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 parties is examining 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 allure 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, conservatives argue that the current system also fails the test of vertical equity, which states that persons in different circumstances receive differential rewards to economic activity, these higher tax rates encourage people to work and save less. The result is a less productive economy than without the loopholes. By comparison, the second source of inefficiency is more subtle in its impact on economic welfare. Loopholes encourage people to alter their behavior so as to receive large fringe benefits, such as health and disability insurance, at lightly taxed activities. For example, take more of their total "income" in income for purposes of the federal income tax.

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2. A tax credit is a provision that allows the taxpayer to reduce his total tax bill after he has figured his tax base (in this case, his income from various sources) and has applied the appropriate tax rate against that base. A tax deduction offsets (or reduces) the citizen's tax base—for example, the taxpayer might be allowed to reduce his taxable income by some portion of the amount he paid for medical care. A tax exemption or exclusion is a tax item that could, under a comprehensive tax plan, be considered as part of the citizen's tax base but, for one reason or another, is not counted in the base for tax purposes. For example, income from state and local government bonds is not counted in the base for the purposes of the federal income tax.
The economic losses from this second type of efficiency are subtle and can only be appreciated by comparison. In particular, any reduction in the tax of one that does not alter individuals' behavior. Under the current system, the tax becomes "attached" to certain activities, especially in rental housing or taking income rather than fringe benefits. In a sense, individuals are taxed out of the money they allocate for that activity. The taxpayer pays the government by paying more for those particular activities, even if they are goods and services that are particularly desirable. By contrast, under a less distorting tax system in which all activities are taxed equally, the individual has the flexibility to distribute the tax burden in any way he wishes; he can pay the tax by giving up the goods and services he values least. Because the individual has the freedom to distribute his tax burden more efficiently, public choice economic theory teaches that a less distorting tax system can generate as much revenue as current while making taxpayers better off.

Flat Taxes—Pure and Modified

A pure flat tax is attractive in its simplicity. All of the taxpayer's income, from whatever source, is subject to a single rate, thereby giving an individual voter the incentive to lobby for the most advantageous preferences. Under the current system, the ratio of the average tax rate to the marginal tax rate helps explain the historical pattern of personal income taxes paid to income would be connected with one another. The unique feature of equity, and efficiency. Historically, citizens' desire for vertical economic efficiency has resulted in a progressive tax system—one in which the proportion of one's income paid in taxes rises with income. The flat tax, however, would result in a proportional tax system in which the ratio of taxes paid to income would be constant across income groups, resulting in a massive redistribution of the tax burden from the rich to the poor. Because this is politically undesirable, one strategy to improve economy into its tax schedu. The Bradley-Gephart plan does this by having three marginal tax rates and a separate standard tax rate. The Kemp-Kasten plan accomplishes this by excluding from tax a large portion of the citizen's first several thousand dollars of income, through a large personal exemption, standard deduction and the special 20 percent wage and salary exclusion. There is a price to be paid, however, for their own tax plan: a flat tax. When progressivity is built into a tax system, the inevitable result is high marginal rates at the top. Hence, for this reason, it is convenient to work and save for high-income taxpayers. Moreover, the saving incentive is particularly important at these high rates (because, for example, the amount of aggregate saving comes from well-to-do taxpayers. The Kemp-Kasten and Bradley-Gephart plans attempt to reconcile the competing demands of equity and efficiency—they do not escape the dilemma. In the Bradley-Gephart paradigm, we can visualize a progressive tax system as using the bucket to transfer wealth from the rich to the poor. Logrolling does not obviate the fact that society wishes to make this transfer; it merely changes who pays the costs. The task faced by policymakers, therefore, is to decide how much water is worth transferring given these leaks.

Conflict between Vertical Equity and Efficiency

Americans value not only the efficiency of their economic system but also equity between income groups. Because it is impossible for one tax system to serve all goals fully, there is inevitably some compromise of efficiency for equity. Historically, citizens' desire for vertical economic efficiency has resulted in a progressive tax system—one in which the proportion of one's income paid in taxes rises with income. The flat tax, however, would result in a proportional system in which the ratio of taxes paid to income would be constant across income groups, resulting in a massive redistribution of the tax burden from the rich to the poor. Because this is politically undesirable, one strategy to improve economy into its tax schedu. The Bradley-Gephart plan does this by having three marginal tax rates and a separate standard tax rate. The Kemp-Kasten plan accomplishes this by excluding from tax a large portion of the citizen's first several thousand dollars of income, through a large personal exemption, standard deduction and the special 20 percent wage and salary exclusion. There is a price to be paid, however, for their own tax plan: a flat tax. When progressivity is built into a tax system, the inevitable result is high marginal rates at the top. Hence, for this reason, it is convenient to work and save for high-income taxpayers. Moreover, the saving incentive is particularly important at these high rates (because, for example, the amount of aggregate saving comes from well-to-do taxpayers. The Kemp-Kasten and Bradley-Gephart plans attempt to reconcile the competing demands of equity and efficiency—they do not escape the dilemma. In the Bradley-Gephart paradigm, we can visualize a progressive tax system as using the bucket to transfer wealth from the rich to the poor. Logrolling does not obviate the fact that society wishes to make this transfer; it merely changes who pays the costs. The task faced by policymakers, therefore, is to decide how much water is worth transferring given these leaks.

Logrolling

While our system of congressional representation is meant to weight all citizens' preferences equally, individuals are likely to have different intensities of feeling about a particular issue. The practice of logrolling helps explain the historical pattern in the United States of relatively high marginal tax rates with lots of tax preferences. Individuals who receive a particular tax preference (e.g., the research and development credit) care a lot more about that issue than individuals who are ineligible for that preference; the benefits are concentrated, whereas the burdens are spread among all taxpayers. If a person is eligible for an energy tax credit, it could mean hundreds or even thousands of dollars. In an ineligible, the cost of bearing the additional tax burden from this loophole is probably only a few pennies. When preferences vary in this fashion, representative systems tend to fall into vote trading, or logrolling. Each representative trades his or her own constituents' votes for the votes of others. Logrolling is tantamount to him in exchange for his colleagues' votes on issues that are vital to him. As a result, issues (or tax preferences) that benefit one group but are considered in isolation because only a small minority of voters favor them.

Scholars disagree on whether this logrolling process results in an inefficient tax system. On the one hand, it can be argued that logrolling allows the representive process to recognize the intensity of voters' preferences. In this sense, logrolling can be a check on the tyranny of the majority. Otherwise, if the majority favored some measure, even if the members of the majority could have voted only if they were only marginally interested in the issue, they would prevail over the demands of a vitally interested minority.

On the other hand, it has been argued that logrolling results in a public policy that is unnecessarily complex for the costs the benefits exceed. Under certain circumstances, logrolling can result in policies that are inefficient because the tax preferences or spending measures that give less satisfaction to each...
A pure flat tax is attractive in its simplicity. All of the taxpayer's income is treated equally and the tax is independent of the taxpayer's consumption decisions (e.g., saving and investment are minimized). Since all income is treated equally, the tax is independent of the taxpayer's consumption decisions (e.g., saving and investment are minimized) and the same amount of revenue as the current system.

The sponsors claim, however, that three-quarters of all taxpayers would face a rate increase (14 percent for those people the plan would have most of the benefits of a pure flat tax). Also, although many deductions are eliminated (as allowed by the flat-tax proposal), most of them count only against the 14 percent bracket, regardless of the citizen's tax bracket. The Bradley-Gephart plan also imposes a total of two taxes—a basic tax of 14 percent and a progressive surtax with rates of 12 percent and 16 percent. This surtax would be applied only against that portion of the taxpayer's income that exceeds $25,000 (for a single return, with a cutoff of $40,000 for a joint return). The unique feature of the Fair tax is that the exemptions listed above can be used to reduce taxable income for the basic tax, but not for the surtax. In effect, the tax reduction resulting from the 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 amount of aggregate saving as the current system.

A Republican alternative to the pure flat tax has been introduced by Congressman Jac Kpm (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 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, taxes paid onKeogh and moderate-income taxpayers, and state and local government general obligation bonds are retained. However, 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" toward a progressive tax system.

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The Bradley-Gephart plan does this by having three marginal tax rates as well as the personalized base, a single 25 percent tax rate would be levied, and in this sense the Kemp-Kasten plan is truly a flat tax. To appeal to lower-income citizens, the plan allows for increases in the personal exemption and standard deduction, and for a special exclusion of 20 percent of all income up to $39,300, an exclusion that would gradually be phased out in higher-income brackets so that it would eventually be phased out completely. Why do these two congressional plans fall short of the flat-tax standard of simplicity? The answer is that the proposals considerably from this simple ideal. The best-known plan, introduced by Senator Bill Bradley (D-N.J.) and Congressman Richard Gephart (D-Mo.), is a case in point. The Bradley-Gephart Fair Tax proposal broadens the tax base to eliminate most existing exemptions, deductions, and credits except for 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, taxes paid on Keogh and moderate-income taxpayers, and 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" toward a progressive tax system.

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A tax system does its own inertia, in the sense that people who make long-term decisions based on the current system argue that it is unfair to change the rules mid-game. More than this, however, the economic system works to dissipate any special benefits of the tax system by adjusting relative prices. The result is that individuals who gain little or no special tax advantage from the current tax system can nevertheless be seriously hurt by tax reform. The result is a wrenching problem for tax reformers: how do we treat these "innocent bystanders" who get caught by the change? For example, take the deductions for mortgage interest and local property taxes, which are among the most popular tax preferences in the current system. When these deductions were enacted, homeowners undoubtedly gained a direct benefit in the form of lower taxes. But these people will eventually sell their homes, and at the time of the sale the circumstances of the buyer will be different than before. The buyer can deduct mortgage interest and property taxes, and this means he will be willing to pay a higher price for the house. The seller knows this, and will accordingly raise the price of the house to try to capture some of this increased willingness to pay. As a result, the new buyer will give up some of this tax benefit to the original owner in the form of higher house prices; economists say that the tax benefits have been capitalized into the price of the house. In fact, under certain market conditions, house prices will rise by just enough to cause the entire tax benefit; in other words, the present value of the stream of future reductions in taxes will be just equal to the increase in house prices. Under more likely conditions, some but not all of the tax benefit will be capitalized away from the new homebuyer.

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

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

Conclusion

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

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Argument For

Transition Problems

Flat taxes, the inadequacies in the present system argue that it is unfair to change the rules mid-game. More than this, however, the economic system works to dissipate any special benefits of the tax system by adjusting relative prices. The result is that individuals who gain little or no special tax advantage from the current tax system can nevertheless be seriously hurt by tax reform. The result is a wrenching problem for tax reformers: how do we treat these "innocent bystanders" who get caught by the change? For example, take the deductions for mortgage interest and local property taxes, which are among the most popular tax preferences in the current system. When these deductions were enacted, homeowners undoubtedly gained a direct benefit in the form of lower taxes. But these people will eventually sell their homes, and at the time of the sale the circumstances of the buyer will be different than before. The buyer can deduct mortgage interest and property taxes, and this means he will be willing to pay a higher price for the house. The seller knows this, and will accordingly raise the price of the house to try to capture some of this increased willingness to pay. As a result, the new buyer will give up some of this tax benefit to the original owner in the form of higher house prices; economists say that the tax benefits have been capitalized into the price of the house. In fact, under certain market conditions, house prices will rise by just enough to cause the entire tax benefit; in other words, the present value of the stream of future reductions in taxes will be just equal to the increase in house prices. Under more likely conditions, some but not all of the tax benefit will be capitalized away from the new homebuyer.

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