



BRIEF ANALYSIS

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The Flat Tax: Improving on a Good Idea

by John C. Goodman

Steve Forbes has done a commendable job spelling out why America's tax system must be simplified. Scrap the mind-numbingly complex, loophole-filled, savings-averse code, advises the editor-in-chief of *Forbes* magazine, in favor of one elegant, clear rate. A flat-rate income tax is what America needs.

Forbes has proposed a flat rate of 17 percent, with generous personal exemptions for all families, so that a family of four would not pay taxes until its income exceeded \$46,000. Moreover, the Forbes plan encourages growth by exempting income that is saved and invested. Which means that the Forbes plan is really a consumption tax. It taxes people based on what they take out of the economy, not on what they put in. It is a good plan, but can be improved upon.

A Lower-Rate Flat

Tax. The tax rate can be lowered further — 14 percent as opposed to 17 percent — and at the same time do more to help low-income people. With the assistance of Boston University economist Laurence Kotlikoff, an advocate of a national retail sales tax, the NCPA put together a plan that works in the following way.

First, it would eliminate the across-the-board \$9,000-per-person exemption in the Forbes plan. Why should

billionaires like Bill Gates get an exemption? Forbes is giving too much money away to rich people. Eliminating the across-the-board exemption would allow the money to be rebated to the bottom third of earners, those who bring home roughly less than \$25,000 for a family of four.

Second, Forbes ignores the 12.4 percent Social Security payroll tax (split between employer and employee), although the payroll tax is an example of a pure flat

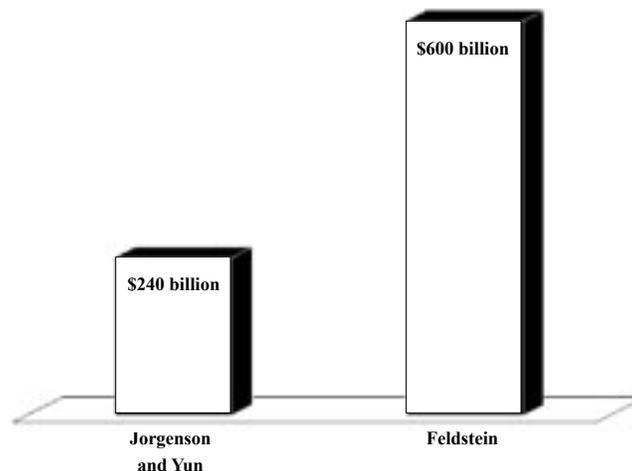
tax. Currently, income over \$90,000 a year is not subject to the tax. It is a regressive feature of the current tax system that a \$50,000-a-year autoworker has to pay payroll taxes on all his income while a million-dollar-a-year auto executive does not. Under the NCPA proposal, the income ceiling would be lifted and all wages would face the same income and payroll tax rates.

Without this change, the Forbes plan is politically impractical. Politicians will not adopt a new system that taxes the paychecks of the rich at a lower rate than those of blue-collar work-

ers. Under the NCPA proposal, all wages would face the same income and payroll tax rates. And they would be taxed only once. All savings would accumulate tax free and be taxed only when withdrawn.

A More Progressive Flat Tax. This plan allows a lower flat-tax rate and produces results that should appeal to liberals as well as conservatives. What conservatives most want is an uncomplicated system that taxes income

Dead Weight Loss to the Economy from Federal Taxes (2005)*



* NCPA projection based on estimates for the mid-1990s.

Sources: Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics*, vol. 81, no. 4, 1999, and Dale Jorgenson and Kun-Young Yun, *Investment Volume 3: Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, Mass.: MIT Press, 2001).

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only once (when it is earned) at one low rate. Liberals are more concerned about progressivity. They want the rich to bear more of a burden than the poor.

“Our flat tax is more progressive than the current system.”

The left objects to most consumption tax proposals because they are not progressive. Low- and middle-income people would pay a greater share of what they earn than rich people. This proposed system is more progressive than the Forbes flat tax. It’s also more progressive than the current system. Using economic modeling, Kotlikoff found that under the NCPA flat tax the rich would bear more of the burden than they currently do.

Health Care and Pensions. Most flat-tax proposals ignore health insurance and retirement saving. Yet the failure to insure or save — especially for low-income families — is a social problem. For that reason, the rebate of tax dollars to the bottom third of taxpayers would be used to help solve these problems. For example, as a condition of receiving the 14 percent rebate, low-income families would be required to show they have health insurance and a retirement pension. Specifically, to get one-half the rebate (7 percent), they would have to produce proof of health insurance. This would encourage millions of people who qualify to enroll in Medicaid or in their employer’s health plan. Barring that, families could apply the tax rebate to health insurance they purchase on their own. The other half (7 percent) of the rebate would be contingent on proof of a pension, an IRA, a 401(k) or some other savings account. So instead of national health insurance and more government spending on the elderly, this flat-tax proposal would encourage people to solve these problems on their own.

A Higher Rate of Economic Growth. The tax system itself drags down the economy with the cost of keeping mountains of records and filling out voluminous forms. It also distorts economic decisions — everything from whether a spouse works to how much families save. The U.S. Government Accountability Office recently published estimates of these economic costs by various researchers. They found the efficiency cost of the tax system — the output lost over and above the amount of taxes collected — is 2 percent to 5 percent of gross domestic product. [See the figure.] In short, we lose between \$240 billion and \$600 billion every year just collecting taxes.

A post-card-sized tax return would slash compliance costs. A single tax rate applied to all wages would make the system more equitable and transparent. By improving economic efficiency, it would raise productivity and hence the rate of economic growth.

Conclusion. A low-rate flat tax would help the economy. A rebate to the poor would enhance progressivity. Making the rebate contingent on the purchase of health care and saving for retirement will improve the quality of life.

President Bush wants to reshape our tax system. Many in Congress agree on the need for change. But an oft-repeated objection is that tax reform benefits high-income taxpayers at the expense of low-income taxpayers. With the proposal presented here — a flat rate and rebates for low-income workers that provides progressivity — that objection need not apply.

John C. Goodman is president of the National Center for Policy Analysis. A version of this article appeared in Forbes magazine.

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