# REFORMING OUR TAX SYSTEM:
# THE FLAT RATE TAX AND SOCIAL SECURITY FINANCING

Testimony Presented

to

The Joint Economic Committee

by

Norman B. Ture

July 27, 1982

It is, as always, a great pleasure to appear before this Committee. The Committee has a well-nigh unbroken record of taking the lead in addressing important issues of public economic policy and doing so in an objective context. Let me offer you my commendations for extending that record by holding these hearings on the flat-rate tax.

My discussion focuses on what I believe to be some of the principal issues raised by flat-rate tax proposals. I shall not attempt to specify a flat-rate tax in any significant detail, although I will identify the criteria which, I believe, should guide the design of the tax. The Committee must surely have discovered that most of the examinations of the flat-rate tax proposals have been far more concerned with design details and with guesses about shifts in the income levels distribution of tax liabilities under each of the alternative sets of specifications than about issues; few of these examinations have sought to provide a careful analysis of purposes and objectives, and few, accordingly, satisfactorily show that tax design, objectives and criteria are consonant.

## Objectives

Any observer of the tax policy scene certainly must be struck by how suddenly, early this year, the interest in a flat-rate tax appeared, and by the momentum that has developed for enacting a flat-rate tax into law. The idea of a flat-rate tax has been around for a long time; the novelty in the current proposals is only in the variations in the basic outlines which are suggested. It somewhat strains the credulity to be asked to believe that the current surge of interest is attributable to the sudden discovery that the existing income tax is unfair, distortive, hideously complex, expensive to comply with, and frightfully costly to enforce. We've all known this for ages. Could it be that the eruption of interest this year reflects an urgent concern to find some way to increase the Federal revenues in a way which might be used to convince taxpayers that good things are to be done to them even while additional taxes are extracted from them? If this is, indeed, the objective, if the motivation behind the present thrust toward "flat-rate" taxes really is to increase taxes in a relatively painless manner, then I think we should avoid these proposals like the plague. Indeed, any such proposal should move toward enactment only if some constitutional or statutory safeguard is provided to limit revenue increases.

There are, on the other hand, quite legitimate objectives which might be pursued by a properly designed flat-rate tax.

<u>Tax Neutrality</u>

Our present income tax is fairly characterized as a collection of excises. The man in the street readily and correctly identifies the nature of an excise in terms of its principal effect—to raise the cost of the thing subject to the excise compared to other things. An excise on gasoline raises its cost. People respond by buying less gasoline, shifting their purchases to other (now) relatively less expensive things. With less gasoline sold, less is produced, less production resources are devoted to gasoline production, and less income is generated by that production.

Any and all taxes have this excise effect of increasing the cost of some thing(s) relative to the cost of other things. Taxes change the relative costs which would prevail in the absence of taxes. Taxpayers respond to these changes in relative costs by changing their behavior. These behavioral changes result in changes in the composition of economic activity--in the allocation of the economy's production capability--and in the income claims generated by production. The greater the excise effect--the greater the effect on relative costs, the less neutral--the more distortive--the tax.

The present income tax is a hodgepodge of such excises. Its weightiest excise effect is in raising the cost of working relative to the cost of "leisure" (all those uses of one's time and resources other than those for which there is a market-determined compensation). The income tax also levies a heavy excise on saving (equals investment).[1] To be sure, both of these excise effects were materially reduced by the Economic Recovery Tax Act (ERTA) of 1981, although the current tax legislation--the largest tax increases in our history--will go far toward restoring the pre-ERTA bias against saving.

These are the basic excise effects in the income tax. At a secondary level, there are a great many provisions of the tax law which act to differentiate the burden of the tax according to a particular activity, industry, or taxpayer characteristic. The income tax, in other words, imposes quite different excises on taxpayers, depending on their activities or other attributes. These excise effects--alterations in relative costs--distort the operation of the market mechanism in allocating production capability among the almost countless alternative uses.

Reducing these excises, their distortive effects of the tax system, and thereby improving the efficiency of the economy's use of its productive resources, should certainly be identified as the primary goal of tax policy. A flat-rate tax is widely believed to be far more neutral and far less beset with excise characteristics than the present income tax. At least in the abstract, it is certainly possible to design a tax which would alter relative costs, particularly the cost of saving relative to the cost of consumption, far less than the present income tax. Moving toward tax neutrality in the sense herein defined should be the principal objective of any proposal for a flat-rate tax. The extent to which the proposed tax would serve this neutrality objective should be the foremost criterion for its design.

### Reducing Compliance Costs and the Need for Enforcement Resources

Any law, regulation, or public institutional arrangement which requires the citizenry to incur costs in complying and/or the commitment of resources by government to enforcement activities imposes a burden on the economy which should be minimized. This burden is the output of goods and services which might have been produced by the resources devoted to compliance and enforcement.

The present income tax has a track record, virtually unbroken over the years, of constantly increasing complexity which has, year by year, expanded both compliance and enforcement costs. One of the claims made by flat-rate tax proponents is that such a tax would be far simpler in design; presumably, it would be far less difficult to comply with and would require far fewer resources allocated to government enforcement activities.

Certainly, such simplification is an important objective to be pursued by the shift, if it is to occur, from the present income tax to a "flat-rate" tax. For the most part, proponents of "flat-rate" taxes fail to point out that it is the change in the tax base which is contemplated by their proposal, not the flatness of rate per se, which is to achieve this simplification and reduction in compliance and enforcement costs. This view is subject to important qualifications.

First, any such simplification and the cost savings it might provide must be weighed in terms of what they cost to achieve, in terms of shortfalls in attaining other objectives. The alterations in the tax base proposed in many of the "flat-rate" tax proposals would increase the cost of saving relative to consumption. Increasing the excise effect of taxes on saving is too high a price to pay for simplification.

Second, much of the complexity in the income tax is the result of efforts to constrain the availability of tax shelters and their effectiveness in reducing tax liabilities. Taxpayers pay a price for these tax shelters in the form of obtaining lower pretax returns on their saving. An efficient shelter-using taxpayer will allocate his saving to such investments only if the after-tax return thereto exceeds that which he can obtain from a nonsheltered investment. In other words, he'll undertake the sheltered investment only if the marginal tax rate thereupon is sufficiently lower than that on nonsheltered investment, and is at least enough to offset the higher pretax rate of return obtainable on the latter. To a significant extent, this search for shelters is a result of marginal rate graduation. It's the possibility of reducing the marginal rate which provides a significant part of the inducement to find deductions, exemptions, deferrals, etc. Flattening the rate structure, in itself, reduces the payoff on tax shelters. A single or flat rate would contribute enormously to simplification, without any alteration in the statutory tax base, merely because, having been made relatively more costly, the sheltering provisions would be used to a far less extent.

Third, even if the tax base revisions contemplated in flat-rate tax proposals were, indeed, to afford simplification <u>when fully implemented</u>, an enormous price in additional complexity may have to be paid to get from where we are now to the fully-implemented flat-rate tax. The ultimate savings in compliance and enforcement costs might well exceed the transition costs, but we certainly should not ignore the latter in assessing the gains we expect from moving to a flat-rate tax.

## <u>Greater Uniformity in Tax Treatment</u>

The most appealing argument, for many people, advanced on behalf of the flat-rate tax is that it would be fairer than the present income tax. It's obvious that for many of the proponents, the gains in fairness are to be achieved not from flattening marginal tax rates—indeed, this is widely perceived as resulting in a loss of equity—but from the tax base changes their proposals contemplate. This illustrates the fact that few tax policy concepts are more ambiguous and less useful as a practical matter for guiding policy than equity.

For this reason, uniformity of tax treatment should be substituted for fairness as the objective one might wish to pursue by replacing the income tax with a flat-rate tax. It does not necessarily follow that more nearly uniform tax treatment of taxpayers is fairer treatment, but greater uniformity is attainable while greater fairness, given its conceptual wispiness, is far more elusive. Greater uniformity may be justified in the interests of simplification, but as in that case its priority must be conditioned on its consistency with the primary objective of neutrality.

## Issues

The broadening enthusiam for a flat-rate tax might lead one to believe that no significant issues are raised by adopting such a tax. In fact, several of the most basic issues of tax policy are involved, and good policy- making requires that these be carefully identified and resolved by consensus.

### Flatness of Rate

As already suggested, the term flat-rate tax, as widely used, is a misnomer. Few of the proposals call for a truly flat-rate marginal rate—a single rate applied to the tax base, and most of these proposals are in fact concerned more with broadening the tax base—than with a flat tax rate. Flatness of rate and broadness of base are not necessarily tax policy buddies; we may well have one without the other. And quite different issues are raised by each.

The matter of how flat the tax rate structure should be addresses a conflict between considerations of economic efficiency and of fairness. The major reason for providing a single rate to be applied to the tax base is to minimize the excise effect of the tax in raising the cost of increasing one's income-producing capacity. Marginal—bracket—rate graduation, by reducing more and more the net return to the earner from each additional dollar of income he or she produces—whether as compensation for labor services or as return on saving—makes it more and more costly to increase his or her income, whether by working more or by saving more. By the same token, graduated marginal rates levy an excise on increasing one's productivity. The cost of progressive tax rates is a less progressive, less efficient economy, in which working, saving, and investment in productivity advance is penalized by the tax.

The question is what do we get in exchange for this loss of efficiency resulting from marginal rate graduation. There are two standard answers. One is that the payoff is a fairer tax—a tax which conforms more closely than otherwise with "ability-to-pay." The other is that we rely on graduation of tax rates as an instrument for redistributing—equalizing—income and wealth. Neither answer is acceptable.

So far as ability-to-pay is concerned, there is a virtually unanimous consensus among tax theorists that the conceptual content of that notion is too vague and elusive to warrant attempting to shape tax policy around it. There is a broadly held and solidly based view that, whatever the conceptual construction (and whatever the utility-maximizing function that is assumed), there is little reason to believe annual income is an adequate measure of taxpaying ability; consumption is deemed by some to be far better, while others hold out for wealth. And no matter which is used, there are extraordinary problems of definition to be resolved if there is to be any confidence that the chosen economic variable has anything to do with ability to pay.

In any event, it does not follow that graduation of marginal rates is called for to satisfy any operational--inelegant--view of ability to pay. Indeed, all that is required is that tax liability increases with income, consumption, or wealth, or whatever magnitude is deemed to be acceptable as a tax base with ability to pay as a criterion. And even if this requirement is construed as calling for more than proportionate increases in tax liability as one's tax base increases, it does not follow that the rate applied to the base must be graduated. Indeed, for this purpose, it is the effective tax rate--the quotient of tax divided by tax base--that is relevant, not the marginal rates. Substantial graduation of effective rates is readily achieved with the imposition of a single--flat--marginal rate simply by exempting the first X dollars of the base from the tax. This may be achieved with a personal exemption system or by providing a zero-rate bracket in the tax base.

The will o' the wisp character of vertical equity was noted and documented very early on in the development of tax theory. It is seldom, if ever, addressed in rigorous discussions of the proper shape of the tax rate structure. Indeed, Henry C. Simons, who probably had the weightiest and most persuasive influence on contemporary thought about such matters, often asserted that the real and only purpose to be served by an income tax with graduated marginal tax rates is to assist in equalizing the distribution of income and wealth. We should not need a reminder that there is far from a substantial consensus that equality of income and wealth distribution is an appropriate objective to be served by public policy. But even if the contrary were true, we should be brought up short by the fact that marginal rate graduation, itself, has obviously been almost, if not completely, ineffectual to this purpose.[2]

Disregarding philosophical reservations and the empirical evidence about the lack of achievement in equalizing income distribution, one must ask why marginal rate graduation is needed for income redistributing purposes. As in the case of ability to pay, it is not the shape of the <u>marginal</u> rate structure which is relevant in this regard; it is the shape of the <u>effective</u> rate structure. If the tax is to be used, however ineffectually, for leveling the distribution of income, this calls at most for graduated <u>effective</u> rates, which, as shown, can be readily provided by a system of personal exemptions or a zero-rate bracket <u>and</u> a single or flat marginal rate.

I arrive at the conclusion that there is not a meaningful reservation to be found in considerations of fairness or income distribution against a flat or single marginal rate. This issue should be resolved in favor of a single rate, with no graduation of marginal rates whatever. Any departure from a single rate almost certainly will lead to more and more graduation through time. One can easily foresee budgetary circumstances akin to those we now face exerting pressure to steepen the graduation then in place as a means of raising revenue without offending all taxpayers. This is, of course, diametrically opposed to <u>good</u> public policy which calls for offending everyone when taxes must be raised.

## <u>Broadening the Tax Base</u>

Issues concerning the tax base are independent—or virtually so—from those pertaining to flatness of the tax rate structure. But as in the case of the tax rate issues, there is a seeming conflict between considerations of economic efficiency and those of fairness which arises in connection with the tax base.

As suggested earlier, the existing income tax is properly characterized as a mix of differential excises. To some extent, the source of the variance in rate from one excise to another in the tax is difference in the statutory rates. But more important than explicit rate differentials is the difference in the extent to which various expenses and receipts are recognized for tax purposes, as well as the timing of such recognition. To repeat an earlier assertion, by far the most consequential of the excise differences are the differentially heavy rates imposed on saving compared with consumption uses of income and working versus "leisure."[3] The efficiency concern focuses attention, in any proposals for redefining the tax base, on minimizing, if not eliminating, these excise differentials.

Although there is general agreement in this regard, there is much less of a consensus as to the priorities to be assigned the various excise differentials as targets for reduction. Those who prefer an expanded income tax base are prepared to accept—often they simply ignore—the anti-saving bias which is intrinsic to such a tax and emphasize eliminating or reducing differences in the tax treatment of income derived from differing saving outlets and differences between the tax treatment of income derived from capital and that obtained from providing labor services. Many of the proponents of this approach perceive the (limited) neutrality goal they identify as indistinguishable from an equity goal often articulated as equal tax treatment of equally situated taxpayers. Implementing this approach would result in adding to the income tax base, and fully exposing to whatever tax rate structure is adopted, substantial amounts of saving or the returns thereto which are only partially taxed under present law. This would very likely result in greater uniformity of excise effect among differing capital uses of saving while significantly increasing the excise on all saving compared with consumption.

The alternative approach to base broadening places the emphasis where it properly belongs—on reducing the basic excise differential against saving. Some of the designations of the tax base resulting from this approach—e.g., the "consumption-based income tax," the "expenditure tax"—are misleading or actually pejorative in connotation. In fact, the basic attribute of this tax base is that it results in the same percentage increase in the cost of saving and of consumption; it is, in other words, neutral between these alternative uses of one's resources. To avoid the unfamiliarity of new terms, let's call this tax base the expenditure tax base.

Without detailing the design of the expenditure tax, its basic attributes can be briefly delineated. Neutrality of excise effect between consumption and saving requires either that 1) all saving—reservation of income from consumption uses or, equivalently, all purchases of sources of future income—be excluded from the tax base while all of the gross returns thereto (including the gross proceeds from the disposition of the capital instruments to which the saving is committed) are included in the tax base, or 2) saving is included fully in the tax base but all the returns thereto are excluded. These alternatives are perfect equivalents; each equally well would eliminate the present excise differential against saving. The choice between them should rest on practical considerations of compliance and enforcement costs. Most proponents of the expenditure tax have preferred the first alternative.

With either alternative, the resulting tax base is far more nearly neutral between saving and consumption than is the expanded income base which, indeed, is likely to intensify the existing tax bias against saving.[4] An additional advantage of the "expenditure" tax over the expanded income tax is that several of the principal sources of tax complexity would simply vanish. Two obvious examples are capital gains and capital recovery provisions of all sorts. With exclusion of current saving from the tax base, there would be no occasion to compute capital gains or losses; all of the proceeds from the disposition of assets would be included in taxable income, not merely the gains or losses in the proceeds. Again, by reason of the exclusion of saving, (i.e., the purchase of sources of future income) from the tax base, there would be no reason to attempt to allocate the recovery of the investment against the income it generates over time. The exclusion of saving is precisely the same as expensing of capital outlays, obviating any additional depreciation, depletion, or other capital recovery.[5]

Fully implementing this approach would not only remove virtually all of the differentially heavy tax burden on saving, it would also eliminate virtually all of the tax differentials among alternative forms of saving. It would, in short, achieve the second level tax neutrality among saving outlets pursued by proponents of the expanded income tax base, while eliminating the basic bias against saving which the expanded income tax base would most likely intensify.

One result of fully implementing the expenditure tax would be the elimination of tax shelters. The expenditure tax approach would automatically eliminate any tax differential in the determination of net returns among alternative investments. Tax sheltered investments would have to make it on their own and would survive, if at all, in substantially smaller volume than at present. This result, moreover, would be obtained without explicit legislative prohibition of such investments.

The expenditure tax confronts a fairness challenge which, when closely examined, confounds arguments about uses of income with those about who the users are. The ability-to-pay adherents maintain that income from capital has at least the same taxpaying capacity as income from labor; on this "reasoning" there should be no distinction in tax treatment on the basis of where the income comes from or how it is used. The point which is overlooked in this assertion is that income which is saved is taxed far more heavily than income which is consumed; income from capital is taxed more heavily than income from labor. It is difficult to understand in what sense it is fair to tax income which is saved more than income which is consumed or why it is fair to tax the returns on one's provision of capital services more heavily than compensation for providing one's labor services.

This challenge is generally finessed by those who advance the fairness argument by turning to the empirical question of who does the saving. It is certainly true that the expenditure tax would shift tax liabilities between those who would and those who would not save compared to the distribution of liabilities under present law. It is also highly likely that those few people in the upper end of the income scale save more of their income than those at the bottom. But this is a minor matter. Individuals at the bottom or lower end of the income scale can be substantially relieved of most tax liability under a really flat-rate expenditure tax by an adequate zero-rate bracket. Those at the top will reduce their tax liabilities only insofar as they continue to be big savers, with beneficial effects for the entire economy. As in the case of the fairness challenge to flatness of marginal rates, there is less in this fairness argument than meets the eye.

## Concluding Observations

As these hearings will make unmistakeably clear, not all flat-rate taxes are born equal. If the current thrust is to produce constructive results rather than the tax backsliding which occurred last week, it will be necessary to discriminate carefully among the increasing number of proposals.

In doing so, the principal criterion should be the contribution of the proposed tax alternative to greater tax neutrality. In this respect, the focus should be on the big picture--eliminating the basic tax bias against saving and secondarily on eliminating differentials in tax on returns to different forms of saving. Close observation of this criterion calls for moving to an expenditure tax, not an expanded income tax, and for insistence on a truly flat marginal tax rate.

This priority for the neutrality criterion does not, certainly, rule out or ignore either simplification--reducing costs of compliance and enforcement--or fairness. A truly flat-rate expenditure tax would be far simpler than the present income tax, but it most assuredly would not be free of complexity. Simplicity, however, must take its place in line as a tax criterion. The ultimate in tax simplicity would be a head tax, but few policy makers, if any, would urge it as the basic tax in our system.

Similarly, no one would deliberately design a tax to be unfair, though with the best intent and greatest effort to produce the fairest possible tax, one is likely to find a thin consensus—if any—to confirm one's success. If for no other reason than we don't know what tax fairness really is, it should take a back seat to other criteria, principally neutrality, in the design of a flat-rate, broad-based tax.

Let us not delude ourselves that a flat-rate, broad-based tax will be easy to come by. The difficulty is not in designing the tax so much as it is in figuring out how to get from here to there without serious injury to one innocent bystander after another—taxpayers. To a huge extent, present business and household arrangements, transactions, and conduct of daily affairs are designed to accomodate the existing tax regimen's exigencies with a minimum of pain and cost. Any abrupt change would prove economically costly. The effort to implement a flat-rate, broad-based tax will require a careful, probably extended transition, which will present a great many very challenging problems.

Finally, my discussion has not addressed the question of Social Security financing. That is itself a subject of huge dimension and great difficulty to which a separate set of hearings might well be directed. I trust there was no suggestion that flat-rate taxes <u>per se</u> offer any solution to these problems. We can, if we were to deem it appropriate, fold the financing of the Social Security System, in whole or in part, into the general revenue system, whatever the character of the taxes in that system. Flat-rate taxes afford no magic formula for solving the Social Security System's financing problems in any greater degree than our present taxes.

Again, commendation is due the Committee for taking the lead in examining the subject of "flat-rate" taxes. In the abstract, there is great promise in a properly designed flat-rate tax system for affording a tax environment far more nearly neutral and therefore far less repressive of economic efficiency than the one we now have. But we should avoid extravagant claims about what, in this real world, we can expect. We need a very hard-headed, critical, in-depth examination of the proposals now offered, and very deliberate and careful progress, not the pell-mell and intemperate tax legislation we saw last week. This Committee can contribute much to assuring that the appropriate examination is undertaken at the appropriate time.

Footnotes

[1]For an extended discussion of these excise effects—of the tax bias against saving—prevailing before ERTA, see Norman B. Ture and B. Kenneth Sanden, Effects of Tax Policy on Capital Formation, Financial Executives Research Foundation, New York (1977), and Ture, "Supply Side Analysis and Public Policy," Essays in Supply Side Economics, David G. Raboy, ed., Institute for Research on the Economics of Taxation (IRET), Washington, D.C. (1982), pp.9-28.

[2]The ultimate results of equality of income achieved by the tax system, and the reasons why the graduated income tax has made no significant progress toward such equality is explored in Norman B. Ture, "Taxation and the Distribution of Income," Principal Paper in Wealth Redistribution and the Income Tax, D.C. Heath and Company, Lexington, Massachusetts, 1978.

[3]Explanations and illustrations of these biases are to be found in Ture and Sanden, op. cit., and Ture, "Supply Side Analysis and Public Policy," op. cit., pp. 9-28.

[4]To cite a single example, presumably an expanded income tax base would include as part of a covered employee's taxable income his employer's contribution to a pension plan on his behalf. If exception were to be made on this score, it is more than likely that other exceptions would proliferate. The ultimate outcome might well be a larger tax base than the present one, but with little less arbitrariness in its composition.

[5]With this treatment of saving (= capital outlays) and the returns thereto, there is clearly no reason to distinguish the tax treatment between new and used assets, as some flat-rate tax proposals would. Any such differentation would alter the relative prices of new and used assets and thereby introduce a needless unneutrality and distortion of investment decisions.