

## **FLAT TAXES: SOME ECONOMIC CONSIDERATIONS**

**Alan J. Auerbach**

A variety of tax-reform proposals have been introduced at both the national and state levels since the last major reform of the federal income tax system in 1986. One particular class of tax systems, "flat" taxes, has gained the support of many in Congress as a simplified alternative to the complexities and disincentives to saving in the current federal income tax system. In the following discussion, my purpose is not to argue either for or against such a tax reform, but rather to comment on several of the issues that should be considered in any serious debate about the merits of flat taxes. Because flat taxes are a relatively new concept, I begin by discussing what they are and how they are imposed, before analyzing their effects on economic growth and the general welfare and reviewing the options available when considering their adoption. My conclusions are the following:

1. As typically conceived, the flat tax is equivalent to a consumption-based national sales or value-added tax that is rebated to those whose income places them below a tax-paying threshold. This equivalence is sometimes obscured by differences in the method of tax collection, such as whether taxes are remitted by businesses or individuals. These differences are superficial, however, and do not alter the effects of the flat tax on progressivity, incentives to work and save, or the price level, and should be given little weight in evaluating the tax's merits.
2. As consumption taxes, flat taxes encourage private saving and investment by exempting capital income from tax. However, the full effect of the flat tax on national saving depends on several factors, including the magnitude of windfalls during the transition to the flat tax and the extent to which government revenues change as a result of its adoption. It is impossible to say whether adoption of a flat tax will increase national saving without considering its provisions in detail.
3. Although flat taxes may be made progressive at low income levels by instituting a high tax-paying threshold, the restriction to a single marginal tax rate<sup>1</sup> limits their progressivity at higher income levels. This problem may be addressed while preserving the basic flat-tax structure by allowing the business and individual (i.e., household) income components of the tax base to face different tax rates and by introducing one or more additional tax brackets at the individual level.
4. Relative to the present income tax, a broad-based flat tax would distort economic decisions far less and would be much simpler to file and administer. However, most of its benefits could be achieved through reforms of the current system, without the adoption of a single marginal tax rate or the switch to a consumption tax base.

## What Are Flat Taxes?

While flat-tax proposals vary, all share three key elements:

- a single marginal tax rate considerably below the top marginal rates of today's income tax;
- few deductions and exclusions from the tax base; and
- high exemption thresholds, below which individuals would not be subject to the tax.

There are several advantages to this general approach. The low marginal tax rate reduces economic distortions induced by the current system's high marginal rates, thereby encouraging more work effort (labor supply) and discouraging unproductive tax-planning activities. The single marginal tax rate reduces the scope for avoidance through income shifting. The broad tax base, which makes the low rate feasible from a revenue standpoint, greatly simplifies tax filing and further reduces the tax system's interference in economic decisions by eliminating a range of "tax expenditures" (such as charitable deductions, savings incentives, and capital gains and other exclusions) applied under the current income tax. The high tax-paying threshold makes the flat tax progressive, and further simplifies tax compliance by eliminating the need for a large segment of the population to file a tax return.

## What Do Flat Taxes Tax?

Flat-tax proposals typically are phrased in terms of taxes on households and businesses, but these distinctions relate primarily to the method of tax collection rather than the incentives and burdens that the taxes impose. All taxes ultimately are borne by individuals, as much as we might wish them to be borne by disembodied "businesses." Of primary importance in determining the economic effects of a tax is the base of that tax. Although it is usually left unclear in the proposals themselves, flat taxes are consumption taxes: rather than taxing income as a whole, they tax only that portion of income that is not saved, i.e., consumption. There is nothing about the logic of flat taxes that requires this; just as easily, one could design a flat tax with an income base. However, one of the additional advantages touted for flat taxes is their intended elimination of the tax on saving that is implicit in the present income tax.

As a consumption tax with a single marginal tax rate, the flat tax is basically a value-added tax<sup>2</sup> combined with a rebate for low-income households. It may differ from more traditional value-added taxes in the method of collection, but this is not of significance. For example, the Hall-Rabushka flat tax, which forms the basis of several current proposals, including those of Representative Richard Armey (R-Texas) and Senator Arlen Specter (R-Pennsylvania), would consist of two components, a business cash-flow tax and an individual wage-income tax, with the two taxes imposed at the same rate. (The individual tax would also apply to certain non-wage income, such as pension benefits, but it would exclude capital income.) In combination, the business cash-flow tax and the individual wage-income tax would cover all domestic income less business investment.

Except for the trivial distinction that the wage taxes are being remitted by individuals, rather than withheld by their employers, the Hall-Rabushka flat tax is simply a subtraction-method, origin-based value-added tax.<sup>3</sup> Their proposed flat tax is neither more nor less progressive than the traditional, European-style value-added tax, or a subtraction-method value-added tax (also known as a business transfer tax), just because a portion of the taxes are remitted by individuals. By excluding investment from taxation, the Hall-Rabushka flat tax will have the same incentive effects as the value-added tax, and the same impact on the Consumer Price Index. Its most substantive difference from the destination-based value-added tax is that it does not tax imports or give a rebate for exports.

This last distinction, and others like it, involves the tax treatment of different forms of saving. A true consumption tax would provide a deduction for all forms of private saving. The origin-based value-added tax included in the Hall-Rabushka flat tax permits a deduction only for saving that takes the form of domestic business capital. A destination-based value-added tax effectively would add to this a deduction for U.S. capital investment abroad, while taxing income earned abroad.<sup>4</sup>

Some have suggested, based on arguments that ignore the flexibility of exchange rates, that its treatment of foreign trade and investment makes the destination-based value-added tax foster exports and competitiveness, but this argument is without economic foundation. Though investments abroad receive a deduction, the tax benefit of this deduction is equal in present value to the taxes that will be paid in the future on the cash flows that the investment generates. As a result, it is not particularly important whether foreign investments are made under an origin-based or destination-based value-added tax.<sup>5</sup> However, the differences in treatment do matter during the transition to the flat tax, because of investments made before the new tax scheme's adoption. For a country that is a net debtor, as the United States has become in recent years, an origin-based value-added tax will raise more revenue in the long run by denying a deduction for the future trade surpluses needed to service this debt.<sup>6</sup>

### **How Broad Should the Flat Tax Be?**

As discussed, a broad tax base permits the flat tax to be imposed at a low rate and lessens the distortions associated with selective tax expenditures. Some of these tax expenditures, such as saving incentives and capital gains exclusions, would disappear automatically with the shift to a tax base that excludes saving. However, a comprehensive consumption tax would include in its base two important items excluded by most flat-tax proposals: the imputed rent on owner-occupied housing,<sup>7</sup> and purchases financed by government transfer payments. These exclusions narrow the tax base, requiring a higher tax rate.

In order to treat owner-occupied housing like other forms of investment under a flat tax, it would be necessary to provide a deduction to home buyers for new housing construction, and to tax home owners on the imputed rent from new and existing housing. This is difficult to accomplish because of the problem of measuring each home owner's imputed rent. One simple alternative, adopted by the Hall-Rabushka plan, is simply to ignore housing altogether, offering no deduction for construction and no tax on imputed rent. This has the effect, however, of taxing the imputed rental flows from new housing only. Excluding housing from the tax base has no net impact on tax revenues from new housing, because the

relief from taxes on imputed rent is offset by the loss of the initial investment deduction; however, excluding existing dwellings, which would not qualify for an investment deduction anyway, simply relieves the tax on all their future imputed rent.

In principle, one could recoup this lost revenue by imposing a one-time tax on the value of all existing homes. However, even if this extra levy is not imposed, the flat tax would be broader in its treatment of housing than the present income tax, which does not tax any of the imputed rent on owner-occupied housing. Furthermore, by implicitly taxing new housing as consumption, the flat tax would remove the present income tax system's distortion (in favor of owner-occupied housing) of the allocation of new investment funds between business and residential uses. Thus, the flat tax would be less distortionary than the present income tax in its treatment of owner-occupied housing.

It is, of course, possible, under a flat tax, to treat owner-occupied housing more generously than this. For example, Senator Specter's version of the flat tax (S. 488, "The Flat Tax Act of 1995") would provide home owners an interest deduction on mortgages up to \$100,000. This deduction would represent a tax cut for all taxpayers with mortgages, and an incentive to acquire more expensive housing for those with mortgages below \$100,000. Ultimately, such a provision makes sense only if it is desirable to maintain the relative tax subsidy to owner-occupied housing. As with many other tax expenditures, this is a question that does not disappear with the shift to a flat tax.

The treatment of government transfer payments, particularly Social Security benefits, presents another challenge in the design of flat taxes. In the past, it was sometimes argued that transfer payments would bear consumption taxes indirectly through induced increases in the price level. Now, however, to whatever extent the price level responds to the imposition of a flat tax, Social Security benefits will be insulated; they are indexed to the Consumer Price Index. Thus, to tax the consumption financed by Social Security benefits, it will be necessary to include these benefits explicitly in the tax base. The easiest way to do so is to add them to wages. Presumably, the high tax-paying threshold would protect the elderly poor, just as it would protect the nonelderly poor.

Most remaining tax expenditures are eliminated under the flat tax, although Senator Specter's version would also provide a limited deduction for charitable contributions. What other tax expenditures might be kept under a flat tax? It is hard to answer this question without knowing why certain tax expenditures exist now. While some are intended to encourage saving, and would be obviated by adoption of the flat tax, others, such as the exclusion of employee health benefits, are no more justified now than they would be under a flat consumption tax. Logically, the merits of eliminating such tax expenditures should be distinguished from the merits of adopting a flat tax; legislators will still have to make the difficult choices about which tax expenditures to keep.

## **Progressivity**

The progressivity of flat taxes relates to three issues that can be considered separately: the rate structure (a low, single rate), the long-run tax base (consumption rather than income), and the treatment of

existing assets during the transition to the new tax system.

**Rate Structure.** While flat taxes can provide tax progressivity at the low end of the income distribution, they cannot do so at the high end. Because a taxpayer's average tax rate can rise no higher than the single marginal rate, virtually any flat tax would reduce the tax burden on very high-income individuals. If the poor also benefit relative to the current system, through the high exemption threshold, and tax revenues remain the same, then even in today's "magical" world of budget analysis this means that the middle class will face a tax increase. Perhaps the easiest way to lessen this problem is to introduce one or more additional tax rates under the individual component of the flat tax and raise the top individual rate and the rate on business cash flow. While this revised tax system could no longer officially be called a "flat" tax, it would preserve most of the simplicity of the flat tax. Compared to the flat tax, the main economic cost would be the greater distortion of labor supply occasioned by the higher marginal tax rates. A much more ambitious approach would be to adopt a personal consumption tax with a progressive rate structure, sometimes called a "consumed income" tax, such as has been proposed by Senators Pete Domenici (R-New Mexico) and Sam Nunn (D-Georgia) as part of their "USA Tax System."

**Long-Run Tax Base.** Proponents of the flat tax may shy away from referring to it by its "real" name -- a consumption tax -- to avoid the perception it must be more regressive than an income tax. But one cannot analyze a tax properly without understanding its basic characteristics. As I have already stressed, the name of a tax or its method of collection is of little economic importance. In particular, policy makers should be highly suspicious of any analysis claiming that the distributional burden of a flat tax is materially different from that of an equal-revenue combination of a value-added tax with a comparable low-income rebate.

As already noted, regressivity of the basic flat tax can be addressed by introducing one or more additional tax rates. If taxing consumption, in itself, makes the tax system more regressive, this can be offset by further rate-structure adjustments. However, perceptions of the underlying regressivity of consumption taxes are overstated by our tendency to look at consumption and income on an annual basis, rather than over longer periods of time. In any given year, consumption as a share of income falls as income rises. However, much of this pattern is due to the fact that, for each individual, income fluctuates more over time than does consumption. Hence, when we observe any particular individual with a relatively high annual income, perhaps during a peak earning year, his consumption will appear relatively low. When we observe the same individual with relatively low annual income, say, as the result of retirement or temporary unemployment, his consumption will appear relatively high. This pattern is much less pronounced if one takes a multiyear or lifetime perspective, as the life-cycle and year-to-year fluctuations in income are averaged out.<sup>8</sup>

**Existing Assets and the Transition.** While the rate structure and the tax base determine the long-run progressivity of any tax, transition policies are important when we consider short-run distributional effects and the relative burden imposed on current and future generations. One example already discussed is that of previously built owner-occupied housing. By failing to tax the imputed rent on such housing, the flat tax improves the well-being of existing home owners in relation to others who will have to make up the lost tax revenue: those now alive who do not own homes (who are likely to be less well

off on average), and members of future generations. As indicated above, this transfer could be undone by a one-time levy on existing owner-occupied housing.

A similar analysis applies to existing corporate assets. In replacing the corporate and individual income taxes on dividends, interest, and capital gains with a single-level business cash-flow tax, the flat tax would eliminate one level of tax on corporate cash flows. While there is no compelling economic logic to having a separate-level corporate tax in the long run, its removal conveys windfalls to the owners of existing shares.<sup>9</sup> As with housing, these windfalls benefit current asset holders at the expense of others, now and in the future. In the same way, this advantage can be alleviated, either through the same sort of one-time levy or, to be more realistic, through a separate tax on corporate cash flows or a higher level of tax on the business cash-flow component of the flat tax. For example, if the household component is taxed at a rate of 20%, the business tax rate could be set higher to offset the windfalls produced by eliminating the corporate tax.<sup>10</sup> Raising the business tax in this way would have no impact on the incentive to save or invest.

### **Impact on Saving**

In addition to simplicity, one of the best arguments for adopting a flat tax is that it would encourage saving, a goal about which there is little argument. The flat tax would encourage saving and investment by eliminating taxes on capital income, although there remains considerable uncertainty as to how much would be saved and invested. The total impact on saving and investment also depends on the level of government revenues, and how the burden of these revenues is distributed during the transition to the new tax. The higher the level of government revenues, assuming government spending is fixed, the higher the level of government saving, and hence national saving. Even if aggregate revenues do not change, shifts in the tax burden among households with different propensities to save will also influence the aggregate level of saving.

Given the uncertainty about just how much savings do result from tax incentives, the most direct way to increase saving would be to reduce government "dissaving" -- by raising taxes, reducing spending, or both. Yet most discussions of the flat tax appear to presume that the tax should be revenue-neutral (though some of the initial proposals appear to fail even that test). There is no compelling reason why adoption of the flat tax cannot be used as an opportunity to increase revenues as well. Indeed, the need for more revenue is, in itself, an argument in favor of the flat tax: it makes more sense to increase revenues if the tax has a broad base and relatively low rates, so that the increase in rates does not distort economic decisions in a major way.

Even if aggregate revenues remain the same as under current law, the level of private saving may be affected by how their burden is distributed among households with different propensities to save. The greater the windfalls to existing assets, the lower the tax burden on existing asset holders, and the higher the burdens on others, including future generations. This shift in the burden is likely to have offsetting effects on saving, as current asset holders are more likely than others to be high lifetime savers, but also more likely to be older, with less need than others to save for the future. Ultimately, the net impact of

transition provisions on saving is an empirical question that depends on the specific proposal.

## Summing Up

The flat tax would provide a much simpler tax system, one with fewer economic distortions. Depending on its precise structure, it might also increase national saving. However, in its purest form, the flat tax lacks the progressivity of the current income tax. Overcoming this lack of progressivity would require a departure from the pure flat tax to a tax system with multiple rates and/or different rates on business and individual tax bases. As an alternative, one could achieve most of the benefits of the flat tax under the current system by eliminating many tax expenditures and reducing marginal tax rates. Whether one modifies the present tax system or the flat tax, the eventual outcome would represent an improvement over the current tax system and, it is important to note, a return to the basic aims of the Tax Reform Act of 1986: low tax rates, a broader tax base, and the elimination of low-income individuals from the tax rolls.

*Alan J. Auerbach is Robert D. Burch Professor of Economics and Law and director of the Burch Center for Tax Policy and Public Finance at the University of California, Berkeley. In 1992 he was deputy chief of staff of the Joint Committee on Taxation of the U.S. Congress. The Burch Center was established to promote research in the areas of tax policy and public finance, disseminate this research to the academic and tax policy communities through its working papers, and stimulate informed discussion of tax policies of national significance. This Brief is adapted from Professor Auerbach's testimony before the U.S. Senate Committee on Finance on April 5, 1995.*

---

## Notes

1. The marginal tax rate refers to the tax rate on the next dollar one would earn above one's current income. Theoretically, the higher the marginal tax rate, the more the individual is discouraged from earning more income.
2. A value-added tax is equivalent in its impact to a sales tax of the same dollar value; it differs from a sales tax only in being levied on each producer or distributor who contributes value to a good, rather than on the ultimate seller of the finished good.
3. An origin-based value-added tax is one that is imposed on goods produced domestically, whereas a destination-based value-added tax is one imposed on goods used domestically. Thus, a destination-based tax provides a rebate of the tax on goods that are exported and imposes a tax on goods that are imported.

4. According to the economic identity relating the current account (goods, services, and net income from abroad) and the capital account (U.S. investment abroad and foreign investment in the U.S.), net foreign-source income less net foreign investment equals imports minus exports. Thus, by taxing imports and rebating tax on exports, the destination-based value-added tax taxes net cash flow from abroad.
5. The comparison is analogous to that between traditional individual retirement accounts, under which investors receive a deduction for invested funds and are taxed on withdrawals and "back-end" IRAs, under which investors receive no deduction for contributions but are not taxed on subsequent withdrawals. In each case, there is no net tax burden imposed on the investment.
6. For further discussion, see Alan J. Auerbach and Laurence J. Kotlikoff, *Macroeconomics: An Integrated Approach* (Cincinnati: South-Western College Publishing, 1995), Chapter 6.
7. Imputed rent is the rental value of living in one's own home. It is equivalent to the rent one would pay to live in a comparable house that one does not own, or the rent one forgoes by not renting out one's home.
8. See Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?* (Washington, D.C.: Brookings, 1993), Chapter 7, and the Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993.
9. The exact size of these windfalls would depend on a number of transition provisions. For example, windfalls would rise to the extent that depreciation deductions were still permitted for assets purchased under prior law.
10. Of course, using a higher business tax rate to offset corporate windfalls would also raise taxes on the cash flows of unincorporated businesses that had not received the windfalls.