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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.” 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 of the major political parties has prepared 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. 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. 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, the system 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:Wall Street Journal 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 work in a productive economy every time the bucket dips into the well and carries off money for use by the government, resources are lost through the leaks. This waste occurs because (i) individuals in the economy are encouraged to produce less than otherwise, and (ii) 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. Since the rate is the price attached to any leaky bucket, by reducing the rate of flow the government can encourage individuals to produce some amount of economic activity. Liberals argue that the current economic conditions bear the same tax. 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, the system 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:Wall Street Journal 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 work in a productive economy every time the bucket dips into the well and carries off money for use by the government, resources are lost through the leaks. This waste occurs because (i) individuals in the economy are encouraged to produce less than otherwise, and (ii) the economy ends up producing the wrong kinds of goods in the wrong quantities.

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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., the deduction of mortgage interest or charitable contributions), the incentives to change the consumer's behavior are also minimized. In addition, a pure flat tax alleviates the 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, while the same tax was collected on an individual basis was 9 percent (i.e., including all items that are exempt or excluded under the current system). Hence, even if long-term marginal tax rates were not affected 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 view. The Bradley-Gephart Fair Tax proposal broadens the tax base to eliminate most existing exemptions, deductions, and credits except for 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, and pensions, pay for themselves or are paid by employers. Certain other mortgage interest, charitable contributions, state and local government general obligation bonds are retained, but the personal exemption and standard deduction are increased. In terms of tax rates, too, the Bradley-Gephart proposal falls short of the ideal; it is really a "giant step" tax, labeled 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 returner) or $50,000 (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 surtax only, not for the surtax. In effect, the tax reduction resulting from the deduction would be limited to 14 percent, regardless of the taxpayer's income. Bradley and Gephart maintain that their proposal would mean roughly the same 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 veterans' benefits would be retained, but the personal exemption and standard tax rate would be levied, and in this

The sponsors claim, however, that three-quarters of all taxpayers would be affected by this tax. For those people the plan would have the most of the benefits of a pure flat tax. Also, although many deductions are retained, including a basic per capita proposal, most of them amount only against the surtax rate of 14 percent, regardless of the citizen's tax bracket. The Bradley-Gephart plan has the very desirable effect of a flat tax, 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 returner) or $50,000 (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 surtax only, not for the surtax. In effect, the tax reduction resulting from the deduction would be limited to 14 percent, regardless of the taxpayer's income. The Kemp-Kasten plan attempts to reconcile the competing demands of equity and efficiency—they do not escape the dilemma. In the context of the current tax paradigm, we can visualize a progressive tax system as operating as an effective approach to transfer wealth from the rich to the poor. The Kemp-Kasten plan adds a little more about that issue than individuals who are ineligibility for that preference; the benefits are concentrated because the individual professionals, while the loophole be spread among all tax-payers. If a person is eligible for an energy tax credit, it could mean hundreds of dollars of additional income. If ineligible, the cost of bearing the additional tax burden from this loophole is probably only a few pennies.

We also note that some variation in this fashion, representative systems tend to fall into voting, or logrolling. Each representative trades his support for the proposal to work and support for high-income taxpayers. Moreover, the saving disincentive is particularly important at the higher end (because all income is subject to the top end and a reduction of incentives into a tax system, the inevitable

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