

The Flat Tax

Proposals to reform the Federal tax system have proliferated in the past year, and among the most prominent of these is the proposal for a flat-rate income tax, which would eliminate loopholes and tax incomes at a single rate. One difficulty is that loopholes are cherished not only by taxpayers who take advantage of them but also by constituencies whose allocation of resources is enhanced as a result of tax loopholes. Politicians love to bestow "goodies" on clearly identified constituencies and are reluctant to take them away. But the major, and probably insurmountable, obstacle to implementation of a flat tax is that, at least in the "all else being equal" analyses of most fiscal analysts, projections of the effects of a flat rate on specified individuals indicate that tax payments for the middle-income Americans would have to increase even if some rates were lowered. Try as they might, politicians are not likely to find a way to reduce the tax burden of middle-income Americans unless genuine cuts are made in Government spending.

It is now 10 years since the 1986 Tax Reform Act became law, reducing income tax rates for individuals and businesses and "broadening" the tax base by eliminating or curtailing deductions and credits (loopholes) that enabled taxpayers to pay average rates of tax far below the rates in the pre-reform tax schedules. Since then, lawmakers have tinkered continuously with the tax code, raising the top individual income tax rate from 28 to 39.6 percent and reopening and creating new loopholes. According to House Majority Leader Dick Armey, in the five years following the 1986 tax reform, Congress made about 5,400 changes to the tax code.

These frequent changes have increased taxpayers' frustration with the tax code, and chronic uncertainty over countless other changes that have been proposed hangs like a cloud over individuals' and businesses' tax planning. At the same time, "supply-siders" continue to argue that lower tax rates and a simplified tax code would help spur economic growth. Consequently, there appears to be growing support for sweeping reform of the tax code.

One proposal, which is supported by Representative Bill Archer and Senator Richard Lugar, would scrap the current

income tax system altogether and replace it with some form of a national sales tax. Another, which received much attention during Steve Forbes' campaign for the Republican presidential nomination and is supported in one form or another by Mr. Armey, Senator Arlen Specter, and "supply sider" and former Congressman Jack Kemp, would replace the current complicated tax structure with a "flat tax."

In its vague form, the flat tax can appeal to everybody. Some advocates claim it would be so simple that taxpayers could file their returns on a postcard. Washington may imagine that the new return will read: "Line 1: How much income did you receive last year? Line 2: Send it in." Taxpayers may dream that it will read: "Only taxpayers with incomes above \$[my income] owe any tax at all."

Those extremes exist only in the imagination. Serious flat-rate proposals must deal with a most difficult issue, namely, the elimination of the special provisions, exclusions, and deductions that are part of the present law. These are the source of a tax return's complexity, and they also reduce taxable income, which requires that tax rates be higher in order to produce a given amount of revenue. So why should the elimination of these provisions be po-

litically difficult? A closer look at them may suggest an answer.

Loopholes or Essential Elements of Equity?

Americans paid nearly \$600 billion in individual Federal income taxes during the 12 months ended last September, fiscal 1995. Personal income during that period was about \$6 trillion. Thus, individual income taxes averaged nearly 10 percent of total personal income. In 1995, Federal income tax rates began at 15 percent and went up to 39.6 percent. How can it be that the average rate was lower than the lowest rate?

One reason is that about \$650 billion of personal "income" was not taxed last year because each man, woman, and child in the United States received a personal exemption of \$2,500. Another \$400 billion or so was not taxed because it fell within the standard deduction allowed to each taxpayer (\$3,900 for single filers and \$6,550 for married couples filing joint returns). Personal income adjusted for these exemptions and deductions totaled about \$4.9 trillion. The \$600 billion in personal income taxes paid in fiscal 1995 amounted to an average tax rate of about 12 percent on such adjusted income.

The major reason that the marginal tax rates of 15 to 39.6 percent did not result in a higher average tax rate than 12 percent or so is that the tax laws: (1) permit some outlays to be treated as deductible expenses for determining taxable income, even when they have nothing to do with generating income; (2) exclude some income from taxable income; and, (3) contain special provisions that otherwise reduce the amount of taxes owed on reported income. If this summary grouping means little to readers, the various individual provisions and their estimated effect in "lost" tax revenues in fiscal 1995 are given in the table on the next page and may be more readily recognized.

The data suggest that, all else unchanged, individuals would have paid at least \$380 billion more in income taxes during fiscal 1995 if these provisions, or loopholes, or tax expenditures did not exist. That would have been more than enough to eliminate the \$164 billion defi-

cit then. It also would have brought the average Federal income tax rate to 16 percent of total "personal income" or 20 percent of the income adjusted for the basic exemptions and standard deductions. The amounts are estimates only, for the reasons given in the footnote to the table.

Moreover, those estimates do not take into account some troublesome issues. Chief among these is the question of what is "income"? When is a specific travel and entertainment outlay, or the purchase of an automobile or of a personal computer, a business expense and therefore deductible in calculating "income"? When are such outlays consumption expenditures and thus not deductible? How can the tax forms be simple if such outlays are deductible? How can the tax fairly be called an "income tax" if they are not deductible when used for generating revenue?

Nevertheless, the data suggest that if all "income" above the present exemptions and standard deduction amounts were subject to tax, with no special provisions or nonbusiness deductions, an income tax rate of as little as 12 percent would provide the same or more revenue for the Treasury. Still appealing? Let's look further.

What Would It Mean For Me?

Taxpayers with very low incomes now are taxed at rates of less than 12 percent. With a flat-rate tax of 12 percent, they of course would pay more taxes, especially if receipts such as Social Security benefits and welfare are no longer excludable from taxable income. "Unfair!" is the cry on this issue. Therefore, most proposals for a flat-rate income tax include some way of increasing the basic exemptions per individual or retaining some of the loopholes now available for low-income taxpayers. If this is done, the flat rate would have to be more than 12 percent, say 20 percent.

With a flat rate of 20 percent or so, many of the "rich" would pay less taxes, assuming they changed none of their spending-saving-investment decisions. The latter is highly doubtful, but analysts do not know how to attach dollar amounts to probable changes — like saving and investing more — so they are assumed away.

If the "poor" pay less (or at least no more) and if the "rich" pay less, *middle income taxpayers would have to pay more if the Government's tax revenues are to increase and the deficit is to be further reduced, given the failure of politicians to cut spending on the social programs that account for the largest and fastest-growing portion of the budget.*

A glance at the list of present loop-

holes shows why. The items for which the larger amounts apply are those utilized mostly by middle-income taxpayers: pension plans, homeowners' interest and property tax payments; employer-paid medical insurance; and so on. Middle-income taxpayers would lose these and much more under any flat-rate income tax proposal.

Some taxpayers who now benefit from loopholes might gladly trade them, even if worth several hundred dollars in tax savings, for a half-page return. Many others probably would not. Plainly, however, loopholes have constituencies in addition to the taxpayers who use them. Not the least of these "vested interests" are the lawyers and accountants who guide taxpayers through the present system. In addition, every specific loophole has its special advocates: builders defend the mortgage interest deduction, investment companies defend the favorable treatment of pension funds, state and local politicians see as essential the exclusion of municipal bond interest and deductions for state and local taxes, etc. Also, many "deviations from the normal structure of income taxes" can be justified with impressive arguments. For example, reported capital gains in large part reflect only the depreciation of the dollar's buying power, not genuine income, and taxing such capital gains as ordinary income would constitute a wealth tax rather than an income tax.

In view of the powerful constituencies of the larger loopholes, the elimination of most of them seems highly improbable. In that case, the rate for a flat-rate income tax (with many loopholes) would apparently have to be quite high — 30 percent would not be unreasonably high. If a flat-tax rate had to be that high, we suspect that there would be little enthusiasm for the whole idea.

"Supply side" proponents of the flat tax argue that a lower rate than this is

feasible, even if big loopholes are maintained, because if marginal tax rates are reduced under a flat rate tax from their current level, productive activity will increase and thus more tax revenue will be generated. There is merit to this argument. When the top tax rate was decreased from 70 percent to 28 percent in the 1980's, the amount of taxes paid by the highest income taxpayers increased in terms of constant dollars and as a percentage of all

Federal "Tax Loopholes" **Fiscal Year 1995 Individual Income Taxes** (Millions of dollars)

<i>Special Provisions</i>	<i>Taxes Saved*</i>
Deferrals of taxable income:	
Pension plans	\$63,105
Other	15,980
Capital gains tax rate	7,300
Earned income credit	4,920
Low-income housing investment credit	1,810
Child and dependent care expenses credit	2,730
All other tax credits	760
Additional exemptions and deductions	
Elderly and blind	1,330
Students	820
Income Not Taxed	
Government transfer payments:	
Retirement [†]	20,150
Disability	4,865
All other	2,620
Workmen's compensation	4,475
Employer-paid fringe benefits	
Medical insurance	59,440
Other	5,700
Capital gains	
On home sales by persons age 55 and over	5,160
At death	28,305
Interest received from state and local governments	12,200
Income on life insurance savings	9,630
Scholarship and fellowship income	825
All other exclusions	7,265
Nonbusiness Deductions	
Home mortgage interest	48,080
Homeowners' property taxes	15,275
Other state and local taxes	27,735
Charitable contributions	17,920
Medical expenses	3,495
All other nonbusiness deductions	9,220
Total Estimated "Loopholes"	\$381,115

Memo: Total individual income tax payments, FY 1995, \$590 billion.

* Estimated reduction of taxes payable ("tax expenditures" from the government's point of view) attributable to various "deviations from the normal structure of income taxes." The normal structure is defined as 15 to 39.6 percent of individual income after allowing for personal exemptions and a standard deduction. The amount of revenue lost from each deviation from the normal structure of the tax law is estimated independently. Because taxpayers would be pushed into higher brackets by the removal of more than one deviation, the amounts shown in the table are understated for situations involving the aggregating of several deviations.

Oppositely, for situations in which estimates are based on the existing levels of transactions that are made to take advantage of a given "loophole," the estimated tax expenditures may be overstated, because taxpayers would curtail such transactions if the "loophole" were removed.

† Mainly tax exempt Social Security payments to retirees and survivors.

Source: Congressional Budget Office, based on tax laws as of December 31, 1995.

income taxes paid to the Treasury. The more loopholes left in place, however, the higher the flat rate needed to generate the same revenue as a “pure” flat tax system; but the higher the flat rate, the smaller the proportion of taxpayers who would see a reduction from what their marginal tax rates are under the existing tax code. Unfortunately, there is no satisfactory way to estimate the net effect of any stimulus that might result from switching to a flat

rate. However, just as advocates of higher taxes for higher-income taxpayers tend to exaggerate the potential gains from “soaking the rich,” supply-siders may be overly optimistic about the revenue to be gained by switching to a flat tax, especially one that retains popular loopholes.

In any event, it seems unlikely that any increase in revenues would be large enough to support a substantial increase in Government spending from its current

level. Yet that is what is projected to occur early in the next century when the baby boomers begin to retire and claim their promised entitlements. In short, if an acceptably low flat tax rate is to be maintained, Government spending and entitlement reform will have to be addressed. Some flat tax proponents acknowledge this, but it remains to be seen whether Washington will be willing to make the necessary but unpopular policy choices. □

CAN WE DO BETTER THAN 2½ PERCENT?

Faster economic growth would have many benefits. The budgetary dilemma would be easier to solve and working-age adults could see their standard of living increase at historic rates. Experience suggests, however, that accelerated inflating will not ensure a lasting acceleration of growth, which can only be built upon sound money and fiscal policies and less invasive regulation of economic activity.

The growth of constant-dollar Gross Domestic Product (GDP) averaged 2.5 percent between 1969 and 1995. An assumption of continued 2.5 percent economic growth indefinitely into the future is incorporated in most of the longer-term forecasts of Federal budgets in general and of the prospects for various entitlement programs (such as Social Security, Medicare, and Medicaid) in particular.

Balancing the budget and cutting back on past promises and commitments might become much easier if the economy grew faster. Adding just half a percentage point to the growth rate (bringing it to 3 percent) would make the economy more than 25 percent larger by the year 2040 than it would be with 2.5 percent growth. Adding a full percentage point would make this happen 20 years sooner, and 3.5 percent growth would make the economy 50 percent larger by the year 2040, again relative to what it would be if growth remains at 2.5 percent.

The thinking here is not only that government resources would be enlarged (the tax code remains progressive, which means that the government would receive an increasingly large proportion of higher incomes), but also that taxpayers would have substantially more even after those higher taxes were paid. This could serve to fulfill the American Dream of ever-increasing living standards, which many appear to believe to have been shattered during recent years.

Historical Context

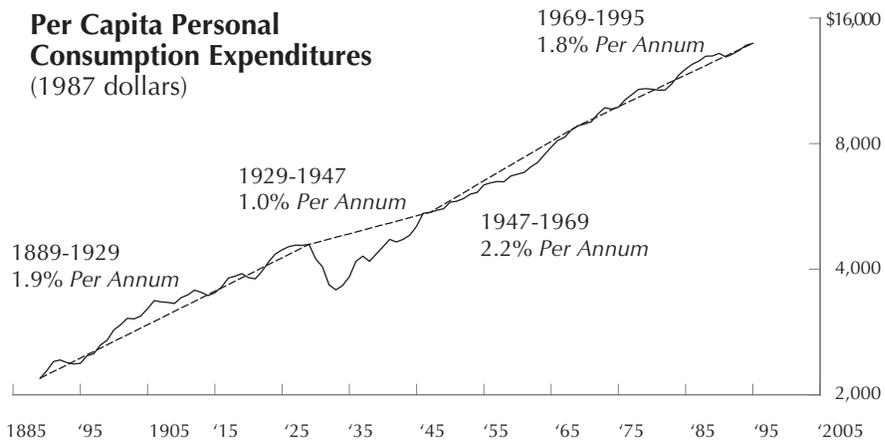
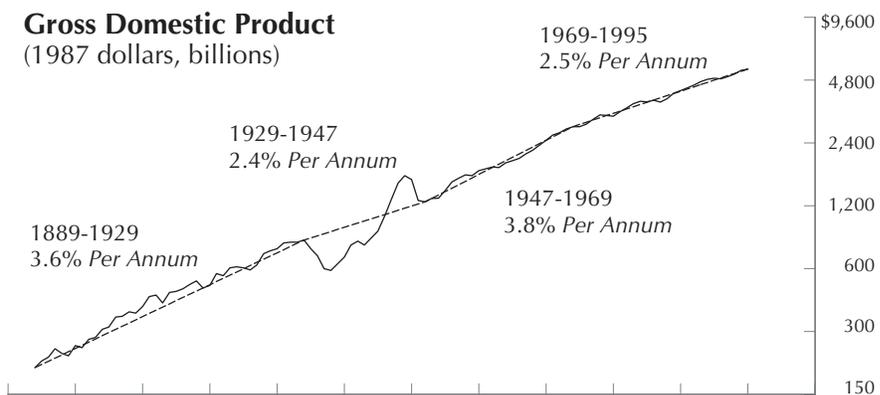
National Income and Product accounting did not begin in earnest until after World War II. The pre-war years were compiled long after the fact, and even the data that were collected contemporaneously have been revised extensively over the years. For this reason, not to mention various methodological and definitional questions

relating to what GDP should or should not measure, the data may well be flawed. Nevertheless, the broad trends indicated by the data plotted in the accompanying chart are probably valid. From 1889 through 1995, the average compound rate of increase in constant-dollar GDP was 3.2 percent. In the chart we have divided these 106 years into 4 periods.

As the chart shows, the U.S. economy has experienced sustained growth at rates

well in excess of what it has been during recent decades. During the 40 years from 1889 to 1929, economic growth averaged 3.6 percent per year, and during the 22 years 1947-1969 it averaged 3.8 percent. Even the period 1929 through 1947, which included the Great Depression, the war, and the post-war adjustment, posted an average of 2.4 percent growth overall, only slightly less than that of the past 26 years.

The astonishingly rapid increase in output indicated for the World War II years and the marked decrease in 1946 (which was steeper than any year of the Depression) suggest an important consideration. However useful the ships, planes, tanks, guns and bullets produced then may have been to armies and navies that used them, they were useless to consumers. This is only one reason why GDP may not be a useful measure of economic well being. Moreover, the growth



of GDP has something to do with that of population, if only because more workers can produce more than fewer workers.

The periods of above-average economic growth were also periods of above-average population growth. Between 1889 and 1929, the U.S. population increased at an average compound rate of 1.7 percent per year, and between 1947 and 1969 it grew by 1.5 percent per year. In contrast, between 1929 and 1947 the population increased only 1.0 percent per year, which is the rate at which it has grown since 1969.

Per Capita PCE

Personal Consumption Expenditures (PCE) is the largest component of GDP. The bottom panel of the chart shows constant-dollar PCE *per capita*, *i.e.*, divided by the population. This series increased at an average compound annual rate of 1.8 percent during the 106 years ended in 1995. PCE excludes gross private domestic investment, but it does include the product of that investment purchased for consumption (including an estimate of the imputed rental value of owner-occupied homes). Similarly, PCE excludes net exports. Goods and services sold abroad are not used by U.S. consumers. On the other hand, the imported goods they purchase are a part of PCE.

Finally, PCE excludes goods and services purchased by government. It could be argued that a portion of these (schools, parks, or roads used for recreation) may be of utility to consumers, but consumers do pay a portion of their cost in direct fees and excise taxes on products included in PCE, and the portion of GDP devoted to such items has been stable over the years, so that it has had little effect on trends.

Once again, these data must be approached with skepticism, especially given the astonishing changes in consumption patterns over the years (is it really possible to compare the outlays for and quantities purchased of, say, corsets and pantyhose, horse feed and gasoline, or lamp wicks and light bulbs?). Nevertheless, as a measure of the pace of increases in the standard of living constant-dollar PCE *per capita* displays a pattern similar to that of “real” GDP: more rapid growth during the 1889-29 and 1947-1969 periods, and slower growth between 1929 and 1947 (it may be noted that “real” *per capita* PCE did not exceed its 1929 level until 1941: all of the increase during the 1929-47 period occurred after the war began) and since 1969.

Because of changes in the rates of population growth and in the relative importance of PCE within GDP, the growth of PCE *per capita* has been more stable than that of GDP. Most astonishingly, the rate of increase in constant-dollar PCE *per capita* since 1969 has been equal to its average rate (1.8 per-

cent) for the entire period, even though the growth of GDP has been below its historical average. As indicated above, slower population growth is a factor in this, but it also reflects a diminishing importance of the other components of GDP.

During the 1947-69 period, PCE accounted for 60.5 percent of GDP, on average, and in 1969 the ratio stood at 61.6 percent. Over the past 26 years PCE has accounted for an increasing share of GDP and, by 1995, PCE accounted for 67.5 percent of output.

The increase reflected net exports turning negative, and decreasing government purchases¹ and private investment, relative to GDP.

The latter decrease may not be as much a problem as commonly believed. There is considerable evidence that capital investment has become more productive over the years, especially that related to communications and information processing. These technological advances have effects well beyond the industries that produce them. For example, as a result of better controls and signaling, major trunk railroads now move more ton-miles on single track lines than were carried on double tracks.

What are the Complaints About?

If constant-dollar PCE *per capita* has been increasing at its long-term average during the past 26 years, *i.e.*, if the standard of living has been improving about as fast as it has during the entire period under review, what are the complaints about?

For one, the 1.8 percent rate of growth is well below the 2.2 percent rate evident for the 1947-69 period, and few persons’ memories extend beyond that. In fact, the 1947-69 period may have reflected to some extent a “catch up” from the dismal experience of the Depression. Over the entire period 1929 to 1969, this measure of the standard of living increased at an average compound rate of 1.7 percent.

Demographic changes may be the real source of dissatisfaction, however. Slower population growth has meant that adults, the main consumers in the U.S. economy, have

¹ It may be noted that the product side of the National Accounts does not include transfer payments, which have come to dominate government outlays, as government purchases.

accounted for a larger proportion of the population, while children who presumably consume less have constituted a smaller proportion. That is, in recent decades the denominator in the per capita measure of PCE has been represented by a larger proportion of adult consumers. In effect this means that, in relation to the historical per capita PCE data, current measures overstate the per capita consumption of adults.

Moreover, the elderly have accounted for an increasing proportion of the adult population, and perhaps even more significantly, far fewer of the elderly live in poverty today than during the years prior to 1969 — mainly because of the huge increase in Social Security benefit payments and Medicare. In effect, this means that they consume a larger proportion of goods and services (the numerator in the per capita PCE calculation) than previously, leaving a smaller proportion for adults of working age. These changes, fewer children and more and better off old people, perforce mean that per capita PCE for adults of working age may be markedly lower than the aggregate data suggest. That these trends are unlikely to change anytime soon suggests that rapid economic growth is the only way to produce increases in the standard of living of working-age adults comparable to the historical experience.

Is it Possible?

Of course it is. There are no immutable constraints to sustained growth at a rate larger than 2.5 percent. However, the remedy most often advocated by advocates of faster growth is an “easier” monetary policy. In particular, at Alan Greenspan’s recent confirmation hearings, the Fed has been criticized for exercising restraint whenever growth has appeared to be exceeding 2.5 percent. It *is* likely that easier monetary policy could foster faster growth for a while, but experience, especially that of the 1970’s, indicates that it could not sustain such growth. Inflating, among other things, distorts price signals and favors speculation over sound investment. The latter is now and has always been crucial to economic growth. If faster growth is to occur, policymakers need to look long and hard at fiscal, tax, and regulatory policies that discourage productive investment. □

PRICE OF GOLD

	1994	1995	— 1996 —	
	July 7	July 6	June 27	July 3
Final fixing in London	\$383.00	\$384.15	\$382.95	\$382.25

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