

Sailing Toward Tax Reform

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Introduction

Good afternoon. There are great changes afoot on the economic landscape, and impending tax reform is one of the most far-reaching. I am pleased to have the opportunity to talk to you today about one of the leading reform proposals: the flat tax.

Let's begin with a virtual reality exercise. All you have to do is close your eyes and use your imagination. Don't worry; you won't miss anything.

First, imagine some ancient ruins – perhaps the Parthenon – with many steps strewn with debris. Maybe some trap doors and other hidden dangers. Next, envision a long, wide, flat beach on a sun-drenched day. A light sea breeze is brushing through the palm trees.

Now back to real reality. The first picture, the ruins, is the U.S. tax code. The second picture, the beach, is the U.S. tax code on drugs, and the active pharmaceutical is the flat tax. Or at least that is what some of its supporters would have us believe.

The truth lies somewhere in-between. The flat tax would be superior to the current system in many ways that I will discuss in a moment. But it would not live up to some claims. I believe Steve Forbes argued that his version would double economic growth indefinitely – a virtual impossibility.

But before I get to that, a little background. The flat tax is not a fresh, new idea. Milton Friedman wrote about it almost 35 years ago, at which time he was stealing it from someone else. Neither is it untried. Estonia enacted a pure flat tax a few years ago, and Hong Kong has a system based on flat tax principles. In both cases, the results have been astonishingly positive.

Here in the U.S., we have long had many flat taxes, such as state sales taxes, the payroll tax, and the gasoline tax.

A version of the flat tax has been introduced into almost every Congress in the last fifteen years, most recently by Representative Dick Armey. Such strange bedfellows as Arlen Specter, Jerry Brown, Dick Gephardt, Jack Kemp, and Eleanor Holmes Norton have advocated different versions of a flat tax. In this year's Republican primary, Steve Forbes made the idea about as famous as tax reform can be.

This afternoon, I will brief you on the version, designed in 1981 by Robert Hall and Alvin Rabushka of Stanford, and given life by Dick Armey's bill. I will outline the system, and then focus on the implications. What is good about it? What is *not* bad about it? And what are some worthy questions and concerns?

What is the Flat Tax?

First, "Flat Tax" is a lousy name. It has no appeal, and it is misleading. Steve Forbes

wised up toward the end of his Primary campaign and began calling it "A-Flat-Tax-That-Is-A-Tax-Cut," but by then it was too late, and that name is cumbersome and still not very catchy.

The "flat," of course, refers to the single rate that would be applied to all taxable income. But the average effective tax rate rises with income, just as under the current system. The flat tax is not flat. But more to the point, the distinguishing feature of the flat tax is not its shape. What matters most is that it circumscribes all income in the economy by integrating the individual and business tax systems and that it taxes all income once and only once at its source. In addition, although the tax is levied on income, it is effectively a tax on consumption, which is a measure of what people take out of the economy, rather than income, which is a measure of what they create.

Here is how it would work. All income in the economy is either wages, salaries and pensions or business income. The system is airtight. Both types of income are subject to the same, single tax rate.

Individuals would pay a flat rate of 17 percent on income beyond the personal allowance. The allowance would be \$11,350 for a single filer, double that for a married couple, and would include \$5,300 for each additional dependent. Note that the marriage penalty disappears.

The allowance makes the system progressive. A family of four, for example, would owe federal income tax on each dollar of taxable income above \$33,300. A family with income of \$40,000, would pay an average tax rate of 2.8 percent under Arney's 17 percent rate. A family with income of \$100,000 would pay 11.3 percent. A millionaire would pay an average rate of 16.5 percent.

I am getting ahead of myself, but part of the beauty of the flat tax is that there is no place to run, no place to hide. And because of the low rate, there is little reason to want to.

Businesses would pay the same 17 percent rate on all income that they generate, except what is paid to workers or invested in plant and equipment. It is not the purpose of the business tax to tax businesses. People pay taxes, not businesses. The idea is to collect the tax that the owners of a business owe on the income produced by the business. The flat tax levies the tax on the business only because that is the most efficient way collect it.

What is good about the Flat Tax?

The flat tax would encourage economic activity and be more fair than the current system.

Albert Einstein said, "The hardest thing in the world to understand is the income tax." I don't know if it is the hardest, but it sure is costly. Estimates of the burden of complying (and not complying) with the current system range from a very conservative \$70 billion, or 10 percent of tax collections, to five times that – every year.

These estimates include direct and indirect costs. Direct costs are those such as record-keeping, learning about tax requirements, preparing, copying, and sending forms, commercial tax preparation fees, audits and correspondence, penalties, errors in processing, litigation, tax court cases, enforcement and collection.

Indirect costs are what economists call "deadweight losses," or reductions in output

caused by actions taken to comply with, to avoid, or to evade taxes, which losses are not offset by gains anywhere else. Examples of indirect costs are reductions in the labor supply, capital formation, business formation, failure to expand existing facilities, and investments designed to lower tax liability rather than produce income.

The flat tax would reduce these costs, perhaps significantly. Presumably these resources could be more productively used, which would make the economy permanently larger and give growth a one-time boost.

The flat tax would also encourage economic activity by lowering the top marginal tax rate. Research over time and across states and countries indicates that economic growth is sensitive to the progressivity of marginal rates (that is, the spread between the rates for highest and lowest brackets) and the level of the top marginal rate. The flatter the marginal rate schedule and the lower the top rate, the faster the economic growth.

And the flat tax would boost long run economic growth by eliminating incentives to consume and disincentives to saving and investment. Over long spans, economic growth is determined largely by population growth and increases in productivity. Productivity is a function of the capital stock, which is built up through investment. No investment can take place without corresponding saving. The current tax system discourages both by taxing returns to capital heavily by taxing it multiple times. The flat tax would tax it only once.

The flat tax would be more fair than the current system in at least three ways. Every taxpayer with the same size family and the same income would pay the same tax, no matter what. No one with a high income would pay less tax than someone with a low income. And the rules would be simple enough that they either would not affect our decisions or we would be more certain of the tax consequences of our actions.

This last point may be the most important. Alexander Hamilton wrote that:

[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; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is to-day, can guess what it will be to-morrow.

Finally, believe it or not, the flat tax would go a long way toward resolving the problem of high and rising medical costs. Employee benefits would not be taxed at the individual level, but would no longer be deductible by the business. That would mark the beginning of the end for essentially first-dollar coverage medical insurance policies that have been forcing up prices for medical goods and services. But that is a different topic.

What is not bad about the flat tax?

The system would not be an economic panacea, but most of the common charges fall short.

It has been widely claimed that rich coupon-clippers in Palm Beach will live tax-free, while hard-working wage and salary earners will pay all of the taxes. That stems from a misunderstanding of the system. Remember, the flat tax is integrated, collecting taxes on all taxable income at the corporate level before it is paid out as interest and dividends or realized as capital gains.

For example, an equivalent means of collecting tax on corporate income would be to have shareholders directly pay the tax on their prorated portion of profits. It would then be clear that people who receive investment income and no wage or salary income are paying taxes. But it would be much more difficult and costly to collect the tax. The IRS sends out about 1 billion 1099 forms per year to track income passed from businesses to individuals under the current system.

A study for the National Association of Realtors that was published last year predicted that the loss of the home mortgage interest deduction would cause a 15 percent drop in home values, on average. I think the consensus among economists is that there would be a decline, but that it would be in the single digits. The real questions should be, not who benefits and who is hurt, but should renters subsidize homeowners and should homeowners with small mortgages subsidize homeowners with big mortgages? Any disruption in the home market could be substantially alleviated by phasing-out the deduction over along period or through a variety of other measures.

Another concern is that eliminating the deduction for charitable giving would undermine philanthropy. Some forms of giving might be curtailed, but history and research suggest people give mostly in proportion to their interests and their wealth. Sociologist Francie Ostrower concludes that, among the wealthy, philanthropy is more a way of living than a means of avoiding taxes. Even a flat tax that eliminates the charitable deduction seems unlikely to weigh heavily against the incentives of status, obligation and tradition that motivate very affluent donors to give.

Ours is a nation with a tradition of giving that pre-dates the federal income tax. The Salvation Army, Red Cross, and Good Will all took hold here long before income taxes mattered. It is hard to believe the flat tax would change that.

A final criticism is that a pure flat tax would end the subsidy to local governments from the tax-exempt status of municipal debt. This might be a good thing. I know of no other federal government in the world that subsidizes municipal borrowing. In addition to transferring income from low to high income taxpayers, it blocks privatization of public facilities and thwarts pension fund investment in infrastructure.

What about the effect on the value of outstanding municipal bonds? No one can say for sure what will happen, but chances are there will be little change. The yields on municipal debt will rise and the value fall relative to yields and values of taxable bonds, but not necessarily relative to current yields and values.

Suppose a borrower is willing to pay and a lender is willing to receive 3 percent after tax and suppose the current tax rate is 50 percent. Under the current system in which interest expense is deductible and interest income is taxable, the two will strike a deal at 6 percent. Under a flat tax with a 25 percent rate and no business deduction for interest expense and no individual tax on interest income, the two would be willing to receive and pay 4 percent. In other words, the entire interest rate structure will decline, offsetting some or all of the negative effects on municipal borrowing costs and the market value of outstanding municipal debt.

What is bad or questionable about the flat tax?

The flat tax is not all sweetness and light; it has its dark side. Two taxpayers with identical income but different family sizes, for example, would pay different amounts of tax. I'm

not sure what economy theory says about this, but it strikes me as unfair or at least somewhat arbitrary for tax law to discriminate on the basis of personal decisions or ability regarding marriage and child-rearing.

The simplicity of the flat tax is oversold. It would clear up questions about deductions, but some uncertainty would remain about income. The postcard size form holds little appeal. I imagine that few are intimidated by the current Form 1040. It is the 1,378 pages of the federal tax code that boggle the mind and turn the stomach. A small form would not by itself change this.

Economists disagree over the favorable treatment of investment in equipment relative to investment in human capital, and I have not figured this one out yet. I have a complicated answer that I think is right, but probably might not go all the way.

Arthur Godfrey said: "I'm proud to be a tax-paying American, but I could be just as proud for half the taxes." Of course if government spending stayed at the same level after such a cut, then he would be twice as much in debt. Many look at the budget deficit and see a glass half full. I see a glass that is just too big, and the flat tax would not make it smaller. The flat tax would be a more efficient means of funding our overgrown central government. And as Peter Drucker has said: "The worst thing you can do is make more efficient something you shouldn't be doing in the first place."

A more pragmatic objection is that politicians will not give up a powerful tool for assisting constituents and backers until threatened with a drive to repeal the 16th Amendment to the Constitution (which gives Congress the power to tax income). According to Milton Friedman, in practice, revenue generation is a secondary function of the federal income tax code. The more important political function of income taxes, is "to provide a means whereby the members of Congress who have anything whatsoever to do with taxation can raise campaign funds."

Finally, even if supporters in Congress somehow succeed in enacting a pure flat tax, who can say how long it will remain that way. Congress came close to a flat tax in 1986, with marginal rates of 15 and 28 percent, but it lasted barely four years. Today, we are back up to five rates, with the highest at 39.6 percent.

Conclusion

In closing, what are the political prospects for the flat tax? My guess is that the chances for passage of something like the 1986 reform – which gave us fewer and lower marginal rates with fewer deductions – are high in the next year or two, depending, of course, on the outcome of elections in November.

Christopher Columbus set out in 1492, certain that the world was not flat, not knowing exactly where he was going, but sure that his voyage would benefit the world. In fact, Columbus did not arrive at the destination he desired, yet his trip proved to be a greater success than he could have imagined.

The "flat taxers" are in the same boat, realizing the flat tax is not flat – or at least that that is not what matters most about it – unsure of the full ramifications of enacting it, but knowing it will be beneficial. They will likely fall short of their goal of a pure flat tax, yet will greatly improve upon the current system.