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FALLING FLAT
The Dubious Case for the Flat Tax

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The flat tax, promoted by former congressman Jack Kemp's tax reform commission and likely to be the subject of legislation by House Majority Leader Richard Armey, is sold to the public as having two major virtues: it will spur economic growth by reducing marginal tax rates. and it's simple. Neither of these promises, however. stands up to scrutiny, and instead a host of other concerns are raised:

- There is little if any evidence that a flat tax will raise economic growth.
- Lower tax rates for the wealthy will have to be financed by some combination of higher taxes on the middle class and larger budget deficits.
- For the vast majority of taxpayers, the flat tax will be no simpler than current taxes.
- In eliminating deductions. the flat tax will hurt homeowners, residents of states with high income and property taxes, charitable organizations (including religious institutions), and people with high medical expenses. among many others.

False promises of economic growth

It was claimed in the 1980s that lower marginal tax rates would pay for themselves through increased economic growth and tax revenue. But U.S. economic performance in the 1980s did not markedly improve over the previous decade, and it was inferior to U.S. postwar experience prior to 1972, when marginal tax rates were much higher. Furthermore, U.S. savings and investment fell after 1981, while labor supply exhibited insignificant changes. One outcome that can be directly attributed to the 1981 tax cuts was record budget deficits.

A single, lower tax rate for workers and business firms is supposed to boost economic growth by inducing people to work. save, and invest more than they otherwise would. But under the flat tax many workers would face higher marginal rates, not lower ones. Currently the lowest wage workers pay no income tax but bear a payroll tax burden of 15.3% (employer plus employee). When they earn enough to move into the first income tax bracket--15%--their marginal rate rises to 30.3%. A flat tax rate will inevitably be higher than 15%; it could easily be as high as 24%, thereby boosting the tax rate of these workers to 39.3%. Moreover, they will bear an additional tax paid by the employer on all employer-paid fringe benefits, including health insurance. Even for workers in higher income brackets, who will face reduced marginal tax rates, the consequence for work effort is questionable: most empirical research shows the labor supply of full-time. primary earners in families to be unaffected by tax rates. In other words, for those born without the proverbial silver spoon, there is no satisfactory financial alternative to using one's healthy years to work. Higher after-tax wages increase the incentive to work because the "price" of not working goes up, but they reduce the incentive to work because one can earn more at the cost of fewer hours of work. For many workers, of course, there is little flexibility in varying their hours of work in either direction. Try telling your boss that, because your wages fell2% this year, you plan to work 38.6 hours instead of 40.

The same doubts about a flat tax-inspired economic boom apply to its effect on savings (Rogers 1995). Higher after-tax returns make saving more rewarding, but greater rewards reduce the need to save and increase current spending. A flat tax could also reduce saving by shifting the tax burden from the elderly, who tend to spend down their savings, to working families trying to build a nest egg (Gravelle 1992). On the whole, empirical research has not found significant savings effects stemming from higher rates of return.

In any case, hopes for more saving and investment are futile if the flat tax increases deficits. If individuals' increased saving is borrowed by the federal government, then there is no benefit to growth in the supply-side framework.

Tradeoff between higher taxes for middle class and higher deficits

Since the current tax code is progressive--the rich do in fact pay a larger share of their incomes in taxes than do the less well-off--a flat tax that raises the same revenues cannot fail to shift a significant portion of the tax burden from the rich to the non-rich, as early flat tax proponents Robert Hall and Alvin Rabushka freely admit (1985). According to Citizens for Tax Justice, under a flat tax, the fortunate few with incomes above $200,000 will see their taxes fall by an average *of $53,940* (CTJ 1995; Toder 1995).

Rep. Armey promises that nobody will pay more under his tax because the basic standard deduction will be high and the rate will be low. If this is the case, then the rewards enjoyed by upper-income persons will have to be financed by higher deficits. When the Treasury Department estimated that Rep. Armey's original flat tax proposal would raise deficits by about $200 billion per year, Armey initially denounced the finding as fraudulent, though he lacked any reputable alternative estimate. He subsequently revised his proposal to reduce, though not eliminate, the expected revenue shortfall.

Arrney's fiscal irresponsibility replays the so-called "riverboat gamble" of tax cuts pushed through by the Reagan Administration in 198 1. Echoing the promises of those early supply siders, flat tax advocates predict that economic growth induced by the change will "make the pie bigger." As everyone now knows, those 1980s' promises proved to be unfulfilled.

Democrats have wrongly interpreted such proposals to be motivated by a lust for accolades from taxpayers or by faith in a resurgence of economic growth. The more likely explanation is that flat taxers want higher deficits to force deeper cuts in federal spending.

The price of simplicity

Taxes are already simple for a supermajority of taxpayers: about 70% of tax returns include no itemized deductions or complicated forms. Even so, complicated aspects of taxes usually have a purpose, and such purposes are thwarted if the tax form and its instructions must be squeezed onto the proposed postcard. Deductions are ways in which the tax code calibrates its measure of each taxpayer's ability to pay. For instance, in a case where two families receive the same income but one has high medical bills, a deduction allows the tax code to say they are not equal and should not pay equal taxes.

Deductions would be sorely missed. In 199 1. among those filing for itemized deductions, state and local tax deductions averaged $5.45 1 per return; medical and dental expenses, $4,444; charitable contributions, $2,050; interest on state and local government debt, $13,130; and home mortgage interest, $7,443. The postcard conceals the elimination of another deduction—employee fringe benefits, particularly health insurance. This cost will no longer be deductible by businesses, and the added expense will most likely be passed on to workers in the form of lower wages or to consumers in the form of higher prices. Similarly, state and local taxes paid by business firms will no longer be deductible under Rep. Armey's proposal. This hidden tax on state and local governments is the kind of burden conservatives usually decry as an "unfunded mandate."

The elimination of the mortgage interest and property tax deduction could have a big impact on house prices. Because these deductions increase the value of homes, billions of dollars in home equity could be destroyed, and many homeowners could face "upside-down mortgages," where the house price plummets below the outstanding mortgage principal. Retirees planning to trade down their homes to finance retirement or gifts to children and grandchildren could be badly hurt.

Flat is not necessarily simple

The idea of a flat tax postcard for individuals has been widely circulated, but business taxes could not possibly be filed in this manner (McIntyre 1995). Since the postcard conveys minimal information, the Internal Revenue Service would have to conduct a full-scale audit to check on any return. Also, any worker with Schedule C or other business income would have to file a business return, perhaps in addition to the postcard.

The Republicans' proposal has yet to be specified in any detail. Among other things, the transition process-the most complicated part of any radical tax reform--has yet to be addressed. Done properly, transition would entail great complexity and could easily occupy a decade; if Congress succumbs to the temptation to fiddle with tax law, transition and its attendant complexity will be forever. There is nothing in the flat tax to restrain lawmakers' profiting from the continuous revision of tax law.

In apparent fear of the political consequences, the Kemp commission has avoided calling for the elimination of specific, popular deductions, preferring instead to celebrate the general virtues of flatness and simplicity. What is simple about a flat tax. however, is not the single rate or the absence of deductions; rather, it is the way in which taxable income is calculated. The more complicated the definition of taxable income, the less simple a return will be--and the less likely it will fit on a postcard.

Simple doesn't need flat

The simplicity of the flat tax, such as it is, would not be compromised by the inclusion of graduated rates. The postcard could be retained, and taxpayers above the first bracket would need only a tax table on the side. This method has been suggested by David Bradford (1986), a member of President Bush's Council of Economic Advisers, as a way to make the tax more progressive and no less simple. Alvin Rabushka (in a conversation with the author) acknowledged that such a change would be a major advance.

Furthermore, there are other ways to attain simplicity. Rep. Richard Gephardt has proposed a "10% tax" that would reduce marginal rates by eliminating most deductions. Complying with this tax would be simple for the vast majority of taxpayers. A more comprehensive reform that entails abolishing the corporate income tax has been proposed by Robert Eisner (1996). In contrast to the Armey proposal, these plans match the progressivity of the existing system, but they don't spend money the government doesn't have.

Conclusion

The economic benefits of the flat tax are dubious, there are other devices available for tax simplification, and there are alternative policies to stimulate economic growth (Schafer and Faux 1996). As Professor Steven Mann of Texas Christian University pointed out recently, since all of the goals of the flat tax can be realized without it, the only purpose of the tax must be to reward the rich at the expense of the middle class. Another unwholesome motivation is to reduce federal revenue, increase deficits, and force further cuts in public spending to balance a deliberately unbalanced budget (Sawicky 1995). This conclusion follows with even greater force if the Republican legislative proposal departs significantly from the original Hall-Rabushka design in terms of the way in which taxable income is calculated, since the comparative simplicity of the proposal will be seriously compromised.

The flat tax affronts the traditional, popular principle that one's tax bill should be based on ability to pay. It shifts the tax burden from rich to non-rich, from capital to labor, from elderly to non-elderly, and to all making heavy use of itemized deductions. It also takes a fiscal potshot at state and local governments, which already face damaging cuts in federal grants-in-aid. It is unfair four times over. Worst of all, however, there is no gain to show for all the pain to be endured.

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