

The Flat Tax Proposal – Will Voters Understand the Issues?

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ON JUNE 17, 1998, by a margin of 219-209, the House of Representatives voted to repeal the Internal Revenue Code in its entirety, provided an unspecified replacement is in effect by July 4, 2002. Although criticized by some as reckless and irresponsible, the repeal measure was praised by Speaker Gingrich as a “very important step in the right direction.” The Speaker gave no clear indication of what the “right direction” might turn out to be, but it is no secret that the Republican party now supports the adoption of a national consumption tax to take the place of our present individual and corporate income tax and presumably intends to press that proposal in upcoming election contests, both locally and nationally.

While it is not the only consumption tax idea in the wind, I think the so-called Flat Tax proposal has attracted the largest number of active supporters, both in and out of Congress.

Among Presidential aspirants, Steve Forbes and Jack Kemp are the leading but by no means the only proponents; in Congress, Majority Leader Armev and Senator Shelby are the named sponsors of a Flat Tax bill, but again, judging by public comments from members of their party cohort, including the present Chairman of the House Ways and Means Committee, there are others, many others, who can be expected to lend their support if the Flat Tax begins to look as if it has substantial voter appeal.

For those of us who make a specialty of teaching and practicing in the field of federal taxation, one of the abiding frustrations is the extent to which *nonspecialists* – including lawyers, business people and other well-educated citizens – can be misled and misinformed, even lied to, about the general subject of “taxation.” Regarding the Flat Tax proposal in particular, my sense (based, I admit, on casual

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though numerous conversations with friends and colleagues) is that the phenomenon of “misapprehension” remains fairly widespread. If so, the situation is really quite dangerous, because it leaves voters wide open to being told what they want to hear, no more no less. That, in turn, creates ample opportunities for exaggeration, distortion, false threats and hollow promises that are difficult to counter effectively once they have been burned into people’s minds. To be sure, it is beyond anybody’s capacity to stay on top of every complex public policy issue that deserves study. But this issue – what sort of tax system is best for the nation – is simply too important to ignore and too important to be approached through the medium of sound-bites and political slogans.

Accordingly, the task I have set myself in the pages that follow is to describe the Flat Tax concept in brief detail – how it would work, what its effect would be on taxpayers at various income levels, how it compares with our present income tax – and to do that in a way that general readers will find understandable and useful.

FLAT TAX – OLD

As far as public understanding is concerned, there is at the very outset a problem of nomenclature or terminology. The term “Flat Tax” when used by Forbes, Kemp, Armey and other enthusiasts refers to a wholly new system of taxation – a form of consumption tax – that would, if adopted, entirely replace our present income tax, both individual and corporate. But the same term, as many will recall, has been used on recent occasions, and is still used by some, to refer to a conventional income tax – a tax on income from all sources – that would be imposed at a single “flat” rate

rather than the ascending scale of marginal rates that makes our present income tax “progressive.” The two flat-tax ideas are very different, and it is of course important for voters to understand that proponents of the “Flat Tax” are talking about one and not the other.

The single-rate or flat-rate income tax is a concept that was dear to the heart of President Reagan, a man whose idea of what a just tax system should be was rooted not merely in politics and economics but in Scripture itself. Speaking to the Republican Club of Orange County as long ago as 1961, then-actor Reagan declared:

There can be no moral justification for the progressive tax. Proportionate taxation we would gladly accept on the theory that those better able to pay should remove some of the burden from those least able to pay. The Bible explains this in its instruction on tithing. We are told that we should give the Lord one-tenth, and if the Lord prospers us ten times as much, we should give ten times as much. But under our progressive income tax [which in 1961 rose from a rate of 20% at the bottom to 90% at the top], computing Caesar’s share is a little different ...¹

Mr. Reagan went on in the same speech to assert that the progressive income tax had actually been received “direct from Karl Marx,” whose devilish aim was the total destruction of the professional and entrepreneurial classes.

Strong views, although setting up an opposition between Marx and the Bible on the subject of tax policy might now seem slightly over-dramatic. But in any case, Mr. Reagan, to his credit, remained faithful to his convictions as the decades passed, and in 1986, midway through his second term, the President achieved his apotheosis. Supported not only by members of his own party but by many

¹ Reagan, *Encroaching Control: Keep Government Poor and Remain Free*, 27 VITAL SPEECHES OF THE DAY 677 (1961).

Democrats as well, President Reagan stumped the country in an effort to persuade voters that our long-standing progressive rate structure was, as he said, “ready for the ash heap of history.” The President had a set speech. Ever the performer, he would cue his audience: “Now listen carefully,” he would say. “If you really, truly love our current Federal tax system ... how about a big cheer for it? [Audience: Boo-o-o!] Now, how about this? If you even like our current Federal tax system, how about a big cheer. [Audience: Boo-o-o!]”

“Well,” the President would observe in mock surprise, “not even one cheer. ...”²

Congress got the message, or what it thought was the message, and at least for the time being exorcised the ghost of Karl Marx by adopting a flat-rate tax structure, a “tithe,” just as President Reagan had urged some twenty-five years before. Hailed by many as a kind of legislative miracle, the Tax Relief Act of 1986 somewhat broadened the tax base by knocking out various special tax preferences – most notably, real estate tax-shelters – and then flattened the rate-structure by imposing a single tax-rate on middle and upper income taxpayers. Under the 1986 Act (omitting some details), income up to about \$30,000 – presumably regarded as low or moderate income – was taxed at a rate of 15%, while income above the \$30,000 level was taxed at a rate of 28% without any further steps or intervening brackets. Also, however, both the standard deduction and the personal exemption amounts were sharply increased with a view to relieving very low-income people from tax completely. The system that emerged – a flat rate tax on income above the 15% bracket – was one that is sometimes called “degressive,” meaning that progression halts and the tax becomes proportional once poor and moder-

ate income people have been freed from “normal” tax burdens. Thus, an individual earning \$30,001 above exemptions and the standard deduction was taxed at a marginal rate of 28% on her last dollar of income. The same was true for an individual earning ten or a hundred times more.

To be sure, the flat-rate income tax is by now a matter of history. Faced with climbing budget deficits, President Bush (his “read my lips” notwithstanding) was compelled to add a 31% bracket above President Reagan’s 28% for incomes over \$82,000. President Clinton went even further in his 1993 budget enactment. Insisting that a flat or proportionate rate-structure unduly favors upper-income taxpayers and for that reason fails to meet a standard of tax equity or “fairness,” Clinton effectively restored full-scale progressivity by increasing the tax credit allowed to very low wage-earners and by adding a 36% and a 39.6% bracket above President Bush’s 31% for incomes over \$140,000 and \$250,000, respectively. At the present time, then, while our rate-structure is by no means the steep ladder-like structure that it used to be, we do again pay our income taxes under a system that can be called “progressive.”

Economists and others have debated the ethical merits of progressive versus proportionate taxation for decades, even centuries. How taxpayers in general feel about that question, or whether they even care very much about it, I really do not know. Based on opinion sampling, some researchers have concluded that people on the whole do think that high-income taxpayers should be subject to higher marginal tax rates than low-income taxpayers. But that conclusion is offered somewhat tentatively and it seems even more likely that the public does not regard the issue as especially pressing or dramatic except at the

² Remarks of President Reagan to Citizens of Bloomfield, New Jersey, released by The White House, Office of the Press Secretary, June 13, 1985.

extremes. Americans (we are told) traditionally regard equality of opportunity as more important than equality of outcome – the truly difficult problem being how to distinguish one from the other at any given point in time.

My purpose here, however, is not to join that debate but to make sure that the reader does not confuse the old flat tax with the new one. As I said earlier, I have a pretty clear impression that the term “flat tax” is understood by some, perhaps many, to refer to nothing more or less than the flat-rate or proportionate income tax so much beloved of President Reagan. But that is not the case. President Reagan’s single-rate income tax has absolutely nothing in common with the Flat Tax proposal currently being put forward by members of the Republican leadership – except of course for the word “flat” and the word “tax.”

FLAT TAX – NEW

Briefly stated, the Flat Tax (Forbes/Kemp/Armey etc. version) is not an income tax at all, flat or otherwise. Rather, it is a Value Added Tax with a rebate to low-wage workers. The Value Added Tax – a revenue-raising device that is well-known in Europe but not as yet in the United States – is, quite simply, a tax on “consumption,” on what we spend for food, housing, clothes, transportation, recreation, and whatever else we buy during the year for ourselves and our families. In economic and practical effect, it is the very same thing as the state and city Sales Tax that we now pay when we purchase something at a store, except that the Value Added Tax is collected from businesses rather than from individual shoppers. Under either system, it is we, the consumers,

who actually pay the tax – not directly as we do with an income tax, but in the form of an equivalent increase in the price of the goods and services that we buy and consume every day of our lives.

It is easy to avoid a Value Added Tax, just as it is easy to avoid a local Sales Tax. All you have to do is save your money. Don’t buy anything – at least not much. Spending is taxed but saving is not. That is how a Sales Tax or a Value Added Tax works.

Our income tax (any income tax) operates very differently. The income tax taxes yearly *income* – what you receive from all sources – and it doesn’t care at all about what you do with what you receive. No distinction is made between spending and saving or, of course, between people who spend and people who save. Ideally, the income tax base can be measured by adding together the amount that you spend during the year and the amount that you save during the year. The two together – what you spend plus what you save – necessarily equals your annual income. By obvious contrast, a Sales Tax (or a Value Added Tax) is imposed on only one of those quantities, namely spending, with savings being exempt.

I have asserted that the Flat Tax, the Value Added Tax, and the Sales Tax are essentially one and the same. Knowing that the term “Sales Tax” has a most unpleasant ring to it, Forbes, Kemp, Armey and other Flat Tax proponents tend to keep that fact to themselves, possibly in the hope that it will escape public attention.³ But of course it shouldn’t escape attention. Whether American voters actually do wish to replace our income tax with a Flat Tax (*equals* Value Added Tax *equals* Sales Tax) I can’t be sure, but whatever their preference, voters should, indeed must, have a clear idea of

³ As my colleague Larry Zelenak has pointed out, every other tax system one can think of is named after its tax *base* – “income” tax, “property” tax, “sales” tax. Only the Flat Tax is named after its rate structure. Not too hard to figure out why.

what that choice entails.

Perhaps the best way to make the operation of the Flat Tax clear is through a series of simple transformations, that is, by showing how the familiar state or city Sales Tax just referred to turns into the much less familiar (to us) Value Added Tax, which then “magically” turns into the Flat Tax itself. Having completed that simple analysis, we can then conclude by showing how and why all three differ, and differ fundamentally, from the income tax as we know it.

An ordinary state or city Sales Tax is a revenue-raising device that everybody recognizes easily. If you live in New York City, for example, you pay a Sales Tax of 8¼% on retail purchases of goods and services, with certain basics such as food, medicine and medical services being exempt. The 8¼% Sales Tax is simply added to the retailer’s bill and becomes part of the purchase price of the goods or services in question. So, if I buy a brand-new overcoat at Macy’s this winter for \$300 (reluctant as I am to do that), the actual cost will be \$324.75 – \$300 plus a Sales Tax of \$24.75 – with Macy’s acting as tax-collector on behalf of the State and City of New York.

In effect, then, a Sales Tax is calculated as a percentage of the value of all goods and services sold to consumers. To illustrate very simply, suppose Macy’s stocks overcoats worth \$1,000,000, all of which it sells to you and me and other consumers at retail. Assume that Congress enacts a nationwide federal Sales Tax of 20%. Quite obviously, the federal Sales Tax will amount to \$200,000 in total, which amount would be added to the price we pay for the overcoats that Macy’s sells us. To be sure, we pay that 20% Sales Tax if and only if we actually *spend* our money – not just on overcoats, of course, but on food, rent, bus fare, movie tickets, and everything else. If we refrain from spending (I wear my old winter coat for another year, I walk to work, I watch TV instead of going to the movies) and put

our money in a savings account or in stocks or bonds, we pay no Sales Tax at all. The tax is imposed on spending only – that is, on consumption – but not on saving, or, at least, not until we actually spend the amounts that we have saved.

The very same “analysis” (though perhaps a little harder to see) applies to yet another well-known revenue-raising device. Almost all Western European countries impose and collect their sales taxes at the business level rather than the consumer level through the medium of a so-called Value Added Tax. Value Added Taxes and retail Sales Taxes are essentially alike (apart from point of collection) and indeed any comprehensive retail Sales Tax can be replicated by a Value Added Tax – and vice-versa. The aim of both, quite simply, is to tax households on their consumption expenditures. As stated above, the retail Sales Tax is collected by the retailer at the point of final sale to the consumer. By contrast, the Value Added Tax is collected from the businesses and companies that produce the product rather than the households that consume it – and on the “value added” to the product at each stage of production. The term “value added” refers to the difference between the value of the products sold by a company and the cost of the “inputs” that it buys from other companies, including so-called capital goods such as machinery and equipment. It is important to note (for a reason that will shortly appear) that employees’ wages are not subtracted by the company in calculating “value added.” Accordingly, “value added” can be divided into two components: (1) wages and salaries paid to the company’s employees, and (2) the excess of the company’s product sales over its other expenditures for the year, which for this purpose can be called its “cash-flow profit.”

I said just above that the retail Sales Tax (with which we are all familiar) and the Value Added Tax (which we have never experienced

locally) are essentially identical to one another. That may sound a bit confusing but in fact the point is easy to demonstrate. Assume, again, that Macy's has overcoat sales this year of \$1,000,000 and that it pays \$550,000 to other companies for the overcoats and for accessories and equipment – boxes and display racks, for example. Under (say) a 20% federal Value Added Tax, Macy's owes \$90,000 in taxes – 20% of \$1,000,000 minus the \$550,000 that it has paid to its suppliers. The suppliers themselves owe tax on the \$550,000 received from Macy's, so they owe 20% of \$550,000, or \$110,000. Total taxes are therefore \$200,000, which sum would be collected in pieces from Macy's (\$90,000) and from the various suppliers (\$110,000). A retail Sales Tax of 20% yields the same total tax of \$200,000, assuming, as before, that Macy's sold those overcoats for \$1,000,000 at retail. The two "systems" – the Sales Tax and the Value Added Tax – generate exactly the same amount of taxes and differ only with respect to the point (or points) at which such taxes are collected.

But of course it is we – you and I – who actually pay the tax. Under either regime, the \$200,000 of taxes would be passed on to consumers by being added to the retail prices of the things that Macy's finally sells us. We are fully aware of that when we pay the retail Sales Tax. We are likely to be less aware of it if we pay the same amount as a Value Added Tax, because the tax itself will have been largely prepaid by the companies that make the product and then "silently" passed on to us in the form of a higher price. One alleged virtue of the Value Added Tax as compared with the Sales Tax is that it is easier to collect and less susceptible to evasion. Another alleged virtue is that, being less out in the open where consumers can actually see it, the Value Added Tax is usually applied on a broader base than the Sales Tax, with fewer exemptions for goods that might otherwise be regarded as "necessities."

Consumption taxes (whether retail or company-level) are often objected to on grounds of "regressivity." Low-income households have to spend most or all of their earnings on food, rent, clothes and other living expenses, while upper-income households typically spend only a fraction of their earnings on living expenses and save the rest. Hence a Sales Tax, which cannot as a practical matter be graduated, hits the poor harder in percentage terms than it does the rich. To most though perhaps not all observers, that result seems distinctly unfair. While it may be acceptable to run a regressive tax system at the state or city level where the tax-rate is relatively low, doing the same thing at the federal level where the tax-rate would have to be much higher is a step that few voters would support and not many politicians (only those, really, who enjoy automatic reelection) would have the confidence to propose.

The question, then, is whether people who think that the income tax should be replaced – "buried forever ... torn up by the roots" – can contrive a substitute system that (a) limits the tax base to spending and excludes saving, but also (b) avoids or at least mitigates the objectionable feature of regressivity as well.

Enter the Flat Tax – which, as I have said, is a scheme that combines a tax on consumption with a concession to low-wage individuals and households. Savings are exempt under the Flat Tax plan, which obviously benefits the wealthy, while some relief is extended to people whose earnings are low or moderate. To be sure, the distributional consequences – how the Flat Tax bears upon individuals at different levels of income – are by no means as smoothly symmetrical and even-handed as the preceding sentence implies. But again, that vital question – who pays? – is reserved for later discussion.

The Flat Tax plan has two integrated parts: (1) a so-called Business Tax that is collected from all companies, large or small, and

whether or not incorporated, and (2) an Individual Compensation Tax collected from individual wage-earners. Both taxes would be imposed at the same rate. The tax base for the Business Tax consists of all cash receipts from the sale of a company's products, less the sum of (i) payments made to other firms for services, merchandise and machinery and equipment *and* (ii) wages paid to employees (but not fringe benefits such as health insurance). With one major exception, the Business Tax operates in exactly the same way as a standard Value Added Tax: the company deducts from its total sales all payments made to suppliers, together with any investment it has made in plant and equipment. What is left is the company's "cash-flow profit," which, as will be recalled, is one of the two components of "value added" mentioned above. As suggested earlier, the Business Tax, though collected directly from the company that makes, processes or sells the goods in question, will be passed on to consumers in most cases either as a reduction in purchasing power or in the form of a price increase for those goods just as in the case of a state or city Sales Tax.

The exception (for which great ingenuity is claimed) is the treatment of employees' wages and salaries. Under a standard Value Added Tax, wages are *not* deducted from the tax base. In effect, both the amount earned by the owners of the company – the yearly "profit" – and the amounts earned by the company's employees are subject to the Value Added Tax, the tax itself ultimately being passed on to consumers, as just noted. To counter the regressivity objection that is often raised against the Value Added Tax (as it is against a Sales Tax), the Flat Tax allows firms to deduct employees' wages for Business Tax purposes, but then taxes such wages to the wage-earners themselves under the Individual Compensation tax. While the Individual Compensation tax and the Business Tax are imposed at the same rate, the act of separating the two affords the Flat

Tax an opportunity to exempt a portion of the wages paid to individual employees. Thus, under one version of the Flat Tax proposal, an exemption of \$26,000 is allowed to a married couple plus \$5,000 for each minor child, or \$36,000 for a family of four. In effect, therefore, low-wage households are relieved of the Individual Compensation Tax and regressivity is mitigated. The same exemption cannot be achieved under a standard Value Added Tax or under a retail Sales Tax, because the latter are imposed on the sale of products and do not take the consumer's income level into account.

The Individual Compensation Tax is imposed on wages and salaries only. Income from investment is not included in the tax base, as of course it is under our income tax. Investors in stocks and bonds would thus enjoy a substantial advantage as compared with their present tax status, because the dividends, interest and capital gains that they receive each year – now, of course, taxable – would suddenly become tax-exempt. Putting the point more generally, savers would entirely avoid tax on their savings under the Flat Tax plan, just as they would under a standard Value Added Tax and just as they do under a retail Sales Tax.

The identity between the Flat Tax and a Value Added Tax or a retail Sales Tax is easy to illustrate. Again, assume Macy's sells \$1,000,000 worth of overcoats. It pays \$550,000 to other companies for inventory and equipment *and* pays \$150,000 in wages to its employees, leaving Macy's with a cash-flow "profit" of \$300,000. Using the same 20% tax rate that we used in our earlier examples, Macy's would owe a Business Tax of \$60,000. The Individual Compensation Tax (also at 20%) would be imposed on the \$150,000 of wages received by Macy's employees, but the latter amount would be reduced by whatever exemption amounts were allowed to the individual wage-earners on the basis of their family status. Thus, a low-wage employee – one

whose total wages fell within the exemption amount – would owe no Individual Compensation Tax whatever. Needless to say, the supplier companies and their employees (again, subject to the allowable family exemptions) would pay tax on the remaining \$550,000, which represents their own cash-flow profits plus wages paid.

Apart from the family exemption amounts, the Flat Tax tax-base (all company-level “profits” plus all wages paid to employees) totals \$1,000,000, the same tax-base as in the Value Added Tax and retail Sales Tax illustrations. While I have also used the same 20% tax-rate for all three, it may have occurred to the reader that the Flat Tax rate will actually have to be higher if the Flat Tax is expected to generate the same amount of government revenue as the other two. The reason, obviously, is that the family exemptions – as stated, \$36,000 for a family of four – would substantially reduce the Flat Tax tax-base, resulting in lower revenue or else requiring a higher tax rate if revenue-neutrality is to be achieved.

The point of all this is to make clear that the Flat Tax, the Value Added Tax and the Sales Tax are all versions of the same tax system, one that distinguishes between consumers and savers by taxing spending but exempting personal savings. Our income tax is very different:⁴ it taxes annual income “from whatever source derived” and makes no distinction between people who spend and people who save.

THE CHOICE

What remains is to give the reader some idea, in summary form, of what the consequences are likely to be if we substitute the Flat Tax for our present income tax. Is that the “right direction,” as former Speaker Gingrich and

other Republican leaders appear to think, or would it ultimately be a decision we would regret? The following are the four criteria – simplification, distribution, economic impact, and “fair-ness” – that seem to me most relevant in deciding just which direction the nation ought to take.

Simplification

Our income tax law is too complicated – everyone agrees on that. On the other hand, most of the complexities, almost all of them in fact, have virtually no impact on ordinary taxpayers whose annual income typically consists of wages or salaries plus dividends, interest and an occasional capital gain. Fully 70% of all individual taxpayers elect the standard deduction rather than itemizing their personal expenses and can simply and quickly read the tax due from the tax tables or from the rate schedule. For the great majority of individual filers, therefore, the “postcard-size” tax return so much proclaimed by Flat Tax proponents provides no significant simplification benefits whatever.

For the minority of taxpayers who do itemize their personal expenses, the Flat Tax does achieve some modest simplification for the reason that the personal expense deductions are no longer allowed. Dropping present Schedule A certainly would simplify tax returns. The question then, however, is whether itemizers, especially homeowners, will really welcome that development. Are taxpayers willing to give up the mortgage interest, state income tax and charitable contribution deductions in exchange for what Flat Taxers promise will be a lower tax rate? I doubt it; but if so, there is nothing inherent in our present income tax that requires us to retain those deduction items even now. The fact is that we *choose* to retain them despite the record-

⁴ For a theoretical analysis of the “difference,” see Warren, *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 13-14 (1996).

keeping burdens they entail just because we consider that the activities they support – home-ownership, for example – are deserving and desirable and merit a subsidy via the tax system. Much of the complexity in our tax law, insofar as it relates to individual taxpayers, exists for precisely that reason.

Put differently, we could simplify the income tax and make the audit work of the IRS much easier – and of course reduce rates – if we now gave up the personal expense deductions that we are all accustomed to. Do we need the Flat Tax to achieve that result? Not at all: if we wished (but we obviously don't), we could make the standard deduction universal under the income tax and consign the personal expense deductions to the ash heap of history.

While ordinary wage-earners would gain little from the Flat Tax in the way of simplification, the simplification benefits for investors and for businesses would be very substantial. This follows from the central fact that investment income, whether from the ownership of financial assets such as stocks and bonds by individual investors or of fixed assets such as equipment and real estate by firms, would no longer be taxable under the Flat Tax regime. As far as individuals are concerned, the Individual Compensation tax-base is limited to personal service earnings – wages, salaries and pensions, essentially. Dividends, interest and capital gains would be received or realized tax-free. Since capital gains, whether long-term or short-term, would not be taxable (and, similarly, capital losses would not be deductible), there would be no need to keep track of the basis, or cost, of any of the stocks or bonds that make up the individual investor's portfolio and that now have to be reported on Schedule D. Periodic investment income – chiefly dividends and interest, now reported on Schedule B – would simply be ignored. From the standpoint of an individual investor, therefore, especially one with relatively little salary income, annual filing would be a less

burdensome task than it is today and the tax-return would indeed appear to have shrunk to post-card size.

The effect on business firms, especially larger ones, would be even more substantial. As noted, the Business Tax component of the Flat Tax scheme is merely a modified (to exclude employees' wages) version of the standard Value Added tax. All cash outlays would be currently deductible, even when such outlays would otherwise fall into the category of capital expenditure. None of this means that the firm, whether incorporated or unincorporated, would be free of an annual filing obligation or that the IRS would no longer need to audit and monitor the tax returns as filed, but the replacement of depreciation deductions with expensing and the fact that financial transactions, including the payment and receipt of interest, have no tax consequences would undoubtedly simplify the taxpayer's reporting. On the other hand, self-employed persons as well as small personal-service enterprises, probably the main source of complaints about the complexity of the present system, would in many cases be little affected. Whether (for example) a car is for business or personal use, whether travel expenses are business or personal, whether an alleged home office is in fact an "office" – all of these borderline business expense issues, so often the subject of a painful audit, would be no less contestable under the Flat Tax than they are under our present income tax, and presumably just as vexing to the auditee.

As a final comment, the notion that the Flat Tax base would be immune to erosion and political pressure seems quite unrealistic given our history with the income tax. Indeed, some Flat Tax proponents, hoping to make the proposal more attractive to voters, have already indicated a predisposition to corrupt the Flat Tax base by continuing the deduction for home-mortgage interest and perhaps also for charitable contributions. The effect would

of course be to add complexity back to the system and to require a higher tax rate in order to recoup the cost of those deductions. Homeowners would be encouraged to mortgage their homes to the hilt and use the proceeds to buy stocks and bonds (dividends and interest no longer being taxable), in that way achieving the same sort of "tax arbitrage" that would occur today if one could deduct interest on amounts borrowed to purchase tax-exempt municipal bonds.

In summary, the Flat Tax does offer significant simplification gains. Those gains, however, would chiefly benefit businesses – larger ones more than smaller ones – as well as active individual investors. By contrast, taxpayers whose income consists mainly or exclusively of wages and salaries and who now elect the standard deduction rather than itemizing their personal expenses – as stated, more than 70% of all individual filers – would notice almost no difference as far as the burdens of April 15 are concerned.

Distribution

A question of utmost importance is whether, and how, the replacement of our income tax by the Flat Tax system would change the distribution of tax burdens among individual taxpayers at different levels of income. The world does not, after all, begin anew tomorrow morning. If the adoption of the Flat Tax would lead to the redistribution of existing tax burdens, as of course it would, then voters who are not wholly bemused by philosophical abstraction will have to consider whether such alteration is acceptable and desirable as a social matter or whether they find themselves offended by it. What is important, obviously, is that voters have as clear a sense as possible of how the change from a progressive income tax to the Flat Tax would affect their own tax

positions – both in terms of what they pay currently and in relation to any change in the position of other taxpayers.

Although the results that follow are disputed by some Flat Tax proponents, the statistical study done by the Treasury Department's Office of Tax Analysis in 1996 is generally regarded as the best current approximation of how the distribution of federal taxes would be affected if the Flat Tax were substituted for our present income and estate taxes. As proposed by Rep. Armey and others, the Flat Tax would allow a standard deduction of \$21,400 for a married couple (\$10,700 for single filers and \$14,000 for heads of households) plus an additional \$5,000 exemption for each child or other dependent. The Business Tax would be imposed on the cash-flow profits of all firms, whether or not incorporated, while the Individual Compensation tax would be imposed on wages and salaries, subject to the standard deduction and exemption amounts just mentioned. In order to achieve revenue neutrality, the Treasury found that the applicable tax-rate would have to be 20.8% (assuming the refundable Earned Income Tax Credit for low-income individuals is eliminated, but 2 percentage points higher if EITC is retained).

Table 1, below, shows the Treasury data arranged in the form of percentage change in tax liability and in after-tax income for successive income levels if our present income and estate taxes are replaced by a 20.8% Flat Tax. Table 2 does the same job by population share, first dividing the population into quintiles and then separately examining the effect on taxpayers in the top 10%, 5% and 1% groups.⁵

At the 20.8% tax-rate, and with the family exemption levels mentioned above, the distribution effect – seen most clearly in Column (3) of both Tables, which measures the percentage change in after-tax income – shows

⁵ The Tables are taken from Gravelle, *The Distributional Effects of Fundamental Tax Revisions*, 33 SAN DIEGO L. REV. 1419, 1436-7 (1996).

TABLE 1: PERCENTAGE CHANGES IN TAXES & INCOME, REPLACING INCOME & ESTATE TAXES WITH A FLAT TAX, BY INCOME CLASS

Income Class (\$ thousands)	Percentage Change in Tax Liability (20.8% rate)	Percentage Change in After-tax Income (20.8% rate)	Percentage Change in Tax Liability (17% rate)	Percentage Change in After-tax Income (17% rate)
0 – 10	70.7	-6.2	73.0	-6.4
10 – 20	70.4	-6.8	86.3	-8.4
20 – 30	31.7	-4.9	43.9	-6.8
30 – 50	13.4	-2.8	22.0	-4.7
50 – 75	9.7	-2.4	15.2	-3.8
75 – 100	10.4	-2.8	12.1	-3.2
100 – 200	5.0	-1.4	1.6	-0.4
200 +	-28.1	8.7	-37.4	11.5
Total	1.9	-0.5	20.8	11.8

SOURCE: TREASURY DEPARTMENT (1996).

TABLE 2: PERCENTAGE CHANGES IN TAXES & INCOME, REPLACING INCOME & ESTATE TAXES WITH A FLAT TAX, BY INCOME QUINTILE

Income Quintile	Percentage Change in Tax Liability (20.8% rate)	Percentage Change in After-tax Income (20.8% rate)	Percentage Change in Tax Liability (17% rate)	Percentage Change in After-tax Income (17% rate)
First	80.9	-6.7	92.0	-7.6
Second	37.7	-5.4	50.7	-7.2
Third	13.7	-2.9	22.3	-4.7
Fourth	9.8	-2.4	15.1	-3.8
Highest	-7.4	2.1	-12.0	3.5
Total	1.9	-0.5	1.9	-0.5
Top 10%	-14.4	4.2	-20.7	6.2
Top 5%	-21.3	6.4	-29.5	8.9
Top 1%	-36.1	11.7	-45.2	14.7

SOURCE: DERIVED FROM TREASURY DEPARTMENT (1996) DATA. QUINTILES BEGIN AT \$15,604, SECOND; \$29,717, THIRD; \$48,660, FOURTH; \$79,056, HIGHEST; \$108,704, TOP 10%; \$145,412, TOP 5%; \$349,438, TOP 1%.

that the Flat Tax would redistribute income from lower to higher-income individuals in dramatic fashion if it replaced our present income and estate taxes. Rep. Arney has actually proposed a 17% rate, which would make it necessary to reduce the family exemption amounts in order to maintain revenue-neutrality. Under a 17% rate, as shown in Column (5), the redistributive consequences – poor to rich – are, of course, even more striking. As a matter of plain, crude self-interest, it is hard to suppose in the light of these data that lower and middle income taxpayers, who obviously make up the vast bulk of the voting population, would support the Flat Tax proposal – unless, of course, the data are concealed or presented misleadingly.

Perhaps it is the obligation of those who are aware of the distribution data to do what they can to make sure that doesn't occur.

Savings & Growth

True Flat Tax believers like Mr. Forbes and Mr. Kemp have made “economic growth” a central part of their message to voters. The idea, briefly, is that economic growth depends upon the domestic savings rate. That rate, now regarded as inadequate, can be increased substantially (they think) if investment income is taken out of the tax base. The after-tax return on investment would then be equal to the pre-tax return, which ought logically to encourage nonsavers to save and savers to save still more. That, in turn, should mean a larger capital stock, an increase in productivity and a long-term improvement in our general standard of living.

But this does not quite complete the “logic” of the matter, as many have recognized. While the increase in after-tax return on investment would undoubtedly encourage some people to substitute saving for consumption, it may also

encourage other people – so-called “target” savers – to consume more and save less. If your purpose in saving is to reach a specific dollar amount over a given time-period – e.g., enough to buy a home or to pay college expenses for children – and if that goal can be reached more easily because the after-tax return on your savings is higher than previously, then it is just as “logical” to save less and consume more as it is to do the opposite. Which course of conduct people in general would follow is hard to predict. The domestic savings rate actually declined during the 1980s, as has been often noted, despite our having a combination of lower marginal tax-rates and the highest interest rates in living memory.

Actually, most economists appear to agree that there would be some increase in the saving and growth rate if the present income tax were replaced by the Flat Tax (or some other consumption tax), but there also appears to be no agreement among economists on just how much of an increase can be expected. One estimate that seems to have standing suggests that the saving rate would increase by about one-tenth of its current level, which is obviously quite a small increase. Other estimates, based on various models, are somewhat more optimistic. “Unfortunately,” as has been observed, “the fact is that we can't be sure. Any economists or politicians who say they can precisely predict the impact [of substituting a consumption tax for the income tax] are either kidding themselves or kidding the rest of us. The intelligent citizen must be resigned to making choices in the face of imperfect information about the consequences ...”⁶

A further “macroeconomic” question should be mentioned. How would the stock market react if the Flat Tax were adopted? Answer: probably, by dropping fairly sharply. To see why, consider the following hypotheti-

6 Slemrod & Bakija, *TAXING OURSELVES – A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 231-2* (M.I.T. Press, 1996).

cal. Let's suppose that 30-year United States Treasury Bonds currently yield 6% before tax and sell in the market at the issue value of \$100. If investors, on average, pay income tax at a rate of (say) 33%, then the after-tax return on such Bonds is only 4% or \$4 per \$100 invested. Now suppose (fancifully) that the Treasury decides to issue new *tax-exempt* 6% Bonds at \$100 par, so that investors in the new Bonds can get an after-tax yield of 6% instead of 4%. What happens to the market value of the old *taxable* 30-year Bonds? The obvious answer is that they fall in value to \$66.67 in order to yield 6% and be equally attractive to investors. Holders of old Bonds complain very loudly indeed and perhaps picket the White House.

Economists are in the habit of speaking of the Flat Tax as a tax on wages and "old capital." The wages element is of course picked up by the Individual Compensation tax. The tax on "old capital" refers to the illustration above. Unless a special transition rule is adopted, the Business Tax makes an implicit distinction between capital already invested but not yet fully depreciated at the time the Flat Tax is adopted ("old") and capital invested after adoption of the Flat Tax ("new"). Thus, suppose a business firm invests \$100 in a new machine *after* enactment of the Flat Tax. Suppose also that the Flat Tax rate is 20% and that the investment is expected to yield 10%, or \$10, annually. Since the \$100 investment is fully deductible, the after-tax cost of the investment is only \$80. The \$10 annual yield would be reduced by the 20% Business Tax to \$8, and hence the firm's rate of return would be \$8/\$80 or 10%. But what about the same \$100 investment made *before* enactment of the new tax system? The "old" \$100 investment would not yet have been depreciated for tax purposes, but the annual pretax return of \$10 would nevertheless be reduced by the 20% Business Tax to \$8. As in the Treasury Bond example, the market value of the "old" invest-

ment, or of shares in the firm itself would necessarily drop in value to \$80 in order to generate the same 10% return as the "new" investment and be equally attractive to investors. Put in larger terms, since existing firms hold only "old" investments at this point, the stock market as a whole could be expected to drop in value by 20% – as if a onetime lump-sum tax had been imposed on existing wealth – unless a transition rule allowing "old" investments to be expensed were added to the Flat Tax scheme.

I might add, for whatever effect it has on the reader, that the lump-sum tax just described will largely be borne by older taxpayers, because it is older taxpayers, those at or nearing retirement, who own the majority of existing capital assets at any given point in time. The Flat Tax proposal now being pressed in Congress contains no transition rule that would protect owners of existing capital, which raises a serious fairness problem. So why not add one? The answer, of course, is that the revenue cost of allowing "old" capital investment to be expensed would be so great that the tax-rate on wages, which would be the only item remaining in the tax base, would then have to be raised very substantially in order to produce a revenue-neutral result. Since young and middle-aged wage-earners would bear the brunt of that rate increase, the political consequences would, no doubt, be slightly disastrous. In any case, the addition of a transition-relief rule would entail great complexity and would largely undermine the simplification benefits that are claimed as a major virtue by Flat Tax proponents.

Fairness

Putting every other consideration to one side, a final issue is whether one tax system can somehow be called "fairer" than the other. Which is more "just," an income tax or a consumption tax? Mr. Forbes, among others, has asserted on many occasions that the income

tax is unjust to people who choose to save as compared with those who choose to spend their income on consumption. According to Forbes (and others), the income tax actually taxes savers *twice*, consumers only once. The argument or analysis, which I will try to clarify in a moment, is one of long standing; indeed it is centuries old. Thus: "No income tax is really just, from which savings are not exempted," wrote John Stuart Mill in 1862 in his *Principles of Political Economy*, and much the same idea can be found in Thomas Hobbes' *Leviathan*, published in the 17th century. Adding the name of Steve Forbes to those of Mill and Hobbes is kind of breathtaking, yet it is true that Forbes' argument has an illustrious set of antecedents.

The unjust-to-savers criticism can best be explained with a simple example. Assume we live in a tax-free world and that C for consumer and S for saver both earn \$1,000 in wages this year. C chooses to consume the whole \$1,000 currently because he wants to take his vacation *this* year. S chooses to save his \$1,000 and invest it in a 1-year 10% bond, because he prefers to have \$1,100 to spend on a slightly better vacation next year. The relationship between C and S – between the decision to consume this year and the decision to consume next year – is obviously 1 to 1.1. Now suppose Congress enacts a 40% income tax so that C and S both have to pay a tax of \$400 on their \$1,000 of wages, leaving each with \$600. Once again, C chooses to consume his entire after-tax \$600 this year, while S elects to save by investing in that 1-year 10% bond, expecting to have \$660 to spend next year. But will he? Plainly not if the interest on his bond is taxable, as of course it is under our income tax. S will have to pay a tax of 40% of \$60, or \$24, on his bond interest and instead of having \$660 to spend next year he will have only \$636. The 1 to 1.1 relationship that prevailed in the pre-tax world becomes 6:6.36 in the post-tax world, *i.e.*, 1 to 1.06. At least arguably, S has been taxed

twice on the same income, C only once.

Much vexed, S may simply grind his teeth and sulk, or he may decide to become a consumer like C and give up being a saver. At all events, J. S. Mill (and others) condemns the outcome as unfair to S-types, people who prefer to defer consumption to later periods rather than consume their income currently.

The solution, in the view of those who share Mill's viewpoint, is simple. If we amend the income tax by exempting the \$60 of interest that S receives in Year 2, the 1 to 1.1 relationship between C and S that prevailed in the pre-tax world is restored and the perceived injustice is overcome. Precisely that is what the Flat Tax, indeed what any consumption tax, would do. Although it took time for this proposition to come clear during the 1992 primary campaign, I believe it finally did become apparent to many voters that the Flat Tax would tax wages and salaries only, while dividends, interest, capital gains and other forms of investment income would be exempt.

Was Mill (and are Forbes *et al.*) right or wrong in saying that the income tax treats savers unjustly? The Millian view, essentially, is that consumption is the sole source of personal satisfaction – of what economists call "utility." Consumption, therefore, is the only proper object of taxation. Savings, Mill might say, are of no value to the individual until converted into consumption. You can't eat your stocks and bonds, after all, and it is only *when* converted that such savings should be subject to tax. It follows that a sales tax – a tax on consumption, but not on savings – is the only tax system that can be called truly "just."

My own view – with which anyone is free to disagree – is that savings and consumption have an equally valuable status in the life of an individual and, hence, from a tax standpoint should be treated alike. It seems to me that people who save, or who can save, derive *present* benefits that I would rank at least as high as a good dinner. One such benefit is

protection against adverse contingencies – job loss, family illness or other uninsured disaster. Another is a sense that one is free to change one's life choices – give up practicing law and try something else – if such a change of direction becomes attractive. Protection from risk, and flexibility or freedom from irrevocable commitment, have great present value to my mind. Both are blessedly available if one owns a sizable portfolio of marketable securities, but not otherwise.

My conviction (as one set of writers has put it) is that “[a]ccumulations of wealth confer valuable economic and social benefits to their owners even if the wealth is not consumed.”⁷ For that reason I find it hard to understand the argument that consumption is the only human function that generates “utility,” and I am inclined to view that proposition as cold-blooded and unpersuasive.

CONCLUSION

Justice Holmes' famous statement (“Taxes are what we pay for civilized society”) notwithstanding, most taxpayers do not like paying taxes. In addition, they resent the complexity of Form 1040 and are angry about the time and money they have to spend preparing their annual tax returns. But even so, and after all the complaints have been heard, the fact is that our income tax has been remarkably

successful as a revenue-raising mechanism, particularly when you consider the immense difficulties other countries experience in collecting taxes from their citizens. That success is the more striking when we remember that the income tax still largely depends on voluntary compliance by the nation's taxpayers – on the willingness of individuals and firms to meet their tax obligations without any real threat of coercion. To be sure, it is a crime to cheat; you can be fined or go to jail if you lie about what you owe. Yet the IRS, even with over 100,000 employees, is capable of auditing only a tiny fraction of the 116 million tax returns it receives annually. So, while there is still a fair amount of undetected evasion, by and large people do report honestly and pay up year after year in dutiful fashion.

As I suggested at the beginning, it is relatively easy to misinform the public about the federal tax system, and I am afraid that some of our respected political leaders have done, and are doing, just that. In my judgment, our progressive income tax, having been the principal source of federal revenue for much of this century, is an institution we can be moderately proud of despite its many imperfections. Could it be improved and simplified? Certainly. But should it be discarded and replaced? Depending on electoral outcomes and political developments, that is an issue we may have to face seriously, and very soon. *GB*

⁷ Aaron & Galper, *ASSESSING TAX REFORM 21* (Brookings, 1985).