

BRIEF ANALYSIS

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Benefits of the Flat Tax

A flat or single-rate income tax would replace the current system of five rates and hundreds of deductions, credits, exclusions, etc. This change is grounded in widely accepted principles of taxation. Following is a brief review.

Simplicity. At least since Adam Smith, simplicity in taxation has been considered a virtue. By simplicity we mean not only that the tax system is conceptually easy to understand, but also that the cost of complying with its requirements is low.

Our current tax system fails both tests. It is conceptually incomprehensible, even to tax professionals, and imposes large compliance costs on taxpayers. The principal cost is the time we must spend keeping records, filing forms and paying the tax. A government study estimated that Americans spend some five billion hours per year just doing that.

Some critics of the flat tax ridicule the idea that reducing the size of the tax return to a postcard contributes to meaningful simplification. They point out that only 9 percent of filers of the current 1040EZ form, which is just one page, require professional assistance. However, this only shows that true simplicity requires more than simple forms; it requires a simple tax system as well.

Creating a simple tax system requires stripping away unnecessary exemptions, deductions, credits and exclusions. It means stripping away unnecessary rates and unnecessary levels of taxation. It means moving the point of collection as close to the source as possible. And it means moving any necessary complexity away from individuals and toward businesses, which are better equipped to deal with it.

The flat tax achieves all of these goals. Thus it would

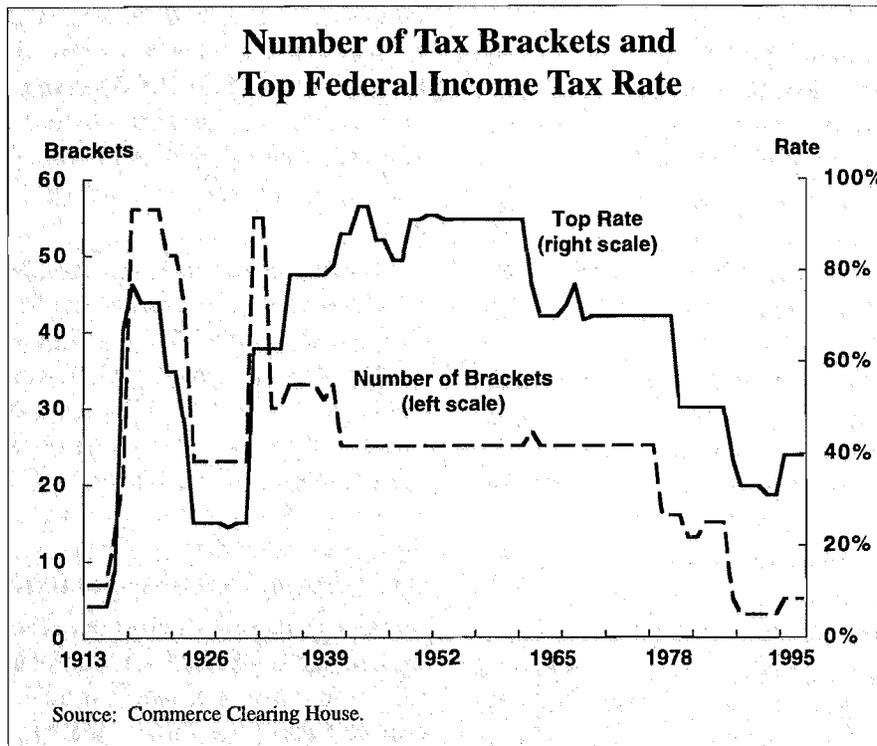
significantly simplify the tax system.

Efficiency. All taxes impose a cost on the economy over and above the amount of actual revenue collected. Economists call this the excess burden or deadweight cost of the tax system. It is in addition to the compliance cost.

Although all taxes impose some deadweight cost, the magnitude of the cost varies enormously de-

pending on how the tax system is structured. Two different tax systems raising the same amount of revenue can impose significantly different burdens on the economy. At the low end is the head tax or poll tax. Since every taxpayer is liable for a specific dollar amount of tax, there are no penalties for those who work, save and invest. At the other end is the steeply progressive income tax, under which the same income is double and triple-taxed. This is the tax we have now.

Various economic studies have found that in addition to the direct tax burden the cost of the U.S. tax system to the private sector is very high.



- A 1976 study in the *Journal of Political Economy* by Professor Edgar Browning found that the cost of taxes on labor was between 9 percent and 16 percent of each additional dollar collected.
- A 1984 study by Professor Charles Stuart, published in the *American Economic Review*, found that the U.S. tax system as a whole costs 24.4 percent of each additional dollar collected; and depending on what assumptions are made, this figure could be more than 100 percent.
- A 1985 study by Charles Ballard, John Shoven and John Whalley, published in the *National Tax Journal*, estimated that economic distortions cost between 13 percent and 24 percent of revenue collected.
- Another study that same year by the same economists, published in the *American Economic Review*, concluded that the cost of the U.S. tax system was between 15 percent and 50 percent of each additional dollar collected.
- A 1987 study by Edgar Browning, published in the *American Economic Review*, found the cost of the U.S. tax system was between 31.8 percent and 46.9 percent of revenue, with plausible assumptions raising this figure to as much as 300 percent!
- A 1991 paper by Professors Dale Jorgenson and Kun-Young Yun in the *Journal of Accounting, Auditing and Finance* put the cost at 18 percent.

Jorgenson and Yun's 18 percent figure implies that our system of collecting taxes costs approximately \$250 billion per year. By collecting the same amount of revenue in a way that does not discourage work, saving and investment, we can potentially gain \$1,000 per person each year.

The flat tax achieves this goal by eliminating distortions in the tax base and the rate structure and eliminating the tax bias against saving and investment. And without progressivity, taxpayers are no longer pushed into a higher tax bracket by inflation.

Fairness. In Washington, fairness has traditionally been defined only one way: the rich should pay more. Of course, this can be achieved simply by a flat rate. Some-

one with an income 10 times higher than another would pay 10 times more. To many Americans this is the essence of fairness. But under progressive tax rates, someone with an income 10 times higher would pay more than 10 times the amount of taxes. During World War II the top tax rate reached 94 percent. As recently as 1981 it went as high as 70 percent. Today it is 39.6 percent.

There are other concepts of fairness. Under "horizontal equity," people with the same incomes would pay the same taxes. Our current system violates this principle because one's tax liability depends not just on the amount of income, but the form of that income (wages vs. business income) and the amount of tax deductions, exclusions, credits and exemptions to which one is entitled.

Another principle is the "benefit principle," which says that one's tax liability ought to be related to the benefits one receives from government. In fact, Professor Richard Epstein of the University of Chicago Law School argues that the Fifth Amendment to the Constitution requires the benefit principle. Of course, our current system does not in any way relate taxes to benefits. While a flat tax will not fix this problem, Epstein believes that the flat tax is more constitutionally sound than a progressive income tax.

Finally, there is a question of fairness in having a tax system that imposes differentially high income tax rates on a minority. In a recent article in the *National Tax Journal*, Professor James Buchanan, a Nobel laureate, argued that the most "politically efficient" system of taxation "would involve a flat-rate, proportional tax on all sources of income, without deduction, exclusion or exemption."

Conclusion. The flat tax is considered by many economists to be the tax system most consistent with widely accepted principles of simplicity, efficiency and fairness.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett.