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The Goodman-Kotlikoff Flat Tax

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While we're discussing alternatives to and modifications of the original Hall-Rabushka flat tax (Flat Tax Classic), we'd do well to remember another proposal, this time from John Goodman of NCPA, Laurence Kotlikoff of Boston University, and Hans Fehr and Sabine Jokisch of the University of Wuerzburg. The authors model four single-rate taxes, all of which are more progressive than Flat Tax Classic:

Under each tax reform, the new tax is rebated to the lowest one-third of income earners. While we don't model the form of these rebates, they could be provided as vouchers for the purchase of health insurance, contributions to personal retirement accounts, or contributions to Individual Development Accounts (IDAs). We also remove the cap on the Social Security payroll tax, but keep the benefit structure in place so that the tax rate on all wage income is the same.

A complaint about previous tax reform proposals is that they undermine the somewhat progressive features of the current fiscal system. The reforms considered here enhance progressivity. The bottom one third of the income distribution of each age group gains the most under each reform proposal.

One version of the proposal strikes me as particularly intriguing, in part on philosophical grounds:

A Fourteen Percent Value-Added Tax (VAT). A second way to tax consumption is with a valueadded tax (VAT). This approach taxes business sales minus the costs of a) intermediate inputs and b) net investment in plant and equipment. Since the value of sales at each stage of production incorporates the costs of intermediate inputs used, what is really being taxed is the additional value that has been added. Across all businesses, taxing value added minus net investment is the same as taxing national income minus net investment. But net investment equals net saving (since what is saved is invested), and income not saved is consumed. Hence, the VAT represents an indirect way to tax consumption.

An advantage of the tax is its ease of administration. Instead of 129 million individual tax returns, the tax would require only 20 million business establishments to file returns. A disadvantage is that the tax tends to be hidden and therefore not transparent. Consumers are usually unaware of how the tax affects the prices of items they buy. Workers are usually unaware of how the tax affects their take-home pay.

The VAT considered here would not be restricted to what most people regard as "business" enterprises. The tax would also apply to schools, hospitals, churches, nonprofit charities and even state and local governments. Under the current system, the federal government collects employee income tax revenue from all of these entities. If we were to abolish the income tax on wages, we must collect an equivalent amount in the form of a VAT. The mechanics are doable, even though they will strike many people as novel.

Note that this VAT is being modeled as a replacement for the personal and corporate income taxes. To maintain progressivity, the IRS (or successor agency) will have to offer a rebate, which in turn means that it will have to collect data on household earnings.

Increasing the VAT by 3 percentage points would allow for a more ambitious Social Security reform:

This proposal consists of four elements: (1) replace federal personal and corporate income taxes with a 17 percent flat-rate consumption tax, where the rate is measured on a tax-inclusive basis; (2) use 3 percentage points of the new tax to match contributions of 1 percent each by employees and their employers to create 5 percent personal retirement accounts designed to eventually replace the current pay-as-you-go Social Security system; (3) rebate the 17 percent consumption tax conditionally to the bottom one-third of the income distribution to those with health insurance and retirement accounts, pensions or Individual Development Accounts; and (4) apply the Social Security (FICA) payroll tax to all wage income.

One wonders about the potential privacy income. If FICA is being collected on all wage income, firms will continue to disclose how much they pay employees. Households will have to disclose total earnings, including but not limited to wage income, to the IRS to determine eligibility for a rebate.

The attractiveness of this approach rests on the interesting possibility that individuals could, at least in theory, opt out from reporting total earnings. Wages will be disclosed and taxed to maintain the Social Security system. But as long as you're comfortable with not receiving a rebate, or rather not having the federal government determine whether or not you're eligible for a rebate, you can affirmatively choose not to disclose. This probably should be opt-out rather than opt-in, as many of the people who'd benefit from the rebate most might have the most difficulty in taking affirmative steps to claim it.

By not means-testing the rebate, i.e., by creating a universal demogrant, we might be able to avoid the disclosure of total earnings full stop, but that would also raise the level of the consumption tax considerably.

So why does this matter? I imagine most of us don't think much of the requirement that we disclose all of our sources of income, etc., to the state, as it is such a commonplace. But if we take the idea of self-authorship seriously, there is something discomfiting about the idea. Imagine, for example, that people had to disclose details about their intimate relationships with the IRS. If the way we choose to make a living reflects deeply personal choices about the kind of people we are, our aspirations, etc., the reporting requirement rankles, as we feel entitled to privacy as an instrument of self-fashioning.

One danger of treating wage income and non-wage income differently is that those who are able to do so will presumably shift to non-wage income in an effort to limit tax liability.