental housing (for which no such preferences are available) into their own homes.

The economic losses from this second type of inefficiency are subtle and can only be appreciated by comparing the present system with one that does not alter individuals' behavior. Under the current system, the tax becomes "attached" to certain activities (such as living in rental housing or taking wage income rather than fringe benefits); in a sense, individuals pay the tax out of the money they allocate for that activity. The taxpayer pays the government by paying more for those particular activities, even if they are goods and services that he particularly desires. By contrast, under a less distorting tax system in which all activities are taxed equally, the individual has the flexibility to distribute this tax burden in any way he wishes; he can pay the tax by giving up the goods and services that he values least. Because the individual has the freedom to distribute his tax burden to minimize his loss of satisfaction, economic theory teaches that a less distorting tax system can generate the same amount of revenue as currently while making taxpayers better off.

Flat Taxes — Pure and Modified

A pure flat tax is attractive in its simplicity. All of the taxpayer's income, from whatever source, is subject to tax (thus eliminating our complex system of tax preferences), and the tax is paid at a single, low rate. In one stroke, the problems of horizontal equity, disincentives for saving and investment, and tax-induced changes in consumption are solved. Since all income is taxed at the same rate, taxpayers with the same income are treated equally. Since marginal tax rates are reduced to one, low level, the reductions in saving and investment are minimized. And since all income is treated equally and the tax is independent of the taxpayer's consumption decisions (i.e., no deduction for mortgage interest or charitable contributions), the incentives to change the consumer's behavior are also minimized. In addition, under a flat tax there is no need to worry about indexation of tax brackets (because tax-bracket *creep* is impossible), income averaging (because all income is subject to the same rate of tax), or a marriage penalty (because individuals pay the same rate of tax regardless of their spouse's income). A recent study estimated that 1984 tax collections averaged 12 percent of total income, when income was measured comprehensively (i.e., including all items that are exempted or excluded under the current system).[5] Hence, even if lower marginal tax rates had no effect on economic activity, a pure flat tax of just 12 percent would raise the same amount of revenue as the current system.

The tax plans now under consideration in Congress, however, stray considerably from this simple ideal.[6] The best-known plan, introduced by Senator Bill Bradley (D-N.J.) and Congressman Richard Gephardt (D-Mo.), is a case in point. The Bradley-Gephardt Fair Tax proposal broadens the tax *base* to eliminate most existing exemptions, deductions, and credits *except* the deductions for mortgage interest, charitable contributions, state and local income and property taxes, payments to IRAs and Keogh plans, and employee business expenses. In addition, the exclusions of veterans' benefits, Social Security payments for low- and moderate-income taxpayers, and interest on state and local government general obligation bonds are retained, and the personal exemption and standard deduction are increased. In terms of tax *rates*, too, the Bradley-Gephardt proposal falls short of the ideal; it is really a "giant step" tax with three very wide tax brackets of 14, 26, and 30 percent.

The sponsors claim, however, that three-quarters of all taxpayers would end up in the 14 percent bracket, and for those people the plan would have most of the benefits of a pure flat tax. Also, although many deductions would still be allowed under the proposal, most of them count only against the 14 percent rate, regardless of the citizen's tax bracket. The Bradley-Gephardt plan actually consists of two taxes—a *basic* tax of 14 percent and a progressive *surtax* with rates of 12 percent and 16 percent. This surtax would be applied only against that portion of the taxpayer's income that exceeds $25,000 (for a single return, with a cutoff of $40,000 for a joint return). The unique feature of the Fair tax is that the exemptions listed above can be used to reduce taxable income for the basic tax, but not for the surtax. In effect, the tax reduction resulting from the deductions would be limited to 14 percent, regardless of the taxpayer's income. Bradley and Gephardt maintain that their proposal would mean roughly the same tax burden across income classes as the current system.

A Republican alternative to the pure flat tax has been introduced by Congressman Jack Kemp (R-N.Y.) and Senator Robert Kasten (R-Wis.). The Kemp-Kasten FAST (Fair and Simple Tax) plan would broaden the tax base by eliminating most special provisions of the tax code, except deductions for charitable contributions, interest on loans for residential property and education, medical expenses above 10 percent of income, ordinary business expenses, payments to IRAs and Keogh plans, and real property taxes. Also, the exemptions for Social Security and military and veterans' benefits would be retained. On this somewhat broadened tax base, a single 25 percent tax rate would be levied, and in this sense the Kemp-Kasten plan is truly a flat tax. To appeal to lower-income citizens, however, the plan also calls for increases in the personal exemption and standard deduction, and for a special exclusion of 20 percent of all wage and salary income up to $39,300, an exclusion that would gradually be phased out in higher-income brackets so that it would equal zero above $100,000.

Why do these two congressional plans fall short of the flat-tax standard of simplicity? The answer is compelling, because public opinion polls show that Americans would prefer a simple flat tax to our current system, and yet these proposals are more like a compromise between these alternatives rather than a flat tax. Rooted in the institutions of the market and Congress (and in the interactions between them) are three reasons why tax reform is a gradual, incremental process.

Conflict between Vertical Equity and Efficiency

Americans value not only the efficiency of their economic system but also equity between income groups. Because it is impossible for one tax system to serve both goals fully, there is inevitably some compromise of efficiency for equity.

Historically, citizens' desire for vertical equity has resulted in a *progressive* tax system—one in which the proportion of one's income paid in taxes rises with income. The flat tax, however, would result in a *proportional* system in which the ratio of taxes paid to income would be constant across income groups, resulting in a massive redistribution of the tax burden from the rich to the poor. Because this is politically unacceptable, both plans build some progressivity into their tax schedules. The Bradley-Gephardt plan does this by having three marginal tax rates that increase with income; the Kemp-Kasten plan accomplishes this by excluding from tax a large portion of the citizen's first several thousand dollars of income, through a large personal exemption and standard deduction and the special 20 percent wage and salary exclusion.

There is a price to be paid, however, for this deviation from the pure flat tax. When progressivity is built into a tax system, the inevitable result is high marginal rates at the top end and a reduction of incentives to work and save for high-income taxpayers. Moreover, the saving disincentive is particularly important at the top, because a disproportionate amount of aggregate saving comes from well-to-do taxpayers. The Kemp-Kasten and Bradley-Gephardt plans attempt to reconcile the competing demands of equity and efficiency —they do not escape the dilemma.

To continue with the leaky bucket paradigm, we can visualize a progressive tax system as using the bucket to transfer wealth from the rich to the poor. That the bucket leaks does not obviate the fact that society wishes to make this transfer; it does, however, make this redistribution more expensive. The task faced by policymakers, therefore, is to decide how much water is worth transferring given these leaks.

Logrolling

While our system of congressional representation is meant to weight all citizens' preferences equally, individuals are likely to have different intensities of feeling about a particular issue. The practice of logrolling helps explain the historical pattern in the United States of relatively high marginal tax rates with lots of tax preferences.

Individuals who receive a particular tax preference (e.g., the residential energy tax credit) care a lot more about that issue than individuals who are ineligible for that preference; the benefits are concentrated among relatively few individuals, while the costs of the loophole are spread among all taxpayers. If a person is eligible for an energy tax credit, it could mean hundreds of dollars in tax savings; if he is ineligible, the cost of bearing the additional tax burden from this loophole is probably only a few pennies.

When preference intensities vary in this fashion, representative systems tend to fall into vote trading, or logrolling. Each representative trades his vote on issues that are not important to him in exchange for his colleagues' votes on issues that are vital to him. As a result, issues (or tax preferences) that might not pass if they were considered in isolation (because only a small minority of voters favor them) can be approved. There is also a more subtle form of vote trading, called implicit logrolling, in which a party or candidate forms its platform by incorporating the positions of many groups, favoring the position of each group on the issue of most intense interest to it. In this way, the party or candidate ratifies in its platform the logrolling outcome that would have occurred had these groups participated in some sort of direct democracy.

Scholars disagree on whether this logrolling process results in an inefficient allocation of resources. On one hand, it can be argued that logrolling allows the representative process to recognize the intensity of voters' preferences.[7] In this sense, logrolling can be a check on the tyranny of the majority.[8] Otherwise, if the majority favored some measure, even if the members of the majority coalition were only marginally interested in the issue, they would prevail over the wishes of a vitally interested minority.

On the other hand, it has been argued that logrolling results in a public sector that is too large, that completes projects for which the costs exceed the benefits.[9] Under certain circumstances, logrolling can result in the passage of a group of tax preferences or spending measures that give less satisfaction to each

3. It has been argued that some of these preferences account for economic differences between taxpayers that are not reflected in their incomes. For example, the deductions for medical expenses can be rationalized as recognizing differences in the need for income. It is difficult, however, to justify most tax preferences in this way, since they do not target relief to the truly needy (i.e., the deductions for local property taxes, mortgage interest, and state and local bond interest).

4. The leaky bucket paradigm, however, was conceived by a liberal economist, the late Arthur Okun. See Arthur M. Okun, *Equality and Efficiency: The Big Tradeoff*, Washington, DC: Brookings Institution, 1975, pp. 91–100.

5. See Joseph A. Pechman and John Karl Scholz, "Comprehensive Income Taxation and Rate Reduction," *Tax Notes*, vol. 17, no. 2 (October 11, 1982), pp. 83–93. Reprinted in Brookings General Series Reprint 390, Washington, DC: Brookings Institution, 1983.

6. The discussion in this section is meant to be a summary of these plans, not a complete description. Many minor features of these proposals have been omitted. For further details, one should contact the congressional offices of the sponsors.

7. See Dennis C. Mueller, "Public Choice: A Survey," *Journal of Economic Literature*, vol. 14, no. 2 (June 1976), p. 406.

8. See Mueller, "Public Choice: A Survey," p. 406.

9. See Gordon Tullock, "A Simple Algebraic Logrolling Model," *American Economic Review*, vol. 60, no. 3 (June 1970), pp. 419–26.