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Perspective

Sizing up the flat tax

It's the talk of the presidential campaign, but would it be good for the country?

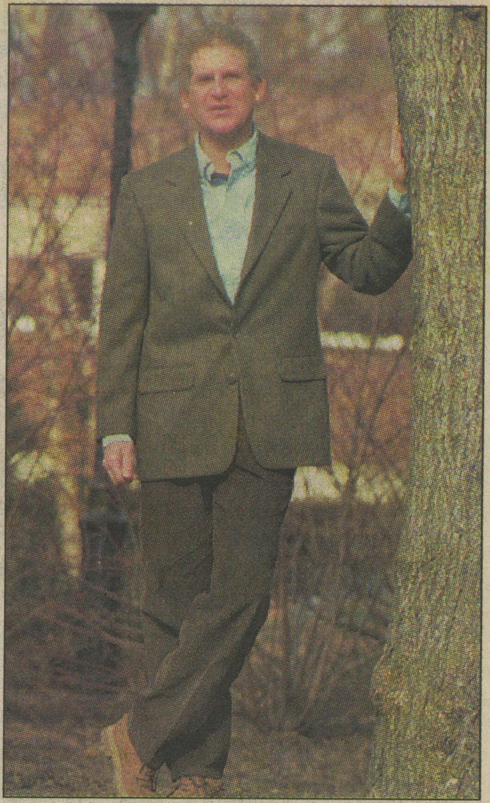
We asked six Delawareans with expertise in economics or taxation to discuss the proposals.

SHELDON D. POLLACK

Politics complicate the code

Replacing the current revenue system with a flat tax is the latest fad among Republicans. In the summer of 1994, Rep. Richard Armey of Texas called for a flat tax imposed at a uniform 17 percent rate. Armey's proposal, modeled on the flat tax designed by economist Robert E. Hall and political scientist Alvin Rabushka over a decade ago, didn't get much attention at the time. But that was before the Republican landslide in the 1994 elections and before Armey became House majority leader.

But before Republicans go out too far out on a limb for the wholesale abandonment of the current income tax, a bit more critical reflection is in order.



The News Journal/BOB HERBERT

Sheldon Pollack says the flat tax is a fad.

Proponents of the flat tax emphasize the complexity of the present income tax. We are reminded that the Internal Revenue Code is thousands of pages long and difficult to comprehend. But its complexity is not attributable to its graduated rate structure, and thus adopting a flat rate will contribute nothing to simplifying the tax system. The income tax became so complicated because politicians use it to implement social and economic policies, rather than just to raise revenue.

Simplifying the income tax system is an admirable and attainable goal. But the same impulses that lead congressmen to complicate the income tax will soon lead to a complicated flat tax, if it ever is adopted.

Flat tax proponents argue that a uniform tax rate will be fairer than the current progressive structure, (which is not to say everyone should pay the same amount of tax). But we all recognize that the poor should pay no taxes at all.

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Pollack: Progressive rates recognize income distinctions

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So we accept some distinctions among taxpayers with different income levels. Flat tax proponents are obligated to present an argument to change the status quo, just as those who believe in progressive tax rates are obliged to defend the justice of income redistribution.

Proponents of the flat tax claim that it will encourage savings and investment. They typically blame the present income tax for the dangerously low savings rate in this country. Steve Forbes, Phil Gramm, Arlen Specter and Dick Armey all suggest that thousands of new jobs will materialize once we adopt a flat tax. Neither claim is plausible nor supported by empirical evidence.

Economists expect only a minor increase in the savings rate from adopting a flat tax. This is mostly because the present income tax already excludes a good deal of the savings of most taxpayers. This is done through pension plans, 401(k) plans, individual retirement accounts and Keogh plans. Adopting an unlimited tax exemption for all investments (as the flat tax plan would do) will not likely increase savings rates because most taxpayers already save all they want and fail to utilize their current exemptions of $2,000 for IRAs and more than $9,000 for 401(k) plans and Keoghs. Exaggerated claims for the creation of jobs likewise should be taken with a grain of salt.

One of the oddest arguments now in vogue in the GOP is that the flat tax is somehow more conducive to strong families. This same sentiment is behind the Contract With America tax bill, vetoed last December by President Clinton, for a $500-per-child tax credit.

Conservatives should be clear and consistent on this. If using the tax system to implement social policy is evil and doomed to fail, as is charged against the present system, then using the flat tax to strengthen families is also neither desirable nor likely to succeed. Anyway, since when do conservatives believe that the morality and cohesion of American families depends upon whether the federal government supplies the appropriate tax credits, deductions and exemptions?

If flat tax proponents make such exaggerated claims, they also grossly underestimate the economic upheaval that could follow junking the income tax.

The most radical and least understood aspect of the flat tax is that it is really a consumption tax in disguise. When you cut through the technical language of the various proposals, the result is to tax an individual's net consumption for the year and exempt the return on capital investment (dividends and interest). This is in contrast to an income tax which taxes annual income plus the return on capital (savings).

That sounds great to economists, who bemoan the disincentives and inefficiencies that result from taxing the return on capital. But the effects of such a shift could be drastic. Savings would no longer be taxed. Certain taxpayers, therefore, would benefit greatly. For example, wealthy individuals with high annual income but low consumption (a rich miser) would likely pay less tax, although their businesses would likely pay more, so the overall affect is not clear.

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For this reason, most proponents of the flat tax accept all kinds of exceptions to consumption tax principles so they don't look so blatantly like they are taking from the middle class and giving to the wealthy, for example, by retaining deductions for home mortgage interest and charitable contributions. Still, a flat tax of 17 percent to 20 percent will inevitably reduce the tax burden on the rich while increasing that of the middle class.

The most radical and pure versions of the flat tax, such as that pushed by Steve Forbes, would do away even with the deductions for mortgage interest and charitable contributions. But whole sectors of the national economy have grown up around, and depend upon, these tax preferences. Universities, museums and city orchestras all rely upon the incentives to charitable giving created by high marginal tax rates and deductions for contributions.

Then there's the housing industry, which has been stimulated from decades by the home mortgage deduction, and which will take a big hit if repealed. Likewise, state and municipal governments won't be thrilled to lose the special tax treatment now afforded to interest paid on their bonds. Since all interest will be exempt from taxation under the flat tax, tax-exempt state and municipal bonds will lose their preference. This could result in as much as a 30 percent drop in the value of portfolios of tax-exempt bonds.

Perhaps the most significant reason conservatives should be cautious in embracing the flat tax is revenue. The Treasury Department initially estimated that Armey's 17 percent flat tax would cost $244 billion in lost revenue a year. Treasury also calculated that a 25.8 percent flat tax would be needed to achieve revenue neutrality. Of course, at such a rate, the flat tax is considerably less attractive politically. Increasing the deficit should be no more attractive. Steve Forbes just shrugs this off.

All these objections aside, how would we actually switch to a consumption tax? Since all current national savings have already been taxed under the current income tax regime, it would be necessary to exempt these amounts from taxation under the new consumption tax. Otherwise, the savings of all taxpayers would be taxed a second time as they spend their savings in retirement.

But any set of rules that would allow taxpayers to identify their pre-reform savings for some grace period would be a nightmare of complexity. And exempting so much of the national wealth from the consumption tax would obviate the very benefits the new tax regime is supposed to bring.