The Flat Tax:
An Analysis of America's Most Controversial Tax Reform Idea

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Abstract

Since its inception nearly a century ago, the federal income tax has experienced various waves of reform, each time government hoping to finally optimize its use. Dreams of a simplified, flat rate structure have intrigued lawmakers for years, and with the same set of issue champions again lobbying for its use, calls for reform enter the policy debate. This paper examines the merits of a proposed flat tax, starting with a brief history of the federal income tax in the U.S., then moving to a review of the basic premise for a flat rate structure and the Hall-Rabushka framework, and concluding with a critical analysis across the competing objectives of equity, efficiency, yield, cost, and feasibility. As a concept, the flat tax is impressive. As practical policy, however, it leaves much to be desired. Its proposed simplicity must be met with great scrutiny, as it remains to be seen whether such an untried system can function exactly as theorized.

INTRODUCTION

The federal tax system exhibits a level of complexity so great that a call for reform yields more bipartisan support than almost any other issue facing policymakers today. Regulatory uncertainty and stubbornly high unemployment have overpowered record levels of government spending, leaving Americans with an expanding budget deficit and mounting debt in the midst of prolonged economic stagnation.[1,2] Given public concerns over increasing costs and levels of spending, income tax reform as a relief mechanism for both taxpayers and government should be rising to the top of the policy priority list. Instead, proposals for reform have floundered in Congress, and voter salience is less now than when similar proposals were introduced during better economic conditions of the past. This counterintuitive environment exists because, for many, the argument for tax reform has dwindled down to a debate between keeping the current structure or moving to an alternative flat rate system.

The great flat rate renaissance of the 1980s enjoys revival every few years, with the same loyal following of fiscal conservatives leading the charge today. However, the "trial run" afforded by the Tax Reform Act of 1986 did little other than to reinforce America's love affair with exceptions to the rule, and hope for a real flat income tax looks equally naive as it did when the concept came to prominence thirty years ago. This paper is an analysis of a proposed flat federal income tax, specifically, and not a national sales tax. First I examine a brief history of the federal income tax in the U.S., including varying progressivity over time and the relative flatness already embedded in today's structure. Second will be a review of the basic merits for a flat rate structure and the Hall-Rabushka framework, upon which most proposals today are modeled. Finally, I will conclude with a critical analysis of the flat tax across the competing objectives of equity, efficiency, yield, cost, and feasibility.

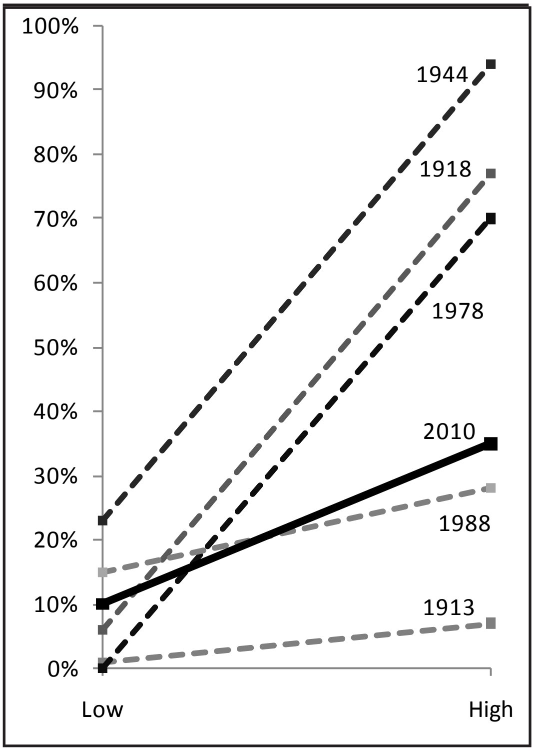
A BRIEF HISTORY

In the United States, the individual income tax is levied predominately at the national level and is by far the largest taxpayer liability. Like the federal government itself, it stayed relatively dormant until the 20th Century, after which point a progressive movement and two world wars ushered in the administrative state of American government. Since the ratification of the 16th Amendment to the Constitution, which gave Congress the power to collect taxes on income earned irrespective of apportionment across the states, debate has existed over the merits of how best to levy the income tax.

1 "Minutes of the Federal Open Market Committee Meeting." *Federal Reserve.* November 2, 2010. Accessed November 25, 2010, http://federalreserve.gov/monetarypolicy/files/fomcminutes20101103.pdf.

2 "Presentation to the Forecasters Club." *Congressional Budget Office.* October 27, 2010, accessed November 20, 2010, http://cbo.gov/ftpdocs/119xx/doc11948/10-27-2010-ForecastersClub.pdf.

Figure 1: PIT Rate Curves



Source: Historical data provided by the Tax Foundation

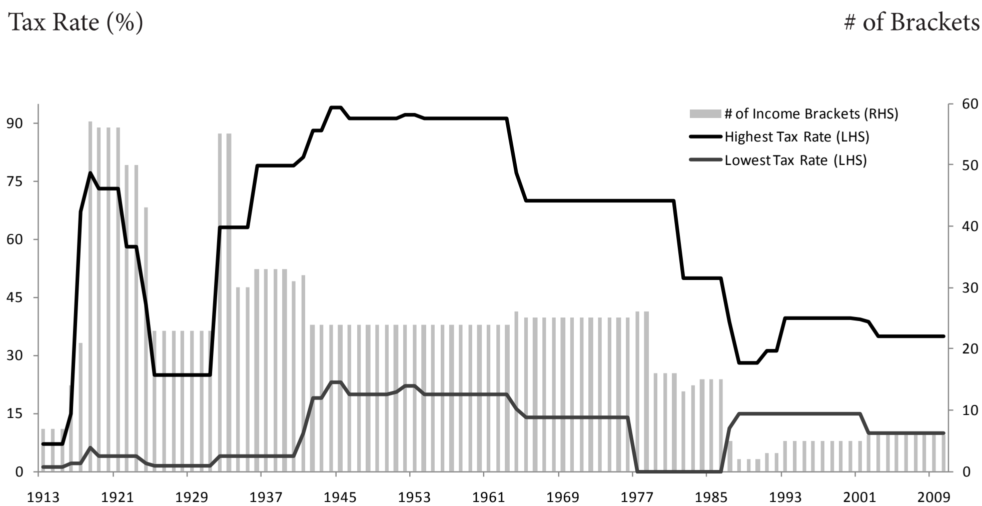
Tax Rate Curves and Brackets

Historically, it is the ability to pay - regardless of the individual's benefit received from government - spending that drives income tax policy. This principle states that the tax levied should be in proportion to the ability of each individual to pay the tax, meaning the largest nominal burden should fall on the largest earners of income.[3] Accepted by economists across the political spectrum, this is the foundation for both American income tax and the flat rate structure. When implemented against the backdrop of severe class inequality and the responding New Deal Era under President Roosevelt, however, the federal income tax structure adjusted for greater progressivity in order to ensure the wealthiest Americans carried the largest nominal *and* real tax burden. This degree of progressivity can be seen through the steepness of the tax rate curve, generically defined here as the slope between the lowest and highest tax rate brackets. Figure 1 depicts the "rate curve" of the federal personal income tax at six points in time: 1913, when the tax was first implemented; 1918, during World War I; 1944, during World War II; 1978, just ahead of the reform movement; 1988, after the implementation of the Tax Reform Act of 1986 (TRA); and today. Figure 1 illustrates how the federal income tax has been trending towards a flat rate structure for a long time. Today's

3 Ronald C. Fisher, *State and Local Public Finance* [Mason, Ohio: Thomson Higher Education, 2007].

curve is significantly more "flat" as a result of tax reform during the 1980s and the temporary tax cuts passed in 2001 and 2003. For example, in 1944, the difference between the highest bracket and the lowest bracket was 71 percent (23.0% - 94.0%). This represents a significant policy effort during the Second World War to increase the burden on the highest income earners for funding government. Conversely, in 1988, the difference between the highest and lowest brackets was just thirteen percent (15.0% - 28.0%) after TRA drastically simplified the structure and consolidated the income tax into two brackets.

Figure 2: Historical Federal Individual Income Tax Rates (1913-2009)



Source: Historical data provided by the Tax Foundation (www.taxfoundation.org)

A second way to study the evolution of the federal income tax is through an analysis of the number of brackets utilized to assess income earners. Figure 2 shows the variation in the number of tax brackets (and the corresponding high and low rates) over time. The number of brackets ranges from as many as 57 during WWI to as few as two after TRA.[4,5] Currently, under the temporary cuts of 2001 and 2003, there are six different brackets, ranging from a low of ten percent to a high of 35 percent.[6]

Going Flat

The rapid growth of the federal budget during the first half of the 20th Century led Congress to increase income tax rates several times, with the number of brackets and the introduction of exemptions seen as the primary tool for delivering fairness in the tax. Since the

4 Holley Ulbrich, "Flat Tax is Class Warfare." *U.S. News*, April 12, 2010, accessed November 24, 2010, http://politics.usnews.com/opinion/articles/2010/04/12/flat-tax-is-class-warfare.html.

5 "History of the U.S. Tax System." *U.S. Department of the Treasury.* August 2003. Accessed November 29, 2010, http://www.treas.gov/education/fact-sheets/taxes/ustax.shtml.

6 The income tax rates established under the *The Economic Growth and Tax Relief Reconciliation Act of 2001* and the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (the "Bush Tax Cuts") were set to expire on December 31st, 2010, but were extended for another two years through the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.*

1980s, however, there has been a considerable shift in favor of a simplified, more flat structure. When President Reagan came into office, the country was experiencing high unemployment and hyperinflation. A growing conservative ideology in favor of smaller government gave birth to calls for serious alteration to the American tax system, which many saw as an excellent way to unleash free market principles and improve the overall economy.

In December of 1981, economists Robert Hall and Alvin Rabushka wrote an op-ed in the *Wall Street Journal* proposing a replacement of the federal income tax with a "low, simple, flat tax."[7] It was here that Hall and Rabushka first coined the now-famous idea of a "postcard" tax return. (Meant to serve as little more than an illustration for the simplicity of their proposal, the postcard concept has since been billed as a viable return format with a flat tax.) Support for the Hall-Rabushka flat tax quickly gained momentum, and in 1984, the Department of the Treasury issued a report to the President entitled *Tax Reform for Fairness, Simplicity, and Economic Growth*.[8,9] In the report, the Treasury laid out the merits of various options and recommended a modified version of the flat tax:

> *In order to simplify and reform the existing income tax, but avoid the massive redistribution of tax liabilities of a pure flat tax…(Treasury) proposes a modified flat tax on income be enacted…By combining a more comprehensive definition of income than under current law with modestly graduated low rates, modified flat tax proposals are able to achieve gains in simplicity, economic neutrality, equal tax treatment of families with equal incomes, and economic growth, without sacrificing distributional equity.*[10]

The Treasury's report served as a major catalyst for TRA, which collapsed the income tax from 15 brackets into two and narrowed the range in rates from 50 percent (0.0% - 50.0%) to 13 percent (15.0% - 28.0%). In addition to this flattening, TRA aimed at eliminating shelters embedded in the tax code and unwinding the growing influence of special interests in tax policy.[11]

Despite its legacy as the most significant reform effort to the federal tax system, TRA enjoyed only a short honeymoon, and Congress was soon under pressure to tweak the structure in favor of more exemptions to the base. In this respect, the legislation served mainly as a "defragmenting" of the tax system, providing a clean foundation for rebuilding the same policies. As of 2006, there had been more than 15,000 changes to the law, returning many of the loopholes eliminated in 1986.[12] By 1993, the income tax expanded from two brackets to five,

7 Robert E. Hall and Alvin Rabushka, *The Flat Tax.*[Stanford, California: Hoover Institution, 2007], 2.

8 Donald T. Regan, *Tax Reform for Fairness, Simplicity, and Economic Growth*. Office of the Secretary of Treasury, Washington, DC: United States Department of the Treasury, (1984).

9 A copy of this report is available on Treasury's website under archives of the Office of Tax Policy, http://www.treasury.gov/offices/tax-policy/library/tax-reform/.

10 Regan, 47.

11 Andrew Chamberlain, "Twenty Years Later: The Tax Reform Act of 1986." *Tax Foundation,* October 23, 2006. Accessed November 26, 2010, http://www.taxfoundation.org/blog/show/1951.html.

12 Jeffrey Birnbaum, "Taxing Lessons, 20 Years in the Making." *The Washinton Post.* October 23, 2006. Accessed November 26, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2006/10/20/AR2006102001255.html.

with the range steepening to 24.6 percent (15.0% - 39.6%).

Flat Tax and the Budget

The increase in taxes during the early 1990s, combined with a prolonged economic expansion, produced a budget surplus of $281 billion in 2000, and cumulative projected surpluses of $5.6 trillion over the next ten years.[13] Despite the excellent opportunity to pay down public debt afforded by a surplus, tax rates (and revenues) dropped dramatically under President George W. Bush as part of a broader conservative return to support of the flat tax proposals first made under President Reagan.

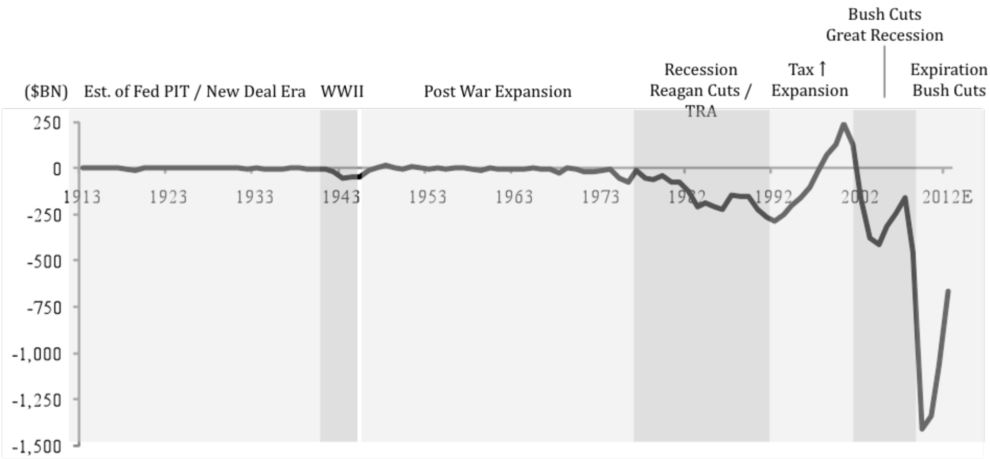
The Bush tax cuts of 2001 and 2003, combined with a significant increase in defense spending and a severe recession in 2008, quickly erased projections of a long-term surplus. In 2004, the federal budget ran a $412 billion deficit and by 2009, that deficit ballooned to $1.4 trillion on the heels of a deep recession and significant spending to prop up the financial sector and stimulate the economy.[14] Figure 3 tracks the balance of the federal budget since enactment of the personal income tax, with forecasted deficit levels included for 2010-2012.[15] The most severe deficits accompany efforts in the 1980s and in this past decade to flatten the tax curve. This is because the federal budget often expands in size but rarely contracts, and those same time periods were stricken with downturns in the economy and shrinking tax revenue, putting the budget under greater pressure. Conversely, the temporary surplus from 1998-2001 came after tax increases in the early 1990s that steepened the tax curve and increased progressivity ahead of a major economic expansion, growing tax revenue significantly by the end of the decade.

13 "History of the U.S. Tax System."

14 The Troubled Asset Relief Program, as part of the Emergency Economic Stabilization Act of 2008, and the American Recovery and Reinvestment Act of 2009 combined to authorize over $1.5 trillion in government spending.

15 Projected budget Deficits and Surpluses are updated periodically for the Congressional Budget Office's baseline forecasts and can be accessed at www.cbo.gov.

Figure 3: Historical Federal Budget Balance – Surplus/Deficits (1913-2012)



Source: Historical data from the Office of Management and Budget, 2010-2012 estimates from the Congressional Budget Office

The point here is not to suggest a flat tax leads to a budget deficit, but it should be obvious that a flat tax will not create a budget surplus either, at least not without considering other factors like the natural business cycle and government spending. This is an important observation because improving the federal budget is an underlying objective of flat tax proponents, an objective that does not appear to be met simply by changing the tax structure.

THE CASE FOR A FLAT TAX

The numerous tax brackets that characterized policy through the 1970s basically ensured a step up in relative liability for even just a few thousand dollars of additional income. Over time, this complexity, combined with the growing number of deductions, led to a reevaluation by policymakers in order to simplify the administrative process of collection and to relieve some the burden on higher income earners, which many perceived to be a major hindrance to growth. The flat tax is a direct outcome of this reevaluation. In conjunction with the broader *New Federalism* and *New Public Management* movement that swept through public administration and politics during the 1980s, the flat tax was offered up as an alternative free of the bureaucracy and inefficiency that had long plagued government programs. Like many other initiatives to form government policy in the shape of private sector best practices, the flat tax stems from one principal objective to simplify the process. With that idea in mind, there are five advantages most often cited in support of a flat rate income tax, discussed below.

Compliance. The current tax structure infamously endures significant compliance costs for both government and taxpayers. For individuals and businesses, the estimated cost of tax preparation and the use of lawyers, accountants, and other resources, is six billion hours and over $250 billion annually.[16] For government, the cost of collection (operating) is approximately $11 billion, or fifty cents for every $100 collected.[17] However, this pales in comparison to the revenue lost from the tax gap (uncollected liabilities), which runs at approximately $300 billion annually, or 10-15% of total revenue collected.[18] The flat tax aims to eliminate many of these administrative costs by drastically reducing the number of deductions and exceptions and in turn providing greater transparency for the liability of each taxpayer.

Single taxation. A primary goal of the flat tax is to ensure that income is only taxed once. Under the current system, it is argued, certain streams are taxed more than once. Estate and capital gains, for example, are presumed to be forms of double taxation.[19] For estate taxes, the wealth created over time is taxed initially when it is earned and then again when it is passed on to an heir. Capital gains (profits from securities purchased) are taxed initially as corporate earnings and then again as income earned on investment for individuals. The Flat tax eliminates any need for estate or capital gains taxation because it is modeled under the idea of taxing only consumption (income minus investment) and only at the origin of the income earned – by an individual or a business, but not both.[20]

Fairness. Proponents of the flat tax argue the current system exhibits a level of progressivity that overburdens higher income earners. Not only does this (theoretically) stifle growth by mitigating the incentive to earn more in wages; it is not fair either. By establishing one rate bracket, the flat tax ensures that each individual payer incurs a liability proportional to his or her income earned.[21,22] In this regard, the flat tax still adheres to the ability to pay principle because the highest income earners will carry the highest absolute (dollar amount) tax burden.

Global Competitiveness. The United States has one of the highest corporate income tax rates in the world, and free market economists argue it serves as a hindrance to domestic growth by deterring investment to less-taxed markets. A flat rate, which is likely to be half of current personal and corporate rates, is seen as a tool for increasing the global competitiveness of the U.S. marketplace and as a catalyst for growth through increased investment. Adding to this argument is the increasing use of the flat tax by developing countries, particularly the eastern bloc of former Soviet Union and Yugoslavian member states. Since 1994, 21 nations have enacted a flat rate tax structure, including eight former members of the Soviet

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16 Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Risng Cost of Complying with the Federal Income Tax", *Tax Foundation* [Washington, DC: Tax Foundation, 2005].

17 "Statistics of Income Division." *Internal Revenue Service.* November 27, 2010. Accessed November 27, 2010, http://www.irs.gov/taxstats/compliancestats/article/0,,id=132165,00.html.

18 "Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance." U.S. Department of the Treasury. July 2009. Accessed November 28, 2010, http://www.irs.gov/pub/newsroom/tax_gap_report_-final_version.pdf.

19 Daniel J. Mitchell, "Eliminate Tax Brackets and Complicated Forms with a Flat Tax," *US News*, April 12, 2010. Accessed November 24, 2010, http://politics.usnews.com/opinion/articles/2010/04/12/eliminate-tax-brackets-and-complicated-forms-with-a-flat-tax.html.

20 Hall and Rabushka.

21 Daniel J. Mitchell, "A Brief Guide to the Flat Tax," *Backgrounder, 1866*(July 2005).

22 Steve Forbes, *Flat Tax Revolution: Using a Postcard to Abolish the IRS* [Washington, DC: Regnery Publishing, 2005].

Union, five of Yugoslavia, and seven that are now members of the European Union.[23,24,25,26]

Special interests. Arguably the most bipartisan argument for the flat tax is the opportunity it provides for stripping the tax code of loopholes that potentially favor special interests. By erasing the use of deductions, credits, and exemptions, the flat tax can mitigate the influence of interest groups and lobbyists largely blamed for the growing complexity of the tax code.[27] This would also fall in line with goals for lower compliance costs and fairness.

THE FLAT TAX PLAN

Like many policy areas, tax reform oscillates in and out of priority for policy analysts and lawmakers. The flat tax, in particular, has enjoyed various waves of reprisal over the last thirty years, gaining steam ahead of TRA in the early 1980s, then again behind former House Majority Leader Dick Armey (R-TX) and billionaire businessman Steve Forbes during the 1990s. Lately, advocacy for a flat tax is usually drowned out by louder calls for additional tax breaks to support struggling individuals and small businesses. However, today's tax code remains as complex as ever before, and as Congress addresses the expiring tax cuts of 2001 and 2003 and the White House moves forward with proposals to shrink the deficit and bring down government spending, the flat tax is sure to come back into play, particularly with free market economists and fiscal conservatives who have supported it all along. Robert Hall and Alvin Rabushka, both fellows at the Hoover Institution, a conservative think tank at Stanford University, have produced the most detailed roadmap for implementing a flat tax in the United States. Their plan forms the outline for almost every proposal lobbied for or introduced in Congress within the last twenty years. An overview of their plan serves well in framing the flat tax debate.

The Hall-Rabushka Framework

First proposed in 1981, the authors still spend countless hours advocating (and defending) the merits of the flat rate structure, and have produced a handy 200 page guidebook, simply titled *The Flat Tax*. The basic premise of their plan is to simplify the system, so much so that an entire tax liability is recorded on a form the size of a postcard. Specifically, Hall and Rabushka propose splitting the income universe into only two categories, individuals and businesses, taxing both at 19 percent, and structuring the code to ensure each dollar of income is taxed just once and as close as possible to its source. Their argument is simple: whenever different forms of income are taxed at different rates, the public figures out how to take advantage of the differential and takes deductions to the highest available rate while reporting income at the lowest rate.[28]

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23 Daniel J. Mitchell, "The Global Flat Tax Revolution." *Cato Policy Report 29*(4).

24 European Commission, *Monitoring Tax Revenues and Tax Reforms in EU Member States.* Directorate General Economic and Financial Affairs, Brussels, BE: European Commission, 2010.

25 European Commission, *Tax Revenues in the European Union: Recent trends and challenges ahead.* Directorate General Economic and Financial Affairs, European Commission, Brussels, BE: European Commission, 2007.

26 The Current European Union member states with flat tax: Estonia, Slovakia, Czech Republic, Bulgaria, Latvia, Lithuania, and Romania.

27 Daniel J. Mitchell, "A Brief Guide to the Flat Tax."

28 Hall and Rabushka, 80.

Individual Income Tax. Understanding the Hall-Rabushka plan requires a return to the argument for progressivity in the tax system. A pure flat tax, where every citizen pays an equally proportioned amount of his or her earned income, is generally considered to be regressive because the liability on lower income earners represents a much larger percentage of consumption spending than the liability on higher income earners who have more disposable income. For this reason, the Hall-Rabushka plan, like most proposals, is actually a modified flat tax with basic exemptions included to relieve the burden on the lowest income earners and provide some progressivity to the tax overall. In their model, each individual wage earner is taxed at the flat rate of 19 percent on all sources of income (i.e. wages, salaries, and retirement benefits), but only after deduction for a personal allowance (e.g. $25,500 for a family of four in 1995). This allowance threshold is designed to minimize (or eliminate) the initial burden on wage earners to the point that only the highest earners actually pay the full 19 percent. Unlike the current structure, which utilizes a higher statutory rate and provides progressivity through numerous deductions and credits, the Hall-Rabushka plan aims at providing some basic progressivity but then yielding greater overall benefit through simplification. This simplicity comes from the plan's integration with the other subset of the tax system: business.

Business Income Tax. As part of the overarching goal to ensure all income is taxed but taxed only once, the Hall-Rabushka plan is supposed to be "airtight" because of the identical rate for individual or business income, eliminating potential gaming between the two, and because every form of income must be classified in one of two buckets. The underlying logic offered by Hall and Rabushka is that the public can only do one of two things with income, spend it or invest it, and taxing consumption (measured as income less investment) is the best way to capture that income without hindering growth.

Specifically, the business tax is designed to tax all income earned by a firm (less wages paid, because those will be taxed on the individual) and investment in plant and equipment.[29] According to Hall and Rabushka, "The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages but to tax it only once."[30] This characteristic is understood best through the consideration for return on investment. Under a flat tax, there is no deduction for interest paid out, meaning that investment will effectively be taxed through the operating income of the firm. As a result, taxing interest earned through return on investment is unnecessary because it would be double taxation. Therefore, a central component to the Hall-Rabushka proposal is the elimination of tax on capital gains.

A second radical element to the business tax proposal is the elimination of the deduction for depreciation of plant, property, and equipment. Instead, Hall and Rabushka recommend firms completely expense investment spending in the year incurred. This, they argue, would be much simpler than the accounting mechanism of depreciating assets over time. While this would produce a negative liability for start-ups that are investing heavily and earning little,

29 *Ibid.*, 83.
30 *Ibid.*, 92.

Hall and Rabushka believe this can be easily managed by allowing firms to carry that negative liability forward as a credit to future taxation.[31]

Hall and Rabushka also tackle the issue of fringe benefits, which are a major form of compensation but for the most part ignored under the current system. The problem with fringe benefits is that there is no logical reason for their popularity other than serving as write-offs for employers and being tax-free for employees. This arbitrariness, Hall and Rabushka argue, creates inefficiencies in the economy because employers serve as an unnecessary intermediary in the purchasing of consumer services like health insurance, transportation, club memberships, etc. If fringe benefits were valued (taxed) identical to wages earned, employees would opt for the cash in hand, rather than the benefit, enabling them with more control over services used.[32]

The examples identified above are supported by numerous other tweaks in the spirit of a flat rate system, each of which is designed to minimize the financial and administrative burden on American taxpayers. Whether or not they are as effective in practice as in theory remains to be seen. Nevertheless, the Hall-Rabushka plan is treated like gospel among free market economists and fiscal conservatives.

31 *Ibid.*, 97.
32 *Ibid.*, 96.

Figure 4: Notable Flat Tax-Related Proposed Legislation
• **Freedom and Fairness Restoration Act** Rep. Armey (R-TX); Sen. Shelby (R-AL) Introduced four times between 1994 and 2001
• **Flat Fair Tax** Sen. Helms (R-NC) in 1995, Sen. Specter (R-PA) 1997-09 Introduced seven times between 1995 and 2009
• **Freedom Flat Tax** Rep. Burgess (R-TX) Introduced four times between 2003 and 2009
• **Tax Simplification Act** Rep. Smith (R-MI) Introduced three times between 2003 and 2007
• **Optional One Page Flat Tax Act** Sen. Alexander (R-TN) Introduced in 2007 and in 2009
• **Fair Tax Act** Rep. Linder (R-GA) Introduced in January 2009, Referred to Ways & Means
• **Simplified, Manageable, and Responsible Act** Sen. Shelby (R-AL) Introduced in April 2009, referred to Finance
• **Tax Code Termination Act** Sen. Isakson (R-GA) Introduced in February 2010, referred to Finance
• **Bipartisan Tax Fairness and Simplification Act** Sen. Wyden (D-OR) and Sen. Greg (R-NH) Introduced in February 2010, referred to Finance
Source: Thomas.gov

FLAT TAX POLICY

Since the full implementation of TRA in 1988, there have been more than fifty bills introduced in the House and Senate proposing some iteration of a flat tax. Virtually none have made it out of Committee. Listed in Figure 4 are some of the more notable pieces of legislation and the flat tax champions sponsoring each bill. Armey's famous *Freedom and Fairness Restoration Act* stirred up a lot of debate but in the end was little more than a political tool used to push the Republican agenda during the 1990s. Now retired from Congress, Armey still promotes his flat tax plan through the libertarian think tank Freedom Works.[33] Sen. Arlen Specter (D-PA) introduced the *Flat Fair Tax Act* during eight Congresses in a row, dating back to 1995. In 2003, he successfully added an amendment to the proposed tax cuts that led to a hearing with the Joint Economic Committee regarding the merits of a flat tax.[34] Less than a month after introducing the bill again in 2009, he switched political parties after

33 "Dick Armey on the Flat Tax." Freedom Works. November 27, 2010. Accessed November 27, 2010, http://www.freedomworks.org/issues/flat-tax.

34 "Senator Specter Introduces 'Flat Tax Act of 2009'." Senator Arlen Specter. March 30, 2009. Accessed November 28, 2010, http://specter.senate.gov/public/index.cfm?FuseAction=NewsRoom.NewsReleases&ContentRecord_id=5988e4d0-eb43-e40d-b3b4-cabcefddae23.

44 years as a Republican. He went on to lose the Democratic primary in 2010. In addition to Sen. Specter's proposed bill, there were five others offered during the 111th Congress, each of which died in committee. Certainly, one can expect new versions of these bills to be introduced in the 112th Congress.

ANALYSIS

Having laid out a brief historical summary of federal income taxes in the U.S., reviewed the arguments for a flat rate system and the nuts and bolts of the Hall-Rabushka proposal, it is important now to discuss the major concerns of the flat tax in an effort to assess its viability as real reform. An excellent way to conduct this analysis is by judging the flat tax against the five primary criteria of good tax policy: equity, efficiency, revenue yield, administrative cost, and political feasibility.[35]

Equity

A common buzzword attached to the flat tax is the "fair tax" because the equal proportionality associated with a single rate is assumed to be fairer than a progressive tax that penalizes wealth creation by overburdening higher income earners. This rationale alone makes little sense. As discussed previously, a pure flat tax will be regressive because of the relative burden placed on lower income earners with less disposable income. The proposals modeled after Hall-Rabushka are not pure flat tax systems; rather, they are modified versions to include progressivity by offering allowances that mitigate the burden on the low levels of income. This is a positive aspect of the flat tax and probably the strongest argument in defense of its equity consideration.

However, relative to the current tax system, there is no denying that the flat tax serves as a major break for higher income earners. Most observers studying the flat tax agree it likely will create a windfall for the wealthiest taxpayers, with the relative burden shifted to middle and lower income taxpayers.[36,37] This is for two main reasons. First, while there are numerous loopholes exploited by wealthier taxpayers, a significant number of current deductions, exemptions, and credits are targeted at lower income earners. The elimination of tax breaks is likely to impact lower income earners more severely than any other class. Second, the wealthy will benefit the most from a change in the statutory rate. For example, a flat rate of 20 percent creates a savings of 15 percent for individuals currently taxed at the highest 35 percent bracket, and doubles the current 10 percent rate charged to the lowest bracket. Large allowances will go a long way towards mitigating any increase in the liabilities of lower income earners, but the actual savings is likely to be experienced only by higher income brackets.

A second equity consideration is the degree to which the flat tax will increase fairness by eliminating loopholes created by special interests, particularly business interests. This is an

35 Daniel R. Mullins, "Local Fiscal Resources: The Basics of a Meaningful Resource Structure," in *Managing Muncipal Change*, by C. F. Bosner [Bloomington, IN: School of Public and Environmental Affairs, 1994].
36 Holley Ulbrich, "Why We Don't Need a Flat Tax." *Strom Thurman Institute of Government and Public Affairs,* 1998. Accessed November 24, 2010, http://www.strom.clemson.edu/opinion/ulbrich/flatax2.html.
37 Amy Dunbar and Thomas Pogue, "Estimating Flat Tax Incidence and Yield: A Sensitivity Analysis." *National Tax Journal 51*(2): 303-321.

admirable improvement over the current tax system, particularly if it can eliminate exemptions that provide no real value other than to create inefficiencies from unnecessary gaming of the code. However, relevant to the argument that a flat rate system will silence corporate lobbyists is the reality that numerous provisions designed to benefit lower class Americans will be eliminated as well. This will have a significant impact on equity, including disruptive effects that will come with the elimination of deductions for pension benefits, employer-provided healthcare, mortgage interest, property taxes, and charitable contributions.[38]

These concerns are important to appreciate when weighing the flat tax because its benefits are not free; there will be a trade off paid for by certain subsets of the population. Overall, the equity effect of a flat tax is likely to be poor. The personal allowances included in most proposals will provide some valuable progressivity, but the short-term shock from eliminating equity-induced provisions of the current system could have a severe impact on the lower class.

Efficiency

Will a flat rate structure make the U.S. tax system better off? The answer to this question is the bottom-line for many Americans. Unfortunately, that answer is just as disputed as the equity argument. In the spirit of simplification, the "airtight" moniker for the Hall-Rabushka flat tax implies significant efficiencies will be realized from a tax that is transparent, utilizes one rate, and ensures all income is taxed just once. Each of these traits, if fully realized, will certainly increase efficiency in the system. However, the flat income tax is a relatively untested structure, particularly on a scale as large as that of the United States.

If any holes are found in this "airtight" system, the flat tax will be quickly downgraded to just an alternative, and not an improvement, to the current system. With that said, there are some red flags raising concerns over the functionality of the flat tax in the long run. For example, a major selling point for the business tax is the abolition of amortization of capital expenditures (investment) in favor of immediate write-offs, as with other general business expenses. This is meant to simplify the controversial process of depreciating assets over time, which can have a major impact on the accounting for paper profit and loss. As mentioned previously, when capital investment is completely expensed upfront, firms are more likely to report negative earnings. When this happens, the Hall-Rabushka plan recommends carrying the negative tax liability forward as credit on future income taxes. This sounds reasonable. It also sounds like the same kind of accounting principles that make deprecation so problematic (both formats carry forward effect of investment purchases into future years). This is just one example of why it is important to respect the complexity of the current tax system. Certainly, there are numerous provisions to the tax code that are frivolous, but there are a significant amount that serve a clear purpose too. In other words, throwing out the rule book most likely will lead to new rules, not the absence of rules.

There is a long list of other side effects to the flat tax which are likely to make the new

38 Holley Ulbrich, "Flat Tax is Class Warfare" *U.S. News*, April 12, 2010. Accessed November 24, 2010, http://politics.usnews.com/opinion/articles/2010/04/12/flat-tax-is-class-warfare.html.

system just as complicated in the long run. These include the distinction between business and individual income for sole proprietorships, tangible versus intangible inputs to business, fringe benefits versus general expenses, and the accounting for income not classified as wages or capital gains (e.g. alimony payments, loan forgiveness, and prize winnings).[39] Overall, the efficiency of a flat tax remains suspect. As with the Tax Reform Act of 1986, any plan capable of making it through Congress is likely to serve more as a rebuilding process to the current tax code than as real reform to the system.

Revenue Yield

Generally speaking, most flat tax proposals are offered as revenue neutral to the current budget. In fact, the exact rate recommended (e.g. 19%) typically comes from a calculation of what will be necessary to meet current revenue projections. Furthermore, supply side economists argue that lower taxes will promote investment, create growth, and stimulate the economy, which will, in turn, increase tax revenues. Dale Jorgensen, a political economics professor at Harvard University, estimates that real reform through a flat tax could lead to wealth creation of almost $5 trillion, a pot of money large enough to yield significant additional tax revenue.[40,41]

To the degree that this estimate is accurate, a flat tax may serve quite well in creating additional yield for the government. However, Jorgensen's estimate, and many others like it, stems primarily from the theory that workers unbounded from the constraints of different tax brackets will discover new motivation to earn more. This was a big part of the rationale behind consolidation of the bracket-heavy structures that characterized federal income taxes prior to 1980. As Figure 3 suggests, supply side economics did little to reign in the federal budget or to create wealth for the middle and lower class (implied by the growing federal budget). If a flat tax is implemented without regard for government spending, then even a significant increase in revenue yield may do little to improve the net impact to the federal budget. (This is particularly likely if previous breaks are merely transitioned into government programs.)

Typically, lowering the income tax rate while simultaneously widening the base can be a good method for generating revenue. However, the flat tax lowers the rate for higher income earners and widens the base to include more lower income earners. From a revenue standpoint, this is likely to be counterproductive because the loss from a lower rate could be significantly more than the gain from a wider base. In this manner, a flat tax is likely to score poorly at generating revenue yield. Not only will the immediate impact be a loss in revenue because it will take time for supply side stimulus to impact the economy, the likelihood for greater government spending means budget deficits will increase as well.

Administrative Cost

Simplification is the backbone of the flat tax. From a purely administrative standpoint, a clearer understanding of tax liabilities will go a long way toward shrinking the tax gap and

39 Alan L. Feld, "Living with the Flat Tax," *National Tax Journal 48*(4).

40 Dale Jorgenson, "Efficient Taxation of Income," *Harvard Magazine*, (March-April 2003): 31-33.

41 Daniel J. Mitchell, "A Brief Guide to the Flat Tax."

the workload of the Internal Revenue Service. If a postcard return is in fact possible, then it is hard to argue with the administrative advantages to a flat tax. However, even the "postcard" examples offered by Hall and Rabushka, Armey, Specter, and Forbes require a lot more than just a mailing address. In relatively fine print, these postcards include line item deductions for personal allowances and adjustments for prior period tax carryovers. Is this drastically simpler than the current form? Of course. However, these draft proposals, no matter how refined, have yet to run the gauntlet of federal bureaucrats and special interests. Overall, it is fair to say a flat tax will provide some much-needed simplicity to the tax system; but it is not fair to say that simplicity will be sustainable, or even implementable.

Political/Legal Feasibility

As suggested by the number of flat tax bills gone nowhere in Congress, the political feasibility of dramatic income tax reform is quite low. For better or for worse, democracy in the United States is rooted in the right to organize, protest, and influence policy. This right is protected by the Constitution and exercised by the tens of thousands of lobbyists pushing special interests on legislators. Many of those interests are with the best of intentions; others are not. Unfortunately, discriminating between the two is impossible. Flat tax legislation, in particular, will have to survive the scrutiny of interest groups protecting favorable tax provisions, a test that no proposal has passed so far.

CONCLUSION

There are three certainties identified in this analysis: one, the federal income tax is increasingly complicated; two, the tax rate has flattened over time; and three, real reform is virtually impossible. The flat tax, as an idea, is impressive. As practical policy, it is a different story. The simplicity it offers is admirable, but the equity, efficiency, and yield considerations remain suspect. Each policy objective deserves great scrutiny and it would be dangerous to assume such an untried system can function exactly as theorized.

No doubt, aspects of the flat rate concept will continue to creep into the U.S. system, and to this end, it may eventually be presented in its full glory. For the time being, however, the flat tax serves best as a check on the direction of the current system. Like the Tax Reform Act of 1986, any tangible legislation is likely to serve as a maintenance tool for cleaning up the current code rather than a charter for a new way forward.

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