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THE FLAT-RATE TAX: A Viable Method of Tax Reform?

Robin Cohen

I. Introduction

The present U.S. tax structure is a graduated system, whereby the taxpayer is taxed at increasingly higher rates as his income rises. For various reasons detailed below, this system has increasingly come under fire. Although the demand for reform is nothing new, it has recently become stronger and more insistent.

Among the more radical reform proposals is the so-called "flat tax", first advocated by Robert Hall and Alvin Rabushka (H&R). In Low Tax, Simple Tax, Flat Tax (Hall & Rabushka, 1983), H&R support a tax system which would place a 19% tax on all income. The general purpose of this paper is to discuss the viability of such a system.

First, I will describe some of the problems of our current tax system. Then, I will summarize the major characteristics and objectives of the proposed flat tax and will present various arguments for and against it. Finally, I will discuss a possible alternative to the flat tax, the "fair tax" proposal of Bradley and Gephart.

II. Problems With the U.S. Tax System

Complexity is surely one of the most frequent complaints made about the current U.S. tax system. This problem is to a large degree the result of "band-aid" approaches to tax reform which have been used in the past; i.e., new provisions have simply been added to the current tax law as new problems arise, with seemingly little thought given to the implications for existing or future laws. In 1981, for instance, form 1040 (the basic individual tax return) consisted of no fewer than 17 pages of schedules and 44 pages of instructions. CPA's and tax lawyers have generally been found to be the only groups with the requisite skill and knowledge to consistently prepare tax returns correctly, but they are usually very expensive sources of assistance. Low-income taxpayers are especially vulnerable since the assistance which they are able to afford is often unreliable. For example, in a special 1971 survey the IRS analyzed tax returns with itemized deductions filed by low-income taxpayers. The survey disclosed an alarming 82% error rate for those...
returns completed by commercial tax-preparing firms. An even higher error rate no doubt characterized individually prepared returns.

The complexity of the U.S. tax system has resulted in enormous costs to American taxpayers, with literally millions of dollars and billions of hours expended each year by Americans filling out their tax returns. Interestingly enough, there is evidence that the tax system may have become too complex even for employees of the IRS who render tax assistance. A recent test by Ralph Nader's Tax Reform Research Group supports this suspicion. The group created a tax schedule for a fictional couple with one child and sent copies to 22 IRS offices throughout the country. Each office calculated a different tax liability, ranging from a tax refund of $811.26 to a tax underpayment of $52.14 (Hall and Rabushka, 1983, p. 4).

In addition to the problems caused by the sheer complexity of the U.S. tax system, many experts agree that certain features of the system also create numerous economic disincentives. For example, Jerry Hausman examined the effects of taxes on the labor supply. Hausman found that the combination of federal and state income taxes and the payroll tax for social security has led married men to significantly reduce their time spent in the labor force. For instance, hours worked by husbands who earned between $8,000 and $12,000 in 1975 were estimated by Hausman to be 8% lower than they would have been without such taxes. In another study, Franco Modigliani and Merton A. Miller found that a tax system which treats the returns from various assets differently leads to an inefficient allocation of risk in corporate finance. Because dividends are subject to a greater tax burden than are interest payments, the corporate ratio of debt to equity is generally too high. Still another type of disincentive caused by the U.S. tax system concerns the so-called "lock-in" effect of the capital gains tax. (The term "lock-in" refers to taxpayers having to hold on to their securities for at least one year in order to take advantage of the 60% long-term capital gains deductions available.) Minarik has found that most taxpayers who invest in stock are generally not willing to sacrifice the deduction, even if they would otherwise prefer not to hold their investments for a full year.1

In addition to the various disincentive effects such as those noted above, another major problem with our tax system is "bracket creep". This phenomenon refers to the effect of inflation on the tax burden. To use an example, suppose that a wage earner receives a pay increase which puts him into the next tax bracket but that prices increase simultaneously at the same rate. Then in real terms, the wage earner is actually in a worse economic position because his real income has remained unchanged while the percentage of his income paid in taxes has risen.

No listing of problems associated with the current U.S. tax system would be complete, finally, without mention of the existence of tax shelters (the legal minimization of one's tax burden) and the outright illegal evasion of taxes. Tax shelters are usually considered to provide an unfair advantage to the wealthy, who are generally the only taxpayers who can afford to invest in them. Tax evasion, on the other hand, costs the federal government billions of dollars each year in lost revenues, in addition to the costs incurred by the IRS in attempting to catch and penalize tax evaders.

III. The Flat Tax

Although it has received increased attention in recent years, the flat-rate income tax is not a new proposal. It was suggested as early as 1962 by Milton Friedman in his book Capitalism and Freedom. Currently, though, the issue has become a central one for debate among policy makers. Stressing incentives, supply-siders in Washington have blamed high marginal tax rates as being partly responsible for the poor performance of the U.S. economy over the recent past. They cite declining savings rates, high unemployment, low rates of capital formation, and severely distressed stock and bond markets. Some proponents of the flat

1For detailed summaries of these and other studies pertaining to disincentive effects of the current U.S. tax system, see Aaron and Pechman, 1981.
tax believe that the stimulation of economic growth requires not simply lower marginal tax rates, but rather the elimination of progressive marginal tax rates altogether.

The provisions of the specific form of the flat-tax system proposed by Hall and Rabushka include the following:

1) All income would be taxed once and only once, as close as possible to its source. The proposed treatment of corporate dividends provides a good illustration of this provision. Under the present tax system, a corporation pays tax on its income before distributing dividends to its stockholders. The stockholders in turn must pay taxes on the dividends they receive. Under the flat-tax system, distributions to shareholders would not be included in their personal liabilities, because the corporation (the source) has already been taxed on them.

2) All types of income would be taxed at the same percentage rate.

3) The poorest families would pay no tax, and lower-income families would pay a smaller fraction of their incomes than do those with higher earnings. This would be possible by means of exemptions based on marital status and the number of children. The result of such exemptions, in real terms, would be a built-in initial progressivity which would diminish rapidly as income increases.

4) Tax returns for both families and businesses would be simple enough to “fit on a postcard” (H&R, 1983, p. 32).

5) All other existing deductions, exemptions, exclusions, credits, etc. provided for under our present tax system would be eliminated.

A. Arguments for the Flat Tax

It is certainly true that simplicity is a very desirable feature of a flat-tax system such as the one described above. As was previously mentioned, the complexity of the present system is the root cause of many of its problems. With a flat tax, it is agreed, taxpayers would be more willing and more competent to compute their own taxes, the IRS would have an easier job in keeping track of and enforcing the tax, and there would be less potential for error and fraud all around.

Another argument sometimes advanced in favor of the flat tax is a political one: the fact that a flat tax could substantially increase government revenues by virtue of increasing the tax base (Shilling, 1983, pp. 206–207). This is so even with the provisions for substantial exemptions which would be necessary to alleviate the impact of the flat tax on the poor. If, for example, anyone with an annual income below $10,000 were exempted from paying federal taxes, 26% of all taxpayers would be so exempted. Even so, under a 20% flat tax (a rate chosen arbitrarily—most flat tax proposals advocate rates between 17–25%) the federal government could raise up to $89 billion toward eliminating the budget deficit.

Flat tax proponents also claim that such a tax would provide improved work and production incentives. Under the current system a typical wage earner in a high tax bracket might hesitate to work an extra hour, knowing that he stands to lose up to half of his additional earning to taxes. Under a flat tax system, however, every additional dollar earned would be taxed at the same rate as the first dollar earned. Advocates claim further that a flat tax could be used to provide more positive incentives for investment as well. It could do so by imposing a lower overall tax burden on the wealthy and by such modifications as replacing current investment incentives (e.g., capital gains deductions, accelerated depreciation, and investment tax credits) with immediate expensing (i.e., expensing an entire investment in the year that it occurs, a feature prohibited by our present tax laws).

B. Arguments Against the Flat Tax

Although the flat-tax proposal has many supporters, it is also not without its critics. Duane Kullberg, managing partner and CEO of Arthur Andersen & Co., addresses the simplicity claim of the flat-tax advocates. He agrees that any new tax system must meet several basic tests: it must be fair, it must be simple, and it
must encourage work and saving. But, as he contends further:

What kind of tax system will give us that? I am convinced that it cannot be a system that is so simple that it will allow, as some suggest, compliance on a postcard. It would be just as difficult to explain to taxpayers why they have suddenly lost all of their deductions, exemptions, and credits as it is now to explain the complexities of our present law. The concept of sudden tax simplification is seductive, but its reality is virtually sure to cause distortions, inequities, and further taxpayer distrust. (Kullberg, 1983, p. 427)

Even Milton Friedman, who formulated one of the earliest flat-tax proposals, did not recommend the elimination of all the components of the present system, but only of a select number of them. As Shilling (1983) comments in this regard, “Of course in the real world tax simplification wouldn’t be that easy. Congress would never eliminate all deductions . . . ,” to which Haseltine replies, “Already we are building in the loopholes, even before we have passed the tax” (Haseltine, 1983, p. 13). In other words, the flat tax, although “simple” in theory, would be difficult to put into practice.

It is also not certain that the flat-rate tax would solve the problem of economic disincentives discussed previously. Haseltine addresses this issue as well, summing up what he describes as “very nice supply-side economics thinking:"

The idea is to leave money for investment. This investment then will create jobs, levels of employment will go up, and we will move out of the ‘depression’ (Haseltine, 1983, p. 13).

But he then explains why such thinking is faulty. It is based on the belief, or apparent belief, that the upper-income earners will necessarily invest their additional post-tax income. However, he notes that for additional investment to take place, there must be demand. “Demand for the product,” Haseltine concludes, “is the mainstay of business, not the fact that the higher-income earner has more left over after necessities are met” (Haseltine, 1983, p. 13). Demand might increase after a tax cut, but it is surely not guaranteed; indeed, it could even fall among lower-income earners.

Other experts are quick to point to various transitional problems in adopting a flat tax. Due to the elimination of the investment tax credit, the introduction of expensing of an entire investment in the year that it is made, and other radically new features of the flat tax, some companies would receive windfall gains while others would incur significant losses. This is a negative effect of the flat-rate tax, the importance of which is severely underestimated by the proponents. Changes in the tax treatment of fringe benefits and charitable contributions are also mentioned by various opponents as serious trouble spots as well, for reasons previously cited by Kullberg. Some opponents even say that the revenue estimates are overstated—that the flat tax would not bring in nearly as much revenue as its supporters claim.

Perhaps the biggest point of contention, however, is the matter of the “fairness” of this new tax. Under a 20% flat tax rate, the average tax rate would increase by 10.5%, causing many people to pay higher taxes than at present. And if the flat tax rate were 25%, only those taxpayers with yearly incomes above $100,000 would pay less in taxes under the new system (Shilling, 1983, pp. 206–207). Even the most vocal of the flat tax supporters concede that “lower taxes on the successful will have to be made up by higher taxes on average people” (Hall and Rabushka, 1983, p. 58). As Ballentine argues:

Indeed, there are strong reasons why we would not want a single tax rate. As an example, Alvin Rabushka noted that the Hall-Rabushka plan would cause some redistribution of income . . . As I understand the numbers, for a family of four with a $20,000 income, including all wages and no tax shelters, no fringe benefits, and no particular tax breaks, the Hall-Rabushka plan would effectively repeal more than the entire 25% 1981 tax cut. Higher income persons would break even or gain. For example, top grade government employees, earning on the order of $60,000, would just about break even. At incomes above $70,000, people would be getting signifi-
IV. An Alternative to the Flat Tax

There are, of course, numerous alternatives to the flat tax system which have been proposed to deal with some of the problems of the current system. Most of these alternatives are not true flat taxes, since they propose only a partial "flattening" of the income tax. Some, for instance, provide for a 10% tax on personal income, with no provisions for changing corporate taxation. Others advocate graduated rates on personal income, with a flat-rate tax on corporate income.

One of the most talked about alternatives currently is the Comprehensive Individual Tax Proposal, or "fair tax," proposed by U.S. Senators Bradley and Gephardt. This "fair tax" proposal addresses only the personal income tax, not the corporate income tax. Bradley and Gephardt propose that a basic tax rate of 14% be levied on taxable incomes below an adjusted gross income (AGI) of $25,000 for single returns and $40,000 for joint returns. They also recommend that a progressive surtax be imposed on AGI. The surtax would be added in three steps reaching a maximum of 14%, for a combined tax rate of 28% above $37,000 AGI for single returns and $65,000 AGI for joint returns. Several other major features of the current tax system would be retained in the Bradley-Gephardt proposal, among them:

1) the zero bracket amount (although they would increase it from $3,400 to $4,600 for joint returns);
2) the taxpayer exemption, which would be increased from $1,000 to $1,500 for single returns, from $2,000 to $3,000 for joint returns, and from $1,000 to $1,750 for single heads of households. Each additional exemption would be worth $1,000.

In addition, Bradley and Gephardt would retain a number of the most "popular" current deductions: employee business expenses, home mortgage interest, charitable contributions, state and local income taxes and property taxes, and the exclusions for social security and veterans' benefits. Basically, the objectives of the Bradley-Gephardt plan are to broaden the tax base and to redistribute the tax burden so that the lowest 60% to 70% of taxpayers would see their taxes reduced, while the upper 30% to 40% would pay more than they do now. While such a plan might not solve the incentive problem under the current system, it would nonetheless be considerably simpler than the current system.

V. Conclusions

It cannot be denied that our current tax system has its shortcomings. It is complex, inefficient and not always equitable. It is also said to be responsible for creating certain economic disincentives which have resulted in reduced work time and an inefficient allocation of risk in corporate finance.

Robert Hall and Alvin Rabushka have proposed a flat-rate tax as the best means of tax reform. Their system would eliminate double taxation, tax all income at the same rate, and simplify compliance. In addition, they contend that it could increase federal government revenues and mitigate certain economic disincentive problems.

Opponents of the flat tax dispute such claims. Although the flat tax seems simple in theory, they charge that it would be difficult to put into practice because it is too "radical" a change—one which would cause taxpayer discontentment and distrust. Loopholes, critics claim further, cannot be permanently eliminated from this or from any tax system. Perhaps most damaging is the contention that the flat tax would be "inequitable," resulting in an increased tax burden for lower- and middle-income wage earners and a reduced tax burden only for the wealthy.

From the discussion above, it would appear that the flat tax may not be the most politically feasible method of tax reform available at the present time. Although it could remedy some of the problems of the current system, a more modest proposal, such as the fair tax plan of Bradley and Gephardt, seems to have considerably broader appeal as an instrument of tax reform.
References


