Important Issues and Serious Problems in Flat-rate Income Taxation

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ABSTRACT. Dozens of important issues are connected with the proposal of *flat-rate income taxation.* How much, if any, activity would leave the *'underground economy'* for the reported one? Would *effort* and *saving* change? Would *efficiency* in the *allocation* of business and personal *resources* be effected? High *rates of taxation* and differences in tax rates influence *behavior* for better or worse. Serious proposals to change them deserve serious consideration, but difficult though not insuperable problems are involved and must be studied.

I

Introduction

HIGH (MARGINAL) RATES of taxation influence behavior. They produce nonrevenue results. Some of the non-revenue effects may be welcome (for example, a stimulus to charitable donations). High tax rates, however, must also create many distortions, wastes, and costs ("excess burdens") which by reasonable standards are undesirable for the economy as a whole. The general public loses more than governmental treasuries receive to pay for collective activities.

Differences in tax rates also produce non-revenue effects. Rate differences (graduated, progressive rates) also provide incentives to alter behavior in ways that would not otherwise be selected by rational buyers, sellers, and investors. The inclusion of some items in the tax base and the exclusion (perhaps by deduction) of others creates differentials. Incentives to alter behavior result. Some receipts are included, others not. Some outlays may be deducted, others not. By general agreement, several of these distinctions are required to get a proper base for measuring income as a source of a share of the costs of government. Others raise questions. The inclusion that thereby incurs tax can be likened to the base for an excise tax. We hear more frequently now the term "excise effect" used to describe the pressures created by the inclusion of some items and the omission of others. Allocations of resources are changed as a result—toward efficiency (by some reasonable measure) in some cases, away from it in others.

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Serious proposals to reduce drastically the *level* of rates and the *differences* among rates—even to substitute a two-rate (zero and one other) schedule for one of many steps—deserve informed attention. So do proposals to revise the constituents of the tax base. Past failure over several years to broaden the base and greatly simplify the rate structure by no means indicates that suggestions for such restructuring are doomed to failure again. Nor do past rejections necessarily establish that on balance the defects will outweigh the merits.

Yet, as the hearings of the U.S. Senate Committee on Finance have shown, fundamentally difficult problems of principle and of implementation exist—with "politics" involved with each. The problems are by no means insuperable if the goal is to *improve* on the present system as distinguished from *achieving some ideal*. Betterment can be realized even when perfection lies beyond realistic hopes.

II

Rate Uniformity or Simplification

DIFFERENCES AMONG INDIVIDUALS and families in sharing the costs of government are inevitable—in any single year or over lifetimes. The inequalities may reflect regressivity, proportionality, or progressivity (relative to income, wealth, or consumption). In any case, with some exceptions, the actual inequalities will lead to differences (large, medium, or small) whereby those with the larger tax base will pay more toward the common, collective expenses of government than those with a smaller base.[1] Most of us, I expect, have been brought up with the belief that progressivity is better than proportionality and much to be preferred over regressivity. The bases for such a conclusion are "more uneasy" than often assumed. Intuitively, my own preference is for some progressivity; but I submit that the logical and humane grounds for such a conclusion do seem less solid than unsophisticated, popular statements suggest.

A flat-rate tax—more correctly, dual-rate, zero and one other—can provide appreciable progressivity for very large numbers of taxpayers. For example, with $7,000 subject to zero rate and all the rest taxed at 20 per cent, a family with $12,000 would pay $1,000 (8.3 per cent) and one with $24,000 would pay $3,400 (14.1 per cent). In fact, with a rather large exemption and zero-rate bracket most Americans can experience appreciable progressivity. The remaining minority in the higher ranges would in fact bear more nearly proportional than progressive burdens. Under any conceivable shift to a flat-rate system, the total tax of the highest income groups would be reduced—unless rate reduction led to decline in the use of avoidance and evasion devices. The latter is certainly to be expected, but we know little about the amounts.

Clearly, the present system, with federal plus state rates of over 50 per cent at the margin, must deserve criticism. Significant rate reduction, however, does not require a shift to a single rate.

Rate modification that appears to reduce progressivity should take explicit note of recent changes that bear upon the total picture. Federal estate and gift taxation have been altered so that most families once potentially subject to these taxes on the transfer of wealth will in the future bear no such taxes. Moreover, some states have reduced such taxes on the transfer of wealth. Expensive government—and all must agree that American government is indeed expensive—may "need" more financing from the prosperous than would eventuate if higher bracket income tax rates were cut substantially.

Complex issues *will* arise as advocates of various positions press their arguments. Large holdings of wealth may result from successful creation and represent capital resources that can benefit innumerable customers and employees. But emotions can be mobilized against large fortunes. Should we not do our best to consider the questions as thoroughly and as realistically as possible? For example, with a modest rate of income tax in, say, 1995, there could be no small number of families living very well indeed on inherited wealth as distinguished from income from their own industry and thrift. Desirable?

III

Broadening the Tax Base

HALF A CENTURY AGO, almost, when I began to study Federal taxation, broadening the tax base was being proposed. Two distinguishable benefits were, and are, expected. (1) Enlarging the base would facilitate rate reduction and the advantages that would follow. (2) The measure (base) for sharing the costs of government could be improved. Note that I use the word "could," not "would," because improvement is not inherently a product of base-broadening.

For example, some present omissions seem to me highly inappropriate—most of Social Security benefits and the imputable income from owner occupancy of housing. In contrast, others are necessary or desirable for obtaining an appropriate measure of the base for sharing the cost of national government—interest associated with obtaining income and major state-local taxes. Or if concern shifts somewhat to altering the structure of the economy, might we not wish to reduce any remaining discriminations against saving (and investments)?

Each of many items deserves attention on its own merits. Historical experience includes more of narrowing than of broadening the concept of taxable income.

If new discussions were to include, explicitly, broad rate reduction as a reward to voters for base-broadening, just conceivably some general public support might develop. More likely, however, single-issue interest groups would bias whatever discussions developed.

A society desiring economic efficiency will find much merit in tax neutrality as a goal, but it is neither a compelling absolute nor a rallying-point for popular support. A true expenditure tax also has merit but, I expect, little popular appeal. Any change would present transition problems that for a time would perhaps overshadow benefits of simplification.

IV

Concluding Comment

DOZENS of distinguishable and important issues arise in the examination of "flat-rate" taxation. Any congressional committee will have available an accumulation of evidence and analysis.

The bases for rational choice improve. Progress is possible. Yet three inherent difficulties should be noted. Estimating cannot have any reliable basis for judging how much, if any (1) activity would leave the underground for the reported economy; (2) effort and saving would change; and (3) efficiency in the allocation of business and personal resources would be affected.

Note

1. Even a regressive tax will amost certainly have this result. Assume, for example, a family with $50,000 (including some exempt municipal bond interest) paying income and Social Security tax of $15,000 (30 per cent) and one with $18,000 paying $6,300 (35 per cent). Regressive, yes. But the less well off pay a total much less than half.

A Last Message from a Valiant Crusader

A NOTE THAT TOUCHED ME was a message that Marc Berc, an educator of Quebec, Canada, prepared before his death on December 5, 1983, to be transmitted posthumously by his wife, Rose, to Robert Clancy, editor of *The Georgist Journal*. It said: "His last days were filled with delight at the great progress being made in furtherance of the great cause of Henry George throughout the world. He leaves with you his best wishes for the continued success of your dedicated efforts to serve misguided humanity."

W.L.