

The Thomas A. Roe Institute for Economic Policy Studies

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JOBS, GROWTH, FREEDOM, AND FAIRNESS: WHY AMERICA NEEDS A FLAT TAX

INTRODUCTION

Legislation to dismantle the current tax code and replace it with a simple, 17 percent flat tax triggered immediate and strong support when introduced last year by now-House Majority Leader Richard Arme y (R-TX). Newspaper columnists said that, among other things, this “revolutionary reform” would eliminate a “Rube Goldberg tax code.”¹ In the view of taxpayer groups, “this legislation would unleash enormous economic growth and greatly increase personal freedom”² while “eliminat[ing] the long-time bias in the current tax code against saving and investment.”³ And Representative Arme y has received thousands of letters of support from people all across the country. In short, millions of Americans know the current system is burdensome, unfair, unworkable, and beyond repair.

- 1 See, for example, George F. Will, “We Need the Flat Tax,” *The Washington Post*, September 11, 1994; William F. Buckley, Jr., “New Flat Tax Idea Stirs Up Interest,” *Omaha World Herald*, July 28, 1994; Tony Snow, “One Way to Flatten Big Government,” *USA Today*, June 13, 1994; Patrick Buchanan, “Texas’ Arme y lays plans for his war on Washington,” *Arizona Republic*, June 27, 1994; W. Russell G. Byers, “Finally, a tax plan that makes sense,” *Philadelphia Daily News*, July 26, 1994; “Declaring War on Big Government,” *The Washington Times*, June 16, 1994, p. A18; Walter E. Williams, “Arme y’s marching toward tax fairness,” *Cincinnati Enquirer*, July 31, 1994; Mona Charen, “Flat Tax Appeal,” *The Washington Times*, December 1, 1994; William Murchison, “Arme y brings common sense,” *The Dallas Morning News*, June 22, 1994; “The Arme y Revolt,” *The Detroit News*, June 13, 1994; Malcolm S. Forbes, Jr., “Happy Days Will Be Here Again,” *Forbes*, July 18, 1994, p. 23; Robert Dietz, “Flat Tax on Income a Horror for Some,” *Charleston [SC] Post and Courier*, November 19, 1994; Bruce Fein, “Morally Right, Fiscally Astute,” *The Washington Times*, December 13, 1994; James K. Glassman, “Praise the Capital Gains Cut and Pass the Flat Tax,” *The Washington Post*, November 30, 1994; Phyllis Schlafly, “Tax Return Plan with Postcard Potential,” *The Washington Times*, December 18, 1994; “Simplifying Taxes Would Save a Bundle,” *Business Week*, January 30, 1995; Claudia Winkler, “Converts enlisting in the flat tax ranks,” *The Washington Times*, January 15, 1995; Christopher Farrell, “A Jumble Only a Flat Tax Can Untangle,” *Business Week*, January 9, 1995.
- 2 Letter to Representative Richard K. Arme y from NTU Vice President David Keating, September 13, 1994.
- 3 Tax Foundation news release, “17% Flat Tax Would Mean \$1,000 Less in Income Taxes for Average Taxpayer,” November 17, 1994.

A flat tax is more than popular, however; it is economically sound. If enacted, for instance, it would:

- ✓ **Produce faster economic growth.** By reducing tax penalties levied against productive economic behavior, a flat tax would spur increased work, saving, and investment. Even if long-term growth rose by as little as 0.5 percent, the average family of four's income after 10 years would be as much as \$5,000 higher than it would be under current tax laws.⁴
- ✓ **Create instant wealth.** According to Harvard economist Dale Jorgenson, the flat tax would boost national wealth by some \$1 trillion.⁵ Among the reasons: Investments would be guided by profitability rather than tax status and the value of income-producing assets would rise as the after-tax stream of income generated by these assets increased.⁶
- ✓ **Lead to simplicity.** One business in 1992 had a tax return 21,000 pages and 30 volumes long.⁷ While generally better off than business, individual taxpayers also face complex regulations, dozens of special forms, and often heavy preparation costs. Under a flat tax, all taxpayers, from General Motors to John Doe, would be able to fill out their tax return on a postcard-size form.⁸ Compliance costs of the current system would drop by tens of billions of dollars.⁹
- ✓ **Achieve fairness.** A flat tax would treat people equally. A taxpayer with 1,000 times the taxable income of another taxpayer would pay 1,000 times more in taxes, but the tax code no longer would penalize success and discriminate against citizens on the basis of income.¹⁰
- ✓ **End micromanagement and political favoritism.** The flat tax would rid the tax code of all deductions, loopholes, credits, and special preferences. The only exemption that would be retained is a personal allowance based on family size. Politicians thus would lose the ability to pick winners and losers, reward friends and punish enemies, and use the tax code to impose their values on the economy.
- ✓ **Increase civil liberties.** Under current law, someone charged with murder has more rights and protections than a taxpayer dealing with the Internal Revenue Service.

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- 4 The estimate of how faster growth translates into higher incomes is taken from Steven Pearlstein, "What's the Speed Limit on Economic Growth," *The Washington Post*, January 15, 1995.
 - 5 Conversation with author and Glassman, "Praise the Capital Gains Cut and Pass the Flat Tax."
 - 6 According to Stanford Professor Alvin Rabushka, uneconomical investments made merely for tax purposes amount to \$100 billion—money that would increase economic growth under a flat tax. *Forbes*, "Happy Days Will Be Here Again."
 - 7 David Wessel, "Another Round: Talk of Tax Reform Is Gaining Momentum, But Plans Vary Widely," *The Wall Street Journal*, January 31, 1995.
 - 8 There would still be some paperwork since businesses would, if asked, have to justify their expenses. Moreover, some taxpayers, such as independent contractors and home businesses, will continue to quarrel with the IRS regarding what counts as business expenses rather than household costs.
 - 9 James L. Payne, *Costly Returns: The Burdens of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies Press, 1993). See also W. Kurt Hauser, "Try the Flat Tax," *The Wall Street Journal*, May 14, 1993.
 - 10 The large family allowance causes some progressivity under a flat tax, since the first \$36,800 of income is exempt from tax for a family of four.

With a simpler, fairer tax code, infringements on freedoms and privacy would fall dramatically.¹¹

- ✓ **Increase tax collections from the wealthy.** Just as happened in the 1920s, 1960s, and 1980s, lower tax rates would result in increased tax collections from upper-income taxpayers. The reason: Incentives to earn *and* report taxable income would climb dramatically.

America's tax system is a major reason for Americans' widespread distrust of politicians. Taxpayers know they can spend their money more wisely than bureaucrats and lawmakers, who seem reflexively to raise taxes at every opportunity. The tax burden in America is now at an all-time high, and economists estimate that this causes both economic growth and job creation to suffer.

But this animosity is driven by more than opposition to an ever-growing tax burden and concerns about lost jobs and lower wages. Most Americans see the tax code as bewilderingly complicated, with laws and regulations written for the benefit of special interests rather than ordinary citizens. Families and businesses must pay huge amounts to comply with this code, but even this does not ensure an audit-proof tax return. Tax lawyers and accountants admit that some provisions of today's tax law are so complex that it is impossible to know whether returns are filed correctly.

Congress could solve most of these problems by adopting a flat tax, taxing income at a low, single rate and, with the exception of a family allowance, eliminating the current labyrinth of rates, deductions, credits, and exemptions. No income tax ever promoted economic growth, but a flat tax at least would penalize work, savings, and investment far less than the current tax code.

Unfortunately, while tax experts across the political spectrum have been attracted to the flat tax, politicians have not been as receptive. A flat tax would undermine their ability to use the tax code to finance new spending, to grant favors to powerful interests, and to generate contributions from those seeking to change or preserve specific features of the tax code. Now, however, thanks to the sweeping changes in Congress wrought by last November's elections and the voters' demand for simplicity and fairness, a historic opportunity exists for radical reform of America's tax system.

WHAT IS A FLAT TAX?

While no two of the several flat tax proposals advanced over the years have been identical, they usually are based on the proposal developed about fifteen years ago by Stanford University economists Alvin Rabushka and Robert Hall. Among the key features of a Hall/Rabushka-style flat tax are:

- ① **A single flat rate** —All flat tax proposals apply a single tax rate to any income subject to tax, although proposed rates may differ. Some plans call for rates as low as 10 percent.

¹¹ For further information, see James Bovard, *Lost Rights: The Destruction of American Liberty* (New York: St. Martin's Press, 1994).

② **Elimination of deductions, credits, and exemptions** — Most flat tax proposals would rid the code of various provisions (for example, deductions for home mortgage interest, charitable contributions, and state and local taxes) that bestow preferential tax treatment on certain behaviors and activities.

③ **No double taxation of savings and investment** — Flat tax proposals are designed to reduce or eliminate the bias against capital formation by ensuring that all income is taxed no more than once. Simply stated, they often include the equivalent of a “super IRA” to protect savings and investment from additional levels of taxation.¹²

While they share certain core principles, however, flat tax proposals are not identical. The Arme y proposal, for instance, calls for a very generous family allowance.¹³ Others include smaller personal allowances, a feature which allows the tax rate to be dropped even further. Another major issue is whether a flat tax also should be a tax cut. The Ar-

1997		Individual Wage Tax		Form 1
Your social security number		Last name Your first name and initial (if joint return, also give spouse's name and initial)		
Spouse's social security number		Home address (number and street including apartment number or rural route)		
Your occupation		City, town, or post office, state and ZIP code		
Spouse's occupation				
	1	1	Wages and salary and Pensions	
	2(a)	2	Personal allowance	
	2(b)	(a)	\$26,200 for married filing jointly	
	2(c)	(b)	\$13,100 for single	
	3	(c)	\$17,200 for single head of household	
	4	3	Number of dependents, not including spouse	
	5	4	Personal allowances for dependents (line 3 multiplied by \$5,300)	
	6	5	Total personal allowances (line 2 plus line 4)	
	7	6	Taxable wages (line 1 less line 5, if positive; otherwise zero)	
	8	7	Tax (17% of line 6)	
	9	8	Tax already paid	
	10	9	Tax due (line 7 less line 8, if positive)	
		10	Refund due (line 8 less line 7, if positive)	

1997		Business Tax		Form 2
Employer identification number		Business name		
County		Street address		
Principal product		City, town, or post office, state and ZIP code		
	1	1	Gross revenue from sales	
	2(a)	2	Allowable costs	
	2(b)	(a)	Purchases of goods, services, and materials	
	2(c)	(b)	Wages, salaries, and retirement benefits	
	3	(c)	Purchases of capital equipment and land	
	4	3	Total allowable costs (sum of lines 2(a), 2(b), and 2(c))	
	5	4	Taxable income (line 1 less line 3)	
	6	5	Tax (17% of line 4)	
	7	6	Carry-forward from 1994	
	8	7	Interest on carry-forward (6 percent of line 6)	
	9	8	Carry-forward into 1995 (line 6 plus line 7)	
	10	9	Tax due (line 5 less line 8, if positive)	
		10	Carry forward to 1996 (line 8 less line 5, if positive)	

12 There are two ways to achieve neutral treatment: a traditional “front-ended” IRA, in which money put into the account is deductible but all withdrawals are taxable (including interest), or a “back-ended” IRA in which initial contributions are not deductible (that is, after-tax income) but all withdrawals are free of tax. Because of its greater simplicity, most flat taxes (including Representative Arme y’s) use the back-ended approach.

13 \$36,800 for a family of four in last year’s bill.

me proposal would reduce government revenues (according to static estimates). Others, like the Specter bill, would collect the same amount of revenue.

Other differences involve the tax treatment of business. All flat tax proposals based on the Hall/Rabushka model, such as Armev's, address the many anti-growth features of the corporate income tax. In theory, however, a flat tax could be designed that applies only to the personal income tax. The Social Security and Medicare payroll taxes, which together are the equivalent of a 15.3 percent income tax for most Americans, are yet another unresolved issue. Unlike the income tax, the Social Security portion of the payroll tax (12.4 percent) is levied only on the first \$61,600 of income. The Medicare portion (2.9 percent) applies to all wage and salary income. Hall/Rabushka-based flat taxes do not attempt to tackle the special problems of these retirement programs, though it would be possible to design a flat tax which incorporated payroll taxes.

In addition, there are proposals that move in the direction of a flat tax but, for various reasons (usually political), do not satisfy all three core criteria. Some retain a "progressive" rate structure, penalizing those who contribute most to the economy's growth;¹⁴ others retain some deductions, usually for fear of offending a powerful constituency;¹⁵ and still others would continue to double-tax savings and investment. Such proposals generally are an improvement over the status quo, but they clearly would not have the positive impact on jobs and wages that a true flat tax would have.

More important, these attempts to find a "middle ground" lack the political appeal of a genuine flat tax. One reason the flat tax is so popular is that it breaks the special-interest logjam by reversing the notion that the tax code should be used to reward some groups while penalizing others. But allowing politicians to continue choosing winners and losers also allows tax lawyers and lobbyists to retain power and influence. Even worse, because of budget deficit concerns, retaining special provisions in the tax code almost inevitably results in tax rates that are higher than they would be under a true flat tax. These halfway steps also undermine the goal of simplicity, since every surviving credit, deduction, and exemption means longer and more complex tax forms. For these reasons, more "moderate" flat tax proposals most likely would fuel cynicism among ordinary Americans and generate far less support than more radical plans.

WHY A FLAT TAX IS FAIR

Perhaps the most common argument against a flat tax is that it would not be "fair." This assumes that the tax code should impose increasingly steep rates on people as their income rises. More specifically, a so-called progressive rate structure facilitates far more income redistribution than is possible under a single-rate system. As will be discussed in further detail later, the economic consequences of this approach are severe and have been demonstrated in many studies. Even leaving the broad economic argument aside, how-

14 House Minority Leader Richard Gephardt (D-MO) has announced support for this type of proposal.

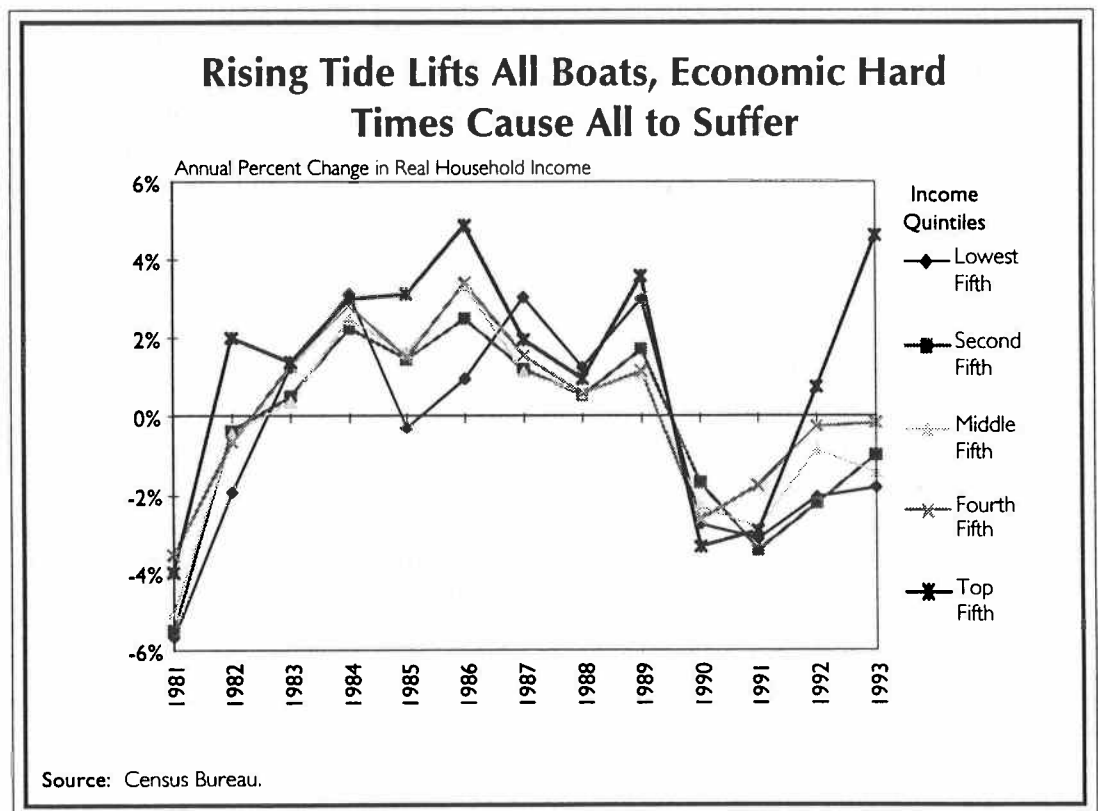
15 Senator Arlen Specter's (R-PA) bill (S. 488) maintains limited deductions for home mortgage interest and charitable contributions.

ever, the redistributionist approach fails any reasonable test of morality and is fiscally counterproductive.

“Progressive” taxation is discriminatory. The central tenet of a progressive tax is that the government has a right to larger shares of an individual’s income as his income rises. But traditional notions of fairness suggest the law should treat citizens equally, and penalizing those with higher incomes violates this principle. As John McCulloch, an early student of taxation, warned, “The moment you abandon... the cardinal principle of exacting from all individuals the same proportion of their income... you are at sea without rudder or compass, and there is no amount of injustice or folly you may not commit.”¹⁶ Those favoring high, confiscatory tax rates sometimes argue that well-to-do taxpayers received so much from society that it is only proper that government seize bigger portions of their income and use the money to benefit the less fortunate. This approach presents several fundamental problems.

First, in the private sector, income is earned by offering others something of value. Employers pay workers because they produce; consumers buy products because they value them. Without government coercion, income is earned by offering something to society, not by taking something from society.

The redistributionist credo, by contrast, holds that income is earned at the expense of others in society. This assumes income is a fixed pie and that any additional income



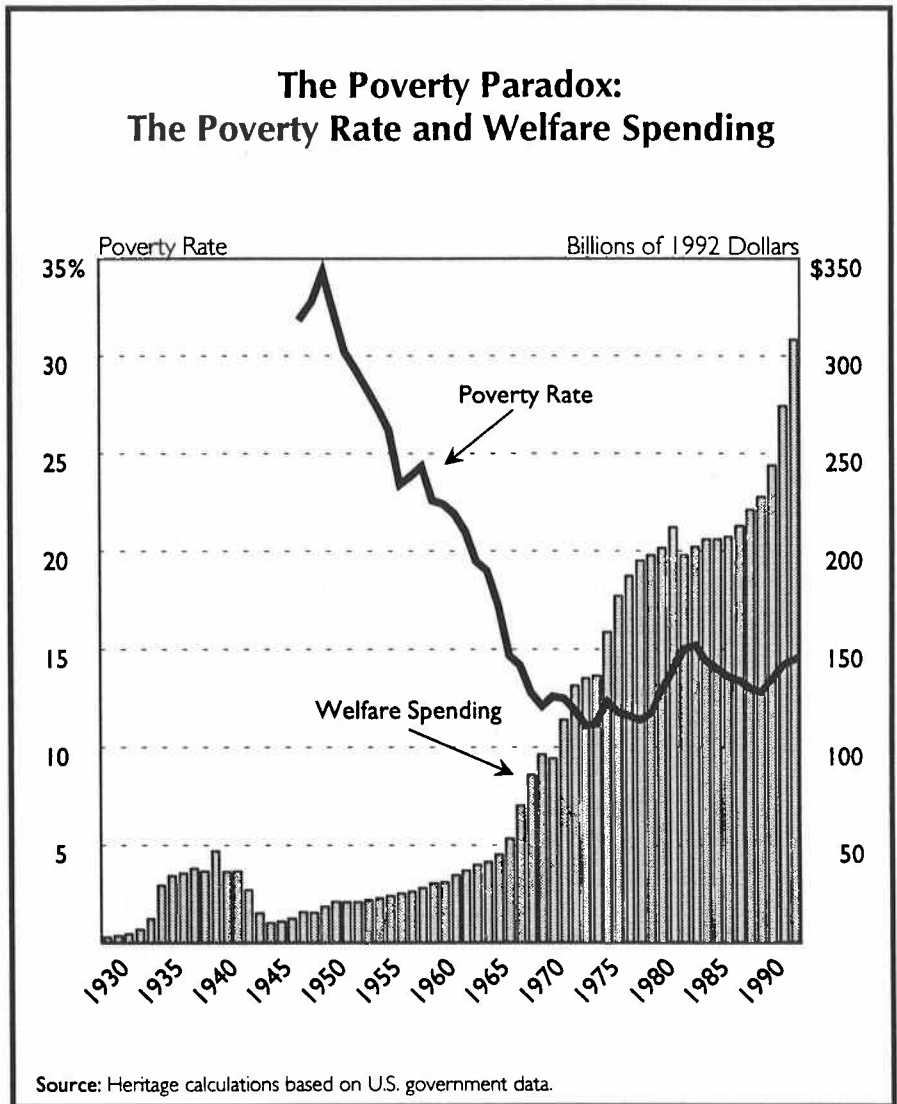
16 Walter J. Blum and Harry Kalven, *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953), p. 45.

earned by one individual somehow comes out of the pockets of everyone else. As the chart above shows, however, earnings for all income groups tend to rise and fall in unison. Incomes for all groups, including the poor, rose substantially during the Reagan years when tax rates were reduced. They did not perform strongly during the Carter, Bush, and Clinton years when high-tax policies were enacted.

Second, advocates of high tax rates often claim that government spending somehow helps the economy in general or the poor in particular. As discussed previously, how-

ever, study after study shows that higher levels of government spending are associated with weaker, not stronger, economic growth. Even programs designed to help the less fortunate, such as welfare and food stamps, seem to worsen conditions for the poor by trapping them in a cycle of dependence on government.¹⁷ As the adjacent chart shows, large amounts of welfare spending have not lowered the poverty rate.

Third, studies have shown that high tax rates can backfire by discouraging work, savings, and invest-



17 C. R. Winegarden, "AFDC and Illegitimacy Ratios: A Vector Autoregressive Model," *Applied Economics*, March 1988, pp. 1589-1601; M. Anne Hill and June O'Neill, *Underclass Behaviors in the United States: Measurement and Analysis of Determinants* (New York: City University of New York, Baruch College, August 1993); Shelley Lundberg and Robert D. Plotnick, "Adolescent Premarital Childbearing: Do Opportunity Costs Matter?" Discussion Paper 90-23, University of Washington (Seattle) Institute for Economic Research, June 1990; Robert Hutchens, "Welfare, Remarriage, and Marital Search," *American Economic Review*, June 1989, pp. 369-379; Robert Rector, "Combating Family Disintegration, Crime, and Dependence: Welfare Reform and Beyond" Heritage Foundation *Backgrounders* No. 983, April 8, 1994; Patrick F. Fagan, "Rising Illegitimacy: America's Social Catastrophe," Heritage Foundation *F.Y.I.* No. 19, June 29, 1994.

ment, thereby reducing taxable income and—depending on the tax rate—causing revenues to stagnate or fall.¹⁸ According to this principle, popularly known as the Laffer curve, when tax rates reach certain levels, total tax revenue will fall. Despite attacks by politicians and journalists, the theory is valid. Imposing a 100 percent tax on income above a certain level, for example, almost certainly would yield no additional revenue, since people no longer would have any incentive to earn money above that amount. Conversely, the government would collect no money if tax rates were zero. The only question (bearing in mind that the revenue maximizing tax rate is not the same as the growth maximizing tax rate) is whether tax rates are so high that government loses potential revenue.

Unfortunately, official government projections are of limited use when attempting to calculate the “revenue-neutral” rate under a flat tax, since tax estimators in the Administration and in Congress assume that taxes have no impact on the economy.¹⁹ Most Americans would find it hard to believe that government ignores economic effects in calculating revenue, but consider the experience of Senator Bob Packwood (R-OR). In 1989, as ranking Republican on the Senate Finance Committee, he asked the Joint Committee on Taxation (JCT) to estimate what would happen if the government confiscated *all* income above \$200,000 per year. The JCT projected that such a tax would raise \$104 billion in 1989, \$204 billion in 1990, \$232 billion in 1991, \$263 billion in 1992, and \$299 billion in 1993. As Senator Packwood remarked, the Joint Committee’s estimate “assume[d] people will work if they have to pay all their money to the Government. They will work forever and pay all their money to the Government when clearly anyone in their right mind will not.”²⁰

This blunder was only a theoretical exercise, but it demonstrates the enormous shortcomings of its methodology. Unfortunately, it is this methodology that drives the JCT estimates that Congress uses when considering alternative tax proposals, and the results can be very costly, as many cases have demonstrated.²¹ Capital gains estimates in the late 1980s that were off by more than 100 percent were used to kill a capital gains tax reduction that could have eased the economic hardship afflicting the nation during the Bush Administration.²² The large tax increase of 1990 was approved in part because lawmakers were told it would balance the budget. Instead, revenues came in below the tax collection estimates made before the tax increase was enacted.²³ Over the years, because of static revenue estimating procedures, the JCT has seriously overestimated revenues from such changes as the windfall profits tax, the corporate income tax after the 1986

18 Larry Lindsey, *The Growth Experiment: How the New Tax Policy Is Transforming the U.S. Economy* (New York: Basic Books, Inc., 1990).

19 In theory, Republican control of Congress will result in more realistic estimates, but this change has not occurred as yet.

20 Statement of Senator Bob Packwood, *Congressional Record*, November 14, 1989, p. S15534.

21 Estimates on the spending side of the fiscal equation also are notoriously inaccurate. Medicare, for instance, originally was projected to cost \$12 billion by 1990. The actual cost was \$107 billion. For more information, see Timothy Muris, “Estimating Government Health Care Costs: Overstating Savings and Underestimating Benefits,” in Conference Proceedings, *Prescription for the Nation’s Health: Where Will the Numbers Lead Us?*, American Enterprise Institute, September 23, 1993.

22 Viveca Novak, “By the Numbers,” *National Journal*, February 12, 1994.

23 Daniel J. Mitchell, “The Impact of Higher Taxes: More Spending, Economic Stagnation, Fewer Jobs, and Higher Deficits,” Heritage Foundation *Background* No. 925, February 10, 1993.

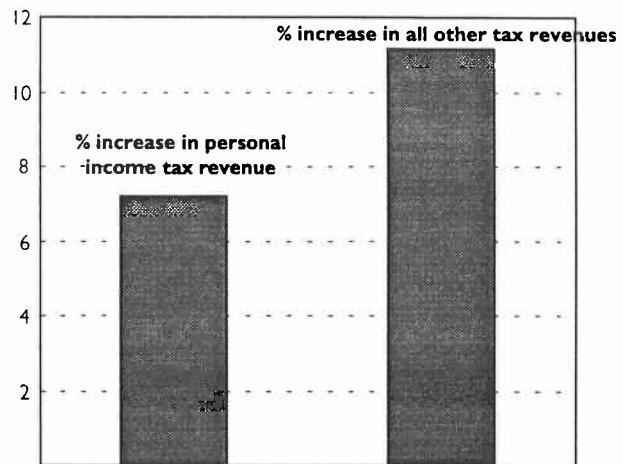
Tax Reform Act, and the 1990 Luxury Tax on yachts.²⁴ Ironically, the Clinton Administration admitted the flaws of static scoring during the debate on the General Agreement on Tariffs and Trade (GATT), arguing correctly that revenues generated by higher economic growth would more than offset tax cuts in the trade legislation.

Recent evidence confirms the negative impact of high

tax rates on revenues. The 1993 Clinton tax increase was supposed to make the "rich" pay more by imposing the largest income tax rate increase since Herbert Hoover's in 1930. Yet,

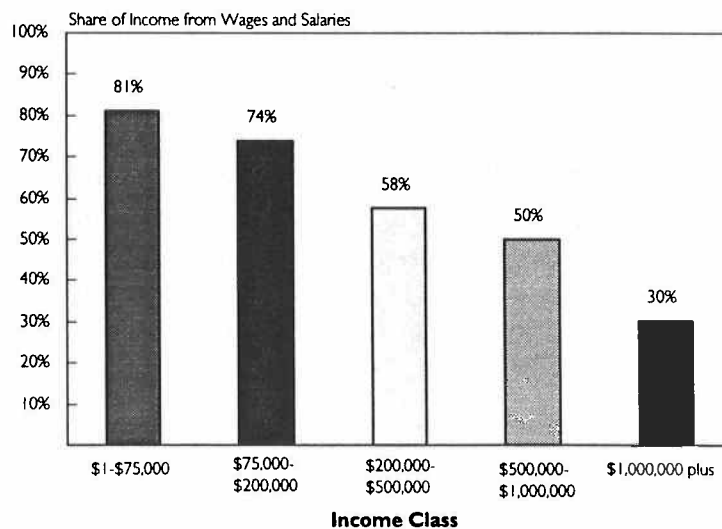
according to Administration budget figures, individual income tax revenues have been growing much more slowly than other tax revenues. These figures are an early sign that this increase in the income

1993 Soak-the-Rich Tax Backfires



Source: Department of Treasury.

Wealthy Taxpayers Do Not Rely on Wages and Salary Income



Source: Internal Revenue Service.

24 Bruce Bartlett, "Static Scoring Gets It Wrong," *The Wall Street Journal*, December 14, 1994.

tax rate will not raise the \$114 billion in new revenue the Administration predicted. What makes the figures even more surprising is that they include money generated by the retroactive—and thus unavoidable—tax increase on 1993 income (due on April 15, 1994). The fact that income tax revenues in 1994 were still 30 percent below the growth rates for all other revenues is particularly significant.

Not surprisingly, the punitive Clinton tax increase caused rich people to report less taxable income in 1993, as the chart above illustrates. The cause of this drop — tax shelters, reduced work effort, evasion — is not yet clear. Whatever the cause, the entire economy suffers.

Given what happened in the 1980s, however, the failure of the Clinton tax hike should be no surprise. Critics charged that the Reagan tax cuts were a “giveaway to the rich,” but government figures show that upper-income taxpayers paid a significantly *larger* share of the income tax burden after their tax rates were reduced. Simply stated, lower tax rates encouraged substantial income growth and reduced incentives to shelter and underreport income, and the result was a large increase in taxable income which generated substantial amounts of new revenue for the government even though actual tax rates were lower.

ADVANTAGES OF A FLAT TAX

There are two principal arguments for a flat tax: growth and simplicity. Economists are attracted to the idea because the current tax system reduces growth, destroys jobs, and lowers incomes. While it would not eliminate this damaging impact, a flat tax would boost the economy’s performance when compared with the present tax code. For many Americans, however, the most persuasive argument for a flat tax is that the complicated documents and instruction manuals they must struggle to decipher every April would be replaced by a simple postcard-size form. This radical reform appeals to citizens who not only resent the time and expense of their own tax forms, but also suspect that the existing maze of credits, deductions, and exemptions gives a special advantage to those with political power and the money to afford tax accountants.

The Complexity Problem with the Current System

By penalizing work, savings, and investment, the income tax has slowed economic growth and lowered living standards significantly. This economic damage is compounded by a tax code that imposes very high costs on those who try to follow the law. As categorized in James L. Payne’s comprehensive *Costly Returns: The Burdens of the U.S. Tax System*, these costs include:²⁵

- X Record keeping** — organizing data collection systems; collecting and appraising data; synthesizing data.
- X Learning about tax requirements** — studying tax form instructions, tax books, pamphlets, and articles; seeking interactive instruction in telephone calls and vis-

25 Payne, *Costly Returns: The Burdens of the U.S. Tax System*, p. 17.

its to IRS, discussion with friends and volunteers, classes, training sessions; finding and using a paid tax preparer

- X **Preparing the return** — making appropriate computations; filling out tax forms and schedules; copying and sending the return.
- X **Tax planning** — studying tax requirements, books, articles, etc.; discussing tax avoidance with tax adviser and others; drafting tax management plan.

According to Payne, today's tax code imposes 24.4 cents of compliance costs for every dollar of taxes raised.²⁶ The Tax Foundation puts the cost at 15.2 cents,²⁷ though even this means the tax code imposes \$192 billion of compliance costs. Testifying before a congressional committee, one economist stated, "If an enemy power bent on destroying our nation were somehow given the opportunity to devise our tax code with a goal of sapping the nation of its economic vitality... it could do little better than adopt our current Internal Revenue Code."²⁸ A professor of tax law declared, "The United States now has the most complex tax laws in the history of civilization."²⁹

While every tax system imposes compliance costs, a simple flat tax would sharply reduce these ancillary costs. As illustrated, the Arney proposal would allow all taxpayers, from the teenager flipping hamburgers to the General Motors Corporation, to submit their returns on a postcard-sized form.³⁰ The original tax code was only 14 pages long, and tax forms were simple one-page documents.³¹ Today's tax code has swelled to 3,458 pages.³² Moreover, the IRS receives more than 1 billion form 1099s every year as part of the government's cumbersome efforts to track income from interest, dividends, and other forms of business income.³³ With a flat tax, this burden disappears. The effect would restore the simplicity of the original income tax.

The tax laws are only the tip of the iceberg. Internal Revenue Service regulations, supposedly written to clarify ambiguities in the tax code, are nearly six times the length of the actual tax law.³⁴ To put this in perspective, federal tax laws and regulations are more than six and one-half times longer than the King James Bible.³⁵ Unfortunately, length is not matched by clarity.

26 *Ibid.*, p. 29.

27 Arthur P. Hall, "Growth of Federal Government Tax 'Industry' Parallels Growth of Federal Tax Code," Tax Foundation *Special Report* No. 39, September 1994.

28 James L. Payne, "Inside the Federal Hurting Machine," *International Money and Politics*, May/June 1994.

29 *Ibid.*

30 This does not mean the paperwork burden would fall to zero, however; taxpayers still would have to be able to document and defend the figures they put on these simple forms.

31 Gerald Carson, *The Golden Egg: The Personal Income Tax, Where It Come From, How It Grew* (Boston: Houghton Mifflin Co., 1977).

32 United States Code: 1988 Edition, Title 26-Internal Revenue Code, Sec. 1-2000 (Washington, D.C.: U.S. Government Printing Office, 1989); United States Code: 1988 Edition: Supplement V, Volume 5, Title 26-Internal Revenue Code (Washington, D.C.: U.S. Government Printing Office, 1994).

33 Robert E. Hall and Alvin Rabushka, "The Flat Tax in 1995," in Conference Proceedings, *The Flat Tax: An Alternative to the Current Income Tax*, American Enterprise Institute, January 27, 1995.

34 Hall, "Growth of Federal Government Tax 'Industry' Parallels Growth of Federal Tax Code."

35 J. L. Meredith, *Meredith's Book of Bible Lists* (Minneapolis: Bethany Fellowships, Inc., 1980).

Compliance Costs of the Personal Income Tax

Most individuals are painfully familiar with the peculiarities of the personal income tax. They wade through the maze of forms and instructions or pay professionals to do the job for them. Studies show that Americans spend between 1.6 billion and 2.1 billion hours each year complying with the personal income tax.³⁶ In dollar terms, this represents an annual burden of between \$51 billion and \$65 billion,³⁷ with compliance costs falling most heavily on small businesses and the self-employed, thereby ensuring that entrepreneurship is penalized.³⁸

What do taxpayers get for their time and effort? All too often, they get wrong answers. Each year, for example, *People* magazine used to send tax information about a hypothetical family to 50 different tax preparers, and each year virtually every one came up with a different estimate of the family's tax bill—most of them missing the right figure by a wide margin.³⁹ They could have called the IRS for advice, but a 1987 General Accounting Office survey found IRS officials giving taxpayers the wrong information 47 percent of the time.⁴⁰ This survey was conducted just after a major tax reform, and accuracy presumably has improved as IRS staff have absorbed its intricacies. Nonetheless, the fact that professionals both inside and outside of government have so much trouble with the law argues compellingly for a simple flat tax.

Compliance Costs of the Corporate Income Tax

The personal income tax code is relatively simple when compared with the laws driving the corporate tax system. According to Payne, American businesses devote more than 3.6 billion hours to tax compliance every year,⁴¹ in addition to which compliance costs actually may exceed the total raised by the corporate income tax. One recent study estimated that these costs exceeded revenues by \$40 billion, while another found them to be as much as 75 percent of revenues.⁴² Small corporations, those with assets of \$1 million or less (90 percent of U.S. corporations), are especially victimized with compliance costs of \$382 for every \$100 raised.⁴³

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- 36 See Joel Slemrod and Nikki Sorum, "The Compliance Cost of the U.S. Individual Income Tax System," *National Tax Journal*, December 1984; Arthur D. Little, "Development of Methodology for Estimating the Taxpayer Paperwork Burden," *Final Report to the Department of the Treasury*, Internal Revenue Service, June 1988; Joel Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters," *Journal of Economic Perspectives*, Vol. 6, No. 1 (Winter 1992); James L. Payne, "Unhappy Returns: The \$600 Billion Tax Ripoff," *Policy Review*, No. 59 (Winter 1992); Marsha Blumenthal and Joel Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform," *National Tax Journal*, June 1992.
- 37 See Payne, *Costly Returns: The Burdens of the U.S. Tax System*, p. 29, and Hall, "Growth of Federal Government Tax 'Industry' Parallels Growth of Federal Tax Code."
- 38 Blumenthal and Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform."
- 39 Greg Anrig, Jr., "The Pros Flunk Our New Tax-Return Test," *Money*, March 1989; Teresa Tritch and Deborah Lohse, "The Pros Flub Our Tax Test (Again)," *Money*, March 1991.
- 40 Carl Horowitz, "The Hidden Cost of Higher Taxes," *Investor's Business Daily*, September 16, 1993.
- 41 Payne, "Unhappy Returns: The \$600 Billion Tax Ripoff."
- 42 James L. Payne and Arthur Hall, "The Compliance Cost and Regulatory Burden Imposed by the Federal Tax Law," Tax Foundation *Special Brief*, January 1995.
- 43 *Ibid.*

Like individual taxpayers, businesses may have no way of knowing whether the information they put on their tax returns is accurate. Provisions like depreciation, alternate minimum tax, uniform capitalization, economic performance rules, transfer pricing, and allocation rules all add to the complexity of corporate taxes and help explain why businesses spend 3.6 billion hours a year trying to figure out their tax bills.⁴⁴ Worst of all are the provisions affecting U.S. corporations that do business overseas. As one executive has remarked, the “forms are so complex they defy interpretation and result in noncompetitive cost burdens.”⁴⁵

Tax Evasion

Many people in America and around the world choose to evade taxes by operating in the underground economy.⁴⁶ By its very nature, the underground economy is difficult to measure. Scholars have come up with estimates ranging from a low of 4.5 percent of official U.S. economic output to a high of 27 percent.⁴⁷ High tax rates and complexity contribute to a decision to operate outside the law,⁴⁸ but a great deal of the underground economy is the result of government decisions to impose criminal penalties on drugs, gambling, and prostitution. Income from such activity would not be disclosed whatever the tax rate, and this makes it more difficult to estimate the tax-induced economic losses from the underground economy.⁴⁹

Costs of Taxation Incurred by Government

A complex tax system with high marginal rates also imposes costs on government. The annual cost of operating the Internal Revenue Service, for instance, is expected to reach almost \$10 billion in 1995, and other government agencies also have tax-related divisions which add about \$3.5 billion to the total. All told, according to one study, the federal government will employ more than 136,000 people and spend more than \$13.7 billion enforcing the tax code in 1995.⁵⁰ While considerably less than the costs borne by the private sector, these figures would drop significantly under a simplified flat tax.

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- 44 Joel Slemrod and Marsha Blumenthal, “The Income Tax Compliance Cost of Big Business,” Office of Tax Policy Research *Working Paper Series* No. 93-11, University of Michigan, July 1993.
- 45 Albert E. Germain, “Four Quality Tax Steps for Enhancing the Competitive Position of U.S. Goods and Services in World Markets,” in *U.S. Foreign Tax Policy: America’s Berlin Wall*, conference proceedings, Institute for Research on the Economics of Taxation (New York: University Press of America, 1991).
- 46 Tax evasion involves a deliberate decision to violate the tax law. Tax avoidance means altering behavior to minimize legal tax obligations.
- 47 Paul Starobin, “The Economy You Can’t See,” *National Journal*, June 18, 1994.
- 48 Vito Tanzi and Parthawarathi Shome, “A Primer on Tax Evasion,” *IMF Staff Papers*, Vol. 40, No. 4 (December 1993).
- 49 In some sense, there are no economic losses, since the income-generating activity does occur. The “losses” are the tax revenue the Treasury foregoes. In addition, costs presumably are borne by those who seek to keep income from the underground economy away from the prying eyes of the IRS.
- 50 Hall, “Growth of Federal Government Tax ‘Industry’ Parallels Growth of Federal Tax Code.”

THE ECONOMIC ARGUMENT FOR A FLAT TAX

There are two ways to increase a nation's economic output or rate of growth.⁵¹ In simple terms, Americans must work more or work more productively. Thus, economic growth depends on some combination of:

- ① **Adding more labor to the economy**, which happens when people choose to work longer hours, they take second jobs, or their spouses join the workforce, or
- ② **Adding more capital to the economy** so that workers can produce more goods and services per hour of time worked.⁵²

A flat tax would build a stronger economy by correcting both the anti-labor and anti-capital features of the current income tax code.

Why High Tax Rates Discourage Work

Taxes on labor discourage work by reducing the benefits (after-tax income) individuals receive from offering their labor to employers. In the language of economists, taxes reduce the "price" of leisure relative to work, so when taxes and other government policies make work less attractive by reducing take-home pay, many individuals choose either not to work or to cut back the number of hours they work.

This can take many forms. Economic research indicates that taxes have a strong impact on whether people work,⁵³ particularly people with low incomes whose welfare benefits often result in higher after-tax "income" than they can earn by holding a job.⁵⁴ Taxes also reduce incentives for those who do choose to work, causing a decline in hours worked and, in the case of high taxes, the willingness to work overtime (at least three strikes in recent months were against additional overtime).⁵⁵ Excessive taxation also dis-

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- 51 Another way to generate growth is by adding to the population. Over time, a higher birth rate or increased immigration will raise total economic output. This is not the same, however, as higher per capita economic output, which is the prerequisite for higher incomes and rising living standards.
- 52 Capital includes not only machinery, equipment, technology, and buildings, but also human skills. A better-educated work force, for instance, is a more productive work force.
- 53 James J. Heckman, "What Has Been Learned About Labor Supply in the Past Twenty Years," *American Economic Review*, May 1993, pp. 116-121.
- 54 Examining the relationship at the time between untaxed unemployment compensation benefits and taxable income, Martin Feldstein estimated that the combination raised the unemployment rate by 1.25 percent and drove 1 million workers out of the labor force. Martin Feldstein, "Unemployment Compensation: Its Effect on Unemployment," *Monthly Labor Review* 99 (March 1976), and "The Effect of Temporary Unemployment Insurance on Temporary Layoff Unemployment," *American Economic Review* 68 (December 1978). A government study found that every \$1.00 of additional welfare lowered labor and earnings among low-income persons by \$0.80. SRI International, *Final Report of the Seattle-Denver Income Maintenance Experiment*, Vol. 1, Design and Results (Washington, D.C., May 1983); Gregory B. Christiansen and Walter E. Williams, "Welfare Family Cohesiveness and Out of Wedlock Births," in Joseph Peden and Fred Glahe, *The American Family and the State* (San Francisco: Pacific Institute for Public Policy Research, 1986). Another study found that increasing monthly AFDC and Food Stamp benefits by 50 percent was followed by a 75 percent increase in the number of women participating in the program and a similar increase in the amount of time spent receiving benefits. M. Anne Hill and June O'Neill, *Underclass Behaviors in the United States: Measurement and Analysis of Determinants* (New York: City University of New York, Baruch College, August 1993). For a complete discussion of these issues, see Rector, "Combatting Family Disintegration, Crime, and Dependence: Welfare Reform and Beyond."

courages second jobs, since workers often find that the additional after-tax income is not enough to offset the leisure time sacrificed. Appendix 1 lists several studies that document the impact of taxes on the decision to work.

Even though studies confirm the relationship, the idea that marginal tax rates profoundly influence individual incentives is not immediately obvious to many Americans. They recognize that businesses must watch the bottom line and thus understand how higher taxes depress wages and cost jobs, but they think about their own lives and conclude that a shift—up or down—in marginal tax rates probably will not mean dramatic change. Most Americans, after all, do not take second jobs in response to lower tax rates.⁵⁶ Nor are many workers likely to refuse overtime just because they rise. How, then, will lower marginal tax rates encourage economic growth?

It turns out that high tax rates have a particularly pronounced effect at the upper end of the income scale. Unlike most citizens, the “rich” have significant control over the timing and composition of their income. As seen in the chart on page 9, “rich” taxpayers receive most of their income from investments and business activity.⁵⁷

Whether wealthy taxpayers are small businesses or investors, their relative lack of dependence on wage and salary income means they have far more ability to alter their economic behavior and protect their income when changes in tax rates alter incentives. For small businesses, any increase in tax rates lessens the ability to hire workers or retain earnings for expansion. Because of the direct ef-

WHY MARGINAL RATES MATTER MOST

The average tax rate is the percentage of a person's income that government takes in taxes each year. It measures the total tax burden but is not a good indicator of how taxes affect incentives to work, save, and invest. The marginal tax rate is the percentage of each additional dollar earned that government takes in taxes.

The marginal rate is critical because the decision to engage in additional productive economic activity is based on the additional after-tax income received from that activity. The marginal income tax rate is zero at very low incomes (up to \$6,250 for a single person and \$16,150 for a family of four in 1994) because of the personal exemption and standard deduction. Under current law, however, government begins taking larger and larger shares of taxpayers' earnings as their income rises. Depending on the level of state and local taxes, successful Americans often face marginal tax rates in excess of 50 percent.

55 Joan E. Rigdon, “Worn Out: Some Workers Gripe Bosses Are Ordering Too Much Overtime,” *The Wall Street Journal*, September 29, 1994, p. A1.

56 While most Americans do not work two jobs, the number of those who do is surprisingly high: nearly 7.5 million. These taxpayers, and those contemplating taking second jobs, clearly examine the costs and benefits of providing additional labor. See “Employment Situation: November 1994,” *BLS Release*, Department of Labor, December 1994, Table A-8.

57 Many of these upper-income taxpayers are small businesses—for example, sole proprietorships, partnerships, and some subchapter S corporations—which file using the personal income tax. Others are entrepreneurs and wealthy individuals who manage large portfolios of investments.

fect taxes have on their generally smaller profit margins, small businesses are even more sensitive to changes in the tax code than large corporations are.

Many well-to-do taxpayers, of course, receive a large portion of their incomes from dividends, interest, capital gains, and other types of investments or passive business earnings. As with most other Americans, they seek to realize the largest possible return on their investments and to protect as much of their wealth and income from the government as possible. In a survey conducted by Prince & Associates, a Connecticut financial consulting firm, 89 percent of 311 high-income business owners were found to be “extremely interested” in “tax minimization strategies.”⁵⁸

One significant advantage these taxpayers have over most other Americans is the ability to retain the services of highly qualified tax lawyers, accountants, and investment advisors, each of whom supposedly can generate the highest after-tax return for clients. Needless to say, increases in marginal tax rates reduce the attractiveness of many investments. This encourages tax professionals and their clients to focus on sheltering income, reducing tax code earnings, placing assets overseas, and otherwise avoiding taxes. Consider the following:

- ☞ **Municipal bonds are exempt from federal tax.** In a *Wall Street Journal* report on the growth of these bonds in the aftermath of Clinton’s record tax increase,⁵⁹ a member of one billionaire family noted, “A wealthy New York City resident is looking at a combined city, state, and federal rate of nearly 50 percent. So you’ve got to buy municipal bonds. You’ve got to. A long-dated muni yielding 5.5 percent is equal to a 10.53 percent yield on a taxable [U.S.] government bond.”⁶⁰ Rather than reduce the budget deficit, as politicians claim, high tax rates merely drive wealthy investors into tax-free municipal bonds and other shelters. The federal government does not collect new tax revenues, and overall tax collections may well fall. In addition, there is real damage to the economy as driving investors out of productive private-sector investments and into buying the debt of state and local government undermines economic growth, resulting in less job creation and stagnating incomes.
- ☞ **Fidelity Investments offers a new mutual fund based on tax minimization strategies.**⁶¹ Again, the issue is economic. As with similar funds, managers’ investment decisions, deploying huge amounts of money, are influenced more by the arcane features of the tax code than by real economic factors.
- ☞ **The tax code drives some people to hide their money by sending it overseas.** Even though such behavior is illegal, one financial adviser recently explained, “People are hiding money. They don’t like the tax system, and they think it will get worse. Legal experts outside the U.S. tell me that they are getting a 100 percent increase in the business every six months.”⁶²

58 Brett D. Fromson, “Wealthy Scramble for Tax Avoidance Strategies,” *The Washington Post*, August 7, 1993.

59 Tom Herman, “Municipal Bonds Blossom Under New Tax Law,” *The Wall Street Journal*, November 5, 1993.

60 Fromson, “Wealthy Scramble for Tax Avoidance Strategies.”

61 Robert McGough, “Fidelity Offers New Fund That Keeps Taxes in Mind,” *The Wall Street Journal*, September 16, 1993.

62 Fromson, “Wealthy Scramble for Tax Avoidance Strategies.”

☞ Perhaps most revealing, the tax burden has become so oppressive that some Americans choose to emigrate to protect their earnings.⁶³

This anecdotal evidence that people respond to tax changes by acting to protect their earnings and change their behavior is supported by government data. Monthly personal income data from the Commerce Department, for example, show that income jumped sharply at the end of 1992 and fell just as dramatically in early 1993. The reason: the widely expected Clinton tax increase. Taxpayers with any discretion over when they received earnings shifted income from 1993 to 1992 to limit the additional amount taken by the government.

Not surprisingly, monthly tax collection figures echo these data. Taxpayers with modest earnings pay most of their income taxes in the form of amounts withheld from their paychecks throughout the year. Wealthy individuals and businesses, however, because most of their income is not subject to withholding, are legally obligated to make quarterly payments. Most of these payments are made routinely in the months they are due, but this pattern changed dramatically in 1993, when January's share of the payments was more than 70 percent higher than the average January share for the previous 15 years. This is significant, because January 1993 was the month quarterly payments for the last three months of 1992 were due. Well-to-do taxpayers shifted large portions of their income to 1992 because of widespread anticipation that the incoming Clinton Administration would increase marginal tax rates.

These quarterly payment figures underscore that small businesses and rich taxpayers can and do alter the timing and composition of their income to protect their earnings. One prominent example is the First Lady of the United States. Hillary Rodham Clinton elected to take her partner's share of earnings at the Rose Law Firm on December 31, 1992, rather than at the beginning of the following year as she had in previous years. Perhaps Mrs. Clinton, like other smart taxpayers, suspected the new President might propose higher tax rates and did what she could to minimize her family's tax liability. If she did, as the following examples indicate, she was not alone.

☞ The two top executives at the Disney Corporation exercised stock options shortly before 1993, presumably to avoid widely expected tax increases once Clinton took office.⁶⁴

☞ Other top-level corporate executives did the same thing. Three General Dynamics Corporation officials exercised options to purchase over 500,000 shares of company stock before the 1993 tax year began.⁶⁵

☞ Well-advised professional athletes also acted to protect their earnings in 1992. Among baseball players, Oakland's Ruben Sierra and Mark McGwire arranged for lump sum payments of \$6 million and \$7 million, respectively, to avoid 1993's higher taxes. Other players doing the same thing included David Cone of the Kansas

63 Robert Lenzner and Phillippe Mao, "The New Refugees," *Forbes*, November 21, 1994.

64 George F. Will, "Making Capitalism Hum," *The Washington Post*, December 20, 1992, p. C7.

65 Jay Mathews, "Dynamics Executives Exercise Options: Three Officials Buy 505,000 Shares to Avoid Anticipated Stock," *The Washington Post*, December 19, 1992.

City Royals, with a lump sum of \$9 million, and Detroit's Cecil Fielder, who negotiated a record \$10 million.⁶⁶

Why High Tax Rates Discourage Savings and Investment

Taxes on savings and investment harm the economy by reducing capital formation, the process by which the quality and quantity of equipment, tools, and technology available to workers are increased, thereby raising their productivity.⁶⁷ Since salaries and wages are linked closely to productivity, the only way to raise the income of workers permanently—assuming no change in their skills—is through savings and investment. Simply put, workers are paid on the basis of what they produce, and giving them better tools allows them to produce more.

The level of capital formation largely explains why workers in the United States, Germany, and Japan earn more than workers in Brazil, India, and Nigeria. Similarly, workers in America today earn more than their parents because of net investment (increases in the capital stock). As a result, they are more productive, generating more output per hour of labor.

An ideal tax system does not penalize or subsidize particular economic choices. Unfortunately, one of the most destructive elements of the current income tax is the multiple taxation of savings and investment. Just as savings, dividend, business, and other forms of investment income are penalized by the personal income tax, capital formation is hindered by corporate income, capital gains, estate, and gift taxes, by depreciation tax provisions, and by the corporate alternative minimum tax.

Appendix 2 reveals ample evidence that taxes significantly reduce savings and investment. This is important, of course, because reduced levels of capital formation translate into reduced levels of income.

Why Capital Formation Matters

Economists of all persuasions recognize the relationship between investment and wages. Paul Samuelson, for example, a Nobel Laureate economist who endorsed Bill Clinton for President, has written:

What happens to the wage rate now that each person works with more capital goods? Because each worker has more capital to work with, his or her marginal product rises. Therefore, the competitive real wage rises as workers become worth more to capitalists and meet with spirited bidding up of their market wage rates.⁶⁸

⁶⁶ Robert Facht, "Rich and Famous Take a Bat to Surtax," *The Washington Post*, August 25, 1993.

⁶⁷ For a detailed discussion of the role of capital in the economy, see Daniel J. Mitchell, "An Action Plan to Create Jobs," Heritage Foundation *Memo to President-Elect Clinton* No. 1, December 14, 1992. See also Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis Report No. 169, January 1992, and Arthur P. Hall II, "Big Government or Economic Prosperity? A Primer on Taxation, Regulation, and Economic Growth," Citizens for a Sound Economy Foundation, June 1992.

⁶⁸ Paul A. Samuelson and William D. Nordhaus, *Economics*, 12th Edition (New York: McGraw-Hill, Inc., 1985), p. 789.

Another example is taken from a 1991 report on economic growth prepared by the staff of the Joint Committee on Taxation, then controlled by the Democrats:

When an economy's rate of net investment (gross investment less depreciation)⁶⁹ increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and, generally, the higher its real wages and salaries. Thus, increases in investment⁷⁰ tend to cause future increases in a nation's standard of living.⁷⁰

According to a 1989 report on economic growth published by the Congressional Research Service,

Capital deepening has been and will likely continue to be a central force for accelerating growth and potential output over the medium term. But as we have seen, a permanent increase in the long-term rate of growth will hinge on the United States ability to increase the pace of technical advance and innovation. However, both of these routes to faster growth will be contingent upon the ability to increase the level of investment spending—more spending for capital equipment and more spending for research and development. To finance higher investment will, in turn, require that Americans raise the national rate of savings.⁷¹

Critics of this analysis complain that it is nothing more than “trickle-down” economics that relies on tax cuts for the “rich” to boost wages. Such rhetoric may be useful politically, but it cannot change economic reality, as economist John Shoven has explained:

The mechanism of raising real wages by stimulating investment is sometimes derisively referred to as “trickle-down” economics. But regardless of the label used, no one doubts that the primary mechanism for raising the return to work is providing each worker with better and more numerous tools. One can wonder about the length of time it takes for such a policy of increasing saving and investments to have a pronounced effect on wages, but I know of no one who doubts the correctness of the underlying mechanism. In fact, most economists would state the *only* way to increase real wages in the long run is through extra investments per worker.⁷²

The following example illustrates why savings and investment suffer in the current tax climate. A taxpayer has \$100 of income and must decide what to do with it. He can consume the \$100, spending it on food, vacations, clothing, haircuts, or some other product

69 Depreciation refers to the amount of capital that is used up or wears out during each period. For instance, a machine may have a life expectancy of five years. In order to measure increases in the capital stock accurately, increases in investment should be adjusted to reflect depreciation.

70 “Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution,” Joint Committee on Taxation report for House Committee on Ways and Means, December 12, 1991, p. 21.

71 Craig Elwell, “The Goal of Economic Growth: Lessons from Japan, West Germany and the United States,” Congressional Research Service, July 17, 1989.

72 Shoven, “Alternative Tax Policies to Lower the U.S. Cost of Capital,” p. 3.

or service, in which case (with the exception of possible sales taxes) he will receive close to \$100 in goods and services for his money. Or he can invest in the stock of a start-up company with the potential to provide new jobs to the community and produce goods that consumers desire. If the company succeeds, the investor most likely will profit. If it fails, he will lose his \$100.

In this case, the investment bears fruit and yields a 10 percent rate of return, enabling the company to produce \$10 of annual income for every \$100 invested. Under the current tax code, 34 percent is skimmed off to pay the corporate income tax, leaving only \$6.60 out of the original \$10. This \$6.60 then goes to the investor as a dividend. But there are other taxes. Depending on the investor's income, the personal income tax will take as much as 39.6 percent of his \$6.60, leaving him with less than \$4.00 of annual income from a "successful" \$100 investment. In addition, he may face applicable state and local income taxes.

Finally, if the investor ever decides to sell the stock, he will be hit by one of the highest capital gains taxes in the industrialized world, and what little income he eventually receives from saving and from having taken the risk of investing most probably will be subject to sales tax when he spends it. To add insult to injury, successful entrepreneurs who try to accumulate an estate to pass on to their children are penalized by inheritance taxes which can confiscate 55 percent of a deceased's assets.

Thanks to the tax code, a fortunate investor—one who actually earns money on his investments—may have to send more than half his earnings to the government, not to mention having already paid taxes on the money used for the investment in the first place. Thus, government tax policy has created a very tilted playing field. By punishing saving and investment, the tax code encourages both individuals and businesses to consume rather than to build for America's future.

As discussed earlier, the only ways to boost per capita income are to work more hours or produce more per hour worked. Since leisure has a positive value to Americans, particularly those with families, most would prefer to raise their living standards by increasing their hourly productivity. This is why taxes on capital are especially damaging. They penalize the very economic actions—saving and investment—necessary for increased productivity and the growth in wages that accompanies it. Thus, while it is important that the tax code not discourage people from working more if that is what they desire, eliminating the multiple layers of taxes on saving and investment is even more critical if we want higher incomes without sacrificing leisure time.

Why High Tax Rates Depress Economic Growth

Since taxes affect incentives to work, save, and invest so powerfully, it should come as no surprise that major tax changes almost always have a significant impact on the economy. Herbert Hoover's decision in 1930 to increase the top tax rate from 25 percent to 63 percent certainly contributed to the Depression. Lyndon Johnson's surtax on income tax liabilities, enacted in 1968, together with an increase in the capital gains tax helped end the 1960s expansion. Large tax increases, including inflation-induced bracket creep, contributed to the economy's dismal performance under Jimmy Carter. George Bush's record tax increase in 1990 was a principal cause of the recent recession and subsequent anemic recovery. And the sub-par performance of today's economy, particularly the de-

cline in median household income,⁷³ almost certainly is attributable in part to the record tax increase pushed through Congress in 1993 by Bill Clinton.

Once again, the evidence is confirmed by academic research. As the examples in Appendix 3 indicate, tax codes that penalize productive economic behavior are associated with weaker growth, fewer jobs, and lower incomes. Other studies find that the damage occurs when government spends the money. In either case, the message is clear: The larger and more intrusive a government is, the worse its economy performs.

FREQUENTLY ASKED QUESTIONS ABOUT A FLAT TAX

Q: Will a flat tax encourage job creation?

A: A flat tax will encourage more jobs and higher wages by boosting incentives to work, save, and invest. In the long run, the elimination of most of the tax code's bias against savings and investment will have the biggest effect. As studies show, a flat tax will encourage capital formation, leading over time to higher levels of productivity, increased wages, and more jobs. A flat tax also will have a more immediate impact on job creation, however, by making work more attractive. High tax rates drive a wedge between what it costs a business to employ a worker and how much the worker receives in take-home pay.⁷⁴ By increasing the cost of labor, taxes lower the number of workers a company is willing to hire. Businesses do not exist to pay workers more than they are worth. They exist to make money and will hire only as long as the value of each new worker's additional output exceeds the total cost of employing that worker.

When politicians enact policies that raise the cost of employment, the total cost of some workers will rise above the value they bring their employers. In the long run, a business has only two options when faced with this predicament: close its doors or lay off workers who are net money losers. Even workers who retain their jobs pay a price. Taxes on labor income, whether paid by employee or employer, dollar for dollar, unavoidably reduce the amount that finds its way into their paychecks. Politicians may pretend otherwise, but every time the tax burden climbs, workers' after-tax income declines.⁷⁵

⁷³ According to the Census Bureau, median household income fell by 1.0 percent in 1993. See "Income, Poverty, and Health Insurance: 1993," Bureau of the Census, U.S. Department of Commerce, October 1994.

⁷⁴ Taxation is not the only government activity that inflates the cost of hiring workers and reduces take-home pay. Myriad regulations, mandated benefits, unemployment compensation, liability costs, and labor laws drive up the cost of employment and shrink workers' pay.

⁷⁵ This process usually works by delaying, reducing, or canceling wage increases. In most years, additional investment and training increase worker productivity, making employees more valuable and allowing businesses to increase wages. When these productivity increases are accompanied by higher taxes, however, it is government, not the workers, that captures all the benefits.

Q: Would a flat tax reduce the budget deficit?

A: This depends on which flat tax is implemented. More specifically, it depends on the tax rate and whether the proposal includes limits on government spending. Even though lower rates generally stimulate economic growth and expand the tax base, at some point they translate into less revenue. A flat tax of 20 percent, for instance, almost certainly would raise more money than a flat tax of 10 percent. The size of the personal exemption/family allowance also plays a key role, since the decision to protect a certain amount of income (\$36,800 for a family of four in last year's Arney bill) generally means the rate on taxable income must be higher.

According to a Treasury Department analysis leaked to the media before the 1994 elections, the Administration estimates that the Arney flat tax would result in a \$244 billion revenue loss to the federal government in 1995.⁷⁶ But this study contained a \$500 billion error, as the Department later admitted,⁷⁷ and used the 17 percent rate to analyze 1995 revenues even though the Arney bill calls explicitly for an initial rate of 20 percent (which would be phased down to 17 percent). The Treasury Department now claims that, once fully phased in, the Arney flat tax would "cost" the government as much as \$186 billion per year.⁷⁸ Because it is based on static analysis, however, this figure assumes that reduced tax rates and simplification would have no positive effect on the economy. Hence, it ignores the additional revenues produced by income growth (as well as the binding caps on federal spending that the Arney bill would impose).⁷⁹

A flat tax almost certainly would reduce long-term government borrowing since its reduced rates and lower taxes on savings and investment would boost economic growth. Each year, the result would be an expanding tax base and at least some reduction in outlays for certain means-tested programs and the unemployment compensation system. According to one relatively modest estimate of supply-side impact, a flat tax would increase the economy's long-run annual growth rate by just 0.5 percent. By the tenth year, national economic output would be \$578 billion higher than it would have been without a flat tax.⁸⁰ Government's "share" of this production of additional goods and services would be \$86 billion in tax revenue.⁸¹ By the twentieth

76 U.S. Treasury Department memorandum, "An Analysis of a Flat Rate Consumption Tax," undated.

77 News release, "The Fate of Flat Tax Critics," Office of Representative Richard K. Arney, December 8, 1994.

78 David Wessel, "Another Round: Talk of Tax Reform is Gaining Momentum, But Plans Vary Widely," *The Wall Street Journal*, January 31, 1995.

79 In its analysis of the Arney proposal, the Treasury Department admitted that "no attempt is made to estimate the tax-induced behavioral responses of either individuals or corporations. Following the standard revenue estimating conventions used by both the Office of Tax Analysis and the Joint Committee on Taxation, the macroeconomic aggregates, such as the level of compensation, prices, employment, and gross domestic product, have been assumed to be unchanged by the proposal."

80 Using \$7 trillion as an estimate of 1995 nominal GDP. The calculations compare GDP with 5.5 percent nominal growth to GDP with 6 percent nominal growth (assuming a similar inflation rate).

81 Assuming taxes would take only 15 percent of the added output. Since taxes currently consume about 19 percent of GDP, this estimate understates the potential supply-side impact on revenues.

eth year, added growth of 0.5 percent would mean an increase of more than \$2 trillion in GDP and additional tax revenues in excess of \$300 billion.

The revenue feedback from higher growth, however, probably would not be enough in the short term to offset the revenue lost from lower tax rates and elimination of the multiple taxation of capital income. Achieving a deficit-neutral flat tax (at least the Arney version) would require some restraints on government spending. And if lawmakers were forced to balance the budget by 2002, the limit on spending increases would have to be even more stringent.

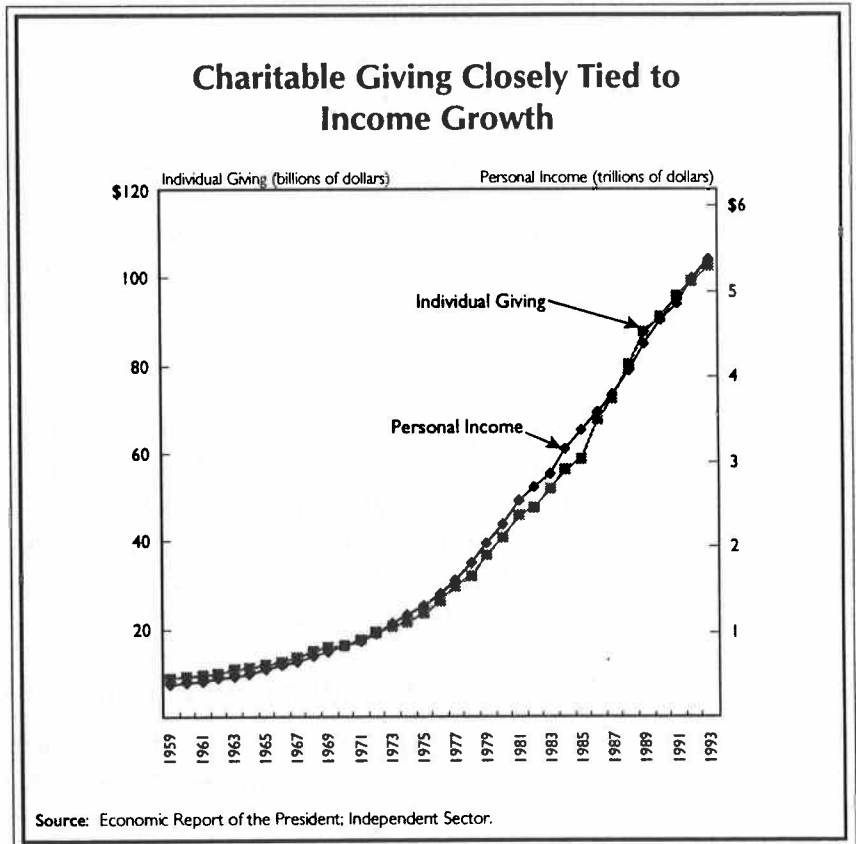
Q: What would happen to charitable contributions and the housing market?

A: While many recognize that a flat tax is far better than the current system, they fear that the transition would create problems—in particular, that the loss of charitable and home mortgage interest deductions could cause turmoil in affected markets. This is a legitimate concern. A wealthy individual donating money to a museum no longer could claim the gift as a deduction, reducing his tax burden by nearly 40 cents for every dollar given and thereby also reducing the “price” of his gift.

The loss of the home mortgage interest deduction would increase the after-tax cost of housing payments and could lead to a drop in housing values, since experts believe the value of the home mortgage interest deduction is factored into home values.

Fortunately, history suggests these fears are exaggerated. During the 1980s, the top tax rate was reduced dramatically, from

70 percent in 1980 to 28 percent in 1988. The effect was to slash the value of the deduction and raise the “price” of gifts. Similarly, the decline in tax rates increased the after-tax cost of mortgage payments. In fact, the after-tax costs of mortgage interest for homeowners and donations for charitable givers in the highest tax bracket jumped from 30 cents to 72 cents on the dollar, an increase of 140 percent. Most other taxpayers also experienced a significant increase in after-tax costs of contributions and mortgages.



If these sectors of the economy depended on the value of the tax deduction, there should have been a noticeable downturn in home values and charitable contributions during the 1980s.

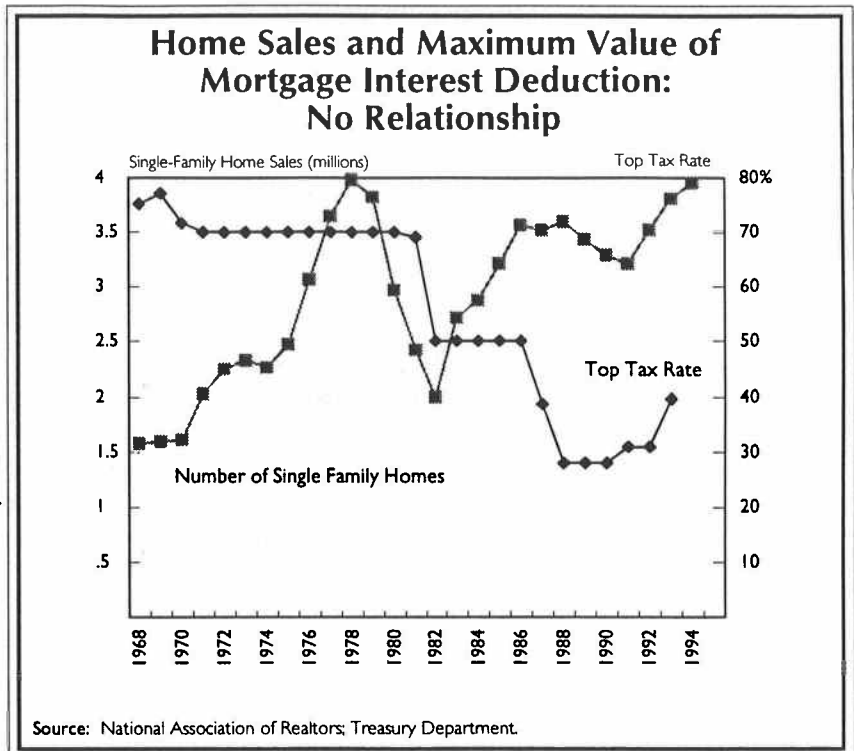
As the charts show, however, the value of housing did not drop. Also, charitable contributions rose throughout the 1980s even as the out-of-pocket cost to donors increased. These charts do not mean that lower tax rates necessarily encourage more charity and higher home values. They simply suggest that any adverse consequences from lower rates—or

from no deductions at all—can be offset if the economy's performance is robust. In other words, charitable contributions and housing values may well depend more on rising incomes and wealth creation than on tax status.

There is strong reason to believe, moreover, that a flat tax would stimulate the housing industry because of its impact on interest rates. The current tax treatment of mortgage interest—deductible to borrowers and taxable to lenders—results in artificially high interest rates.⁸² One need only compare the interest rate on tax-free municipal bonds with the interest rate on taxable bonds to see how tax treatment of interest results in unnecessarily high interest rates. If adoption of a flat tax reduced interest rates to the level enjoyed by municipal bonds, the impact on the housing industry would be substantive and positive.

Q: What would happen to the price of other assets?

A: While the potentially negative impact on housing markets and charity appears negligible, the positive impact on income-producing assets would be large. Assets such as stocks, bonds, and rental properties produce a stream of income over time. Their market price is determined by calculating how much income an asset will produce over time, after taxes, adjusted to reflect the fact that income today is worth more than the same amount of nominal income in the fu-



82 Hall and Rabushka, "The Flat Tax in 1995."

ture.⁸³ By lowering tax rates and removing the double and sometimes triple taxation of capital income, a flat tax can increase dramatically the after-tax income stream an asset will generate. Thus, a low-rate flat tax would be a boon to asset holders, offsetting any theoretical fall in housing prices, and would stimulate a surge of new investment in the economy. Harvard professor and tax economist Dale Jorgenson estimates that a flat tax would increase national wealth by \$1 trillion.⁸⁴ While this may seem high, it should be remembered that the mere announcement in Israel that a capital gains tax was being imposed caused the Israeli stock market to drop by 10 percent in just one day.⁸⁵

Q: Would a flat tax benefit everybody?

A: If the question is considered narrowly (will anyone's tax bill rise?) it depends on how a flat tax is structured. If it is designed to give the government as much money as it receives under the current system, and if there is no consideration of the increased revenue that would accrue from new job creation and higher economic growth, then it is impossible to avoid having winners and losers. In the long run, a flat tax presumably would generate higher incomes and living standards, raising after-tax income even for those who suffered a short-term tax increase. At the same time, it doubtless would have an adverse impact on the lawyers, accountants, and lobbyists who profit from the current law's complexity.

Many flat tax proposals are structured so that few taxpayers, if any, would have higher tax bills. This is because they are designed to go beyond simplification and rate reduction to include significant tax cuts for the American economy. The Arney plan is a good example. Using static estimating techniques, it probably would save taxpayers hundreds of billions of dollars over a five-year period. While the combination of a 17 percent tax rate and generous family exemption would not necessarily guarantee lower tax bills for everyone, few would face higher taxes.

Q: Is there a way to stop politicians from raising tax rates in the future?

A: There is no guarantee that a future Congress would not turn a simple flat tax back into a complicated "progressive" tax. This is the Achilles' Heel of tax reform. The sweeping reform enacted in 1986 expanded the tax base by eliminating many deductions while simultaneously reducing tax rates to keep the total tax burden from climbing. Skeptics warned that politicians could not be trusted to honor this arrangement and that eventually they would raise rates while failing to restore deductions. This is exactly what happened under Presidents Bush and Clinton.

Could this happen with a flat tax? Using the promise of low tax rates, could politicians take away the home mortgage interest deduction, the charitable contributions deduction, and other tax preferences but then raise tax rates in the future? It is to re-

83 In economic and financial circles, this concept is known as present value.

84 Conversation with author and Glassman, "Praise the Capital Gains Cut and Pass the Flat Tax."

85 Robert Stein, "How Low Capital Gains Taxes are Boosting Growth Overseas," *Investor's Business Daily*, December 22, 1994.

duce this danger that most proponents of a flat tax include an ironclad provision to make raising tax rates difficult or impossible. One way to accomplish this would be by amending the Constitution to require that no increase in tax rates can be approved without the votes of at least three-fifths or two-thirds (in other words, a “super-majority”) of both the House and Senate.⁸⁶

Q: Should the income tax be abolished instead?

A: Proponents of a flat tax note that the current “progressive” income tax penalizes growth, discourages savings and investment, imposes heavy compliance costs, destroys jobs, and reduces America’s international competitiveness. It has been pointed out, moreover, that a flat rate income tax reduces but does not eliminate these negative effects. Thus, the question for some becomes whether it would be better to replace the income tax with a sales or “consumption” tax. Proponents of this view, including House Ways and Means Committee Chairman Bill Archer (R-TX) and Senator Richard Lugar (R-IN), usually suggest that the foregone revenue could be offset by spending cuts, consumption taxes, or some combination of the two.

Most advocates of a flat tax recognize that this argument is sound, at least in theory. Abolishing the income tax, closing down the Internal Revenue Service, and repealing the 16th Amendment clearly would be in the national interest. Eliminating the income tax would lead to even more economic growth and job creation than would occur under a flat tax. The real question is how that goal can be achieved.

Supporters of the flat tax have decided that eliminating the income tax is unlikely, especially in the short run. Because so many interest groups benefit from the current tax system, enacting a flat tax will be difficult by itself. Moreover, there is some concern that proposals to abolish the income tax could play into the hands of those who want a national sales tax, or value added tax (VAT), as an add-on tax. If implemented as a replacement for the income tax, either of these would be less destructive to the economy. The experiences of other countries, however, suggest that, while a VAT would be implemented with the promise to eliminate other taxes, politicians would never take that second step. The country then would have the worst of both worlds: income *and* direct consumption taxes.⁸⁷ In any event, enacting a flat tax is probably necessary as an interim measure for those who favor eliminating the income tax.

Q: Would a flat tax eliminate the marriage penalty?

A: Probably, but – again – it depends on how the flat tax is structured.

The marriage penalty refers to the increased tax faced by a married couple compared

86 Some have argued that an amendment is not needed because Members recently voted to change the House rules to impose a three-fifths super-majority. While helpful, however, this rule easily could be repealed in the future by a simple majority vote.

87 For a discussion of the dangers of a Value Added Tax, see Daniel J. Mitchell, “How a Value Added Tax Would Harm the U.S. Economy,” Heritage Foundation *Background* No. 940, May 11, 1993.

to two single people with similar incomes. This penalty is most severe for couples with similar earnings. A flat tax automatically solves part of this problem by making it no longer possible for one spouse's income to push a couple into a higher tax bracket. But the marriage penalty also arises if the personal exemption for a married couple is not twice the size of the exemption for those filing singly. The Armev proposal solves this part of the problem by giving a married couple twice the exemption of a single filer. Nevertheless, a flat tax could be constructed that retains this penalty.

Q: How would a flat tax affect business and payroll taxes?

A: It would be possible to reform the personal income tax dramatically while leaving the corporate income tax untouched. As mentioned earlier, many businesses file using the personal tax code, so many of their problems would be solved by a flat tax that left the corporate tax code untouched. All flat taxes based on the Hall/Rabushka model, however, reform both the personal and corporate income tax codes. Under the Armev proposal, for instance, the business rate would fall to 17 percent, the same as the personal rate, and the code would be reformed to eliminate the excess taxation of capital.

A flat tax can be designed to include substantial reform of Social Security and Medicare payroll taxes. Under current law, payroll taxes totaling 15.3 percent are levied on the first \$61,600 of income (7.65 percent each from employer and employee, though economists agree that the entire tax is borne by the worker).⁸⁸ Although none has reached legislative form, some flat tax plans incorporate the payroll tax, making the total marginal tax rate a fixed percentage regardless of income.

Q: Would a flat tax help America compete?

A: The historic tax rate reductions launched by Ronald Reagan in the 1980s caused a chain reaction around the world. Many nations followed America's example and have made similarly dramatic reductions in marginal tax rates in recent years. In large part, this worldwide shift in tax policy was driven by competition as investors avoided nations with high tax rates. Unfortunately, America seems to be one of the few nations that have not learned from the experience of the 1980s. While the rest of the world has been cutting taxes, the United States stands alone as the only major nation to impose sharply higher tax rates in recent years. Investors have reacted accordingly, and the amount of new investment in American jobs and business from overseas has dropped from an average of \$175 billion per year during the low tax years of the 1980s to an average of only \$108 billion in 1990.⁸⁹

⁸⁸ The Medicare portion of the payroll tax (2.9 percent) is imposed on all "earned" income.

⁸⁹ *Economic Indicators* (Washington, D.C.: U.S. Government Printing Office, December 1994).

Q: What happens to capital gains taxes and estate taxes under a flat tax?

A: They are all eliminated. One of the key principles of a flat tax is that income is taxed only once. A capital gain for a financial asset is simply a reflection that the market's expectation of the after-tax streams of income from that asset has risen. Under a flat tax, that income is taxed at the business level when it is realized. To tax the capital gain is double taxation. Similarly, the estate tax is a second layer of tax on earning which, under the current system, already has been taxed at least once.

CONCLUSION

America's income tax system punishes the economy, imposes heavy compliance costs on taxpayers, rewards special interests, and makes America less competitive. A flat tax would reduce these costs drastically and create a tax system that rewards productive behavior. Perhaps more important, it would reduce the federal government's power over taxpayers' lives and get government out of the business of trying to micromanage the economy. No tax is good for the economy, but the flat tax moves the system much closer to where it should be—to being a tax that raises needed revenue in the least destructive and least intrusive way possible.

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APPENDIX 1: Taxes Affect Decisions to Work

- ✗ Joint research by economists from Princeton University and Brigham Young University, based on a random survey of physicians, found that a one percentage point increase in marginal tax rates is associated with a reduction of as much as 1.11 percent in hours worked.⁹⁰
- ✗ A University of California economist found that because of the Tax Reform Act of 1986 (which lowered tax rates), the work effort of high-income married women rose by 0.8 percent for every one percent their after-tax wages increased.⁹¹
- ✗ Another economist found that “Husbands of retirement age, 60 and over, show substantial variation in hours of work, related systematically to wages and income in the expected way.” Moreover, “Wives in all age groups are quite sensitive to wages and income.”⁹² In other words, as after-tax income falls, so does the incentive to work.
- ✗ Two other economists estimated that “wives’ labor supply will increase by 3.8 percent” in response to a reduction in the marriage penalty.⁹³
- ✗ A comprehensive study in *The Journal of Human Resources* found that taxes reduce married males’ hours of work by 2.6 percent and married females’ by between 10 percent and 30 percent.⁹⁴
- ✗ According to a statistical study in *Econometrica*, yearly hours of work for white married women increase by 2.3 percent for every one percent increase in after-tax earnings.⁹⁵
- ✗ While husbands are not as sensitive to taxes as wives, the impact of taxes on their behavior is nonetheless dramatic. One study found that they work eight percent less than they would in the absence of taxes.⁹⁶ This indicates a loss in economic output of at least \$1,000 per person.⁹⁷

90 Mark Showalter and Norman K. Thurston, “Taxes and Labor Supply of High-Income Physicians,” unpublished manuscript, October 21, 1994.

91 Nada Eissa, “Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment,” unpublished manuscript, September 1994.

92 Robert E. Hall, “Wages, Income, and Hours of Work in the U.S. Labor Force,” in G. Cain and H. Watts, eds., *Income Maintenance and Labor Supply* (Chicago: Markham, 1973).

93 Jerry Hausman and Paul Ruud, “Family Labor Supply with Taxes,” *American Economic Review*, Vol. 74, No. 2 (May 1984), pp. 242-248.

94 Robert K. Triest, “The Effect of Income Taxation on Labor Supply in the United States,” *The Journal of Human Resources*, Vol. XXV, No. 3, pp. 491-516.

95 Harvey S. Rosen, “Taxes in a Labor Supply Model with Joint Wage-Hours Determination,” *Econometrica*, Vol. 44, No. 3 (May 1976), pp. 485-507.

96 Jerry Hausman, “Labor Supply,” in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior* (Washington, D.C.: The Brookings Institution, 1981), pp. 27-83.

97 Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill Book Co., 1983).

- X All studies acknowledge that higher after-tax incomes increase incentives to work by increasing the “price” of leisure, but some assume this effect is offset because lower taxes allow workers to achieve a certain level of income by working fewer hours. While this trade-off is relevant when looking at individual choices, two economists note that “the generalization of the individual analysis to the economy as a whole is invalid” because “It will be impossible for *all* individuals to consume both more goods and more leisure as the individual work-leisure analysis implies.”⁹⁸ The actual economy-wide response to changes in tax rates will be higher than almost all studies indicate.⁹⁹
- X One econometric model found that a one percent reduction in tax rates increased work effort for lower-income workers by 0.1 percent, for middle and upper-middle-income workers by 0.25 percent, and for upper-income workers by more than 2.0 percent.¹⁰⁰

98 James Gwartney and Richard Stroup, “Labor Supply and Tax Rates: A Correction of the Record,” *American Economic Review*, Vol. 73, No. 3 (June 1983), pp. 446-451.

99 This is confirmed by other economists. See, for example, Paul Craig Roberts, “The Breakdown of the Keynesian Model,” *The Public Interest*, No. 52 (Summer 1978), pp. 20-33; Norman B. Ture, “The Economic Effects of Tax Changes: A Neoclassical Analysis,” in Richard H. Fink, ed., *Supply-Side Economics: A Critical Appraisal* (Frederick, Md.: University Publications of America, 1982); and William G. Laffer, “Virtues and Deficiencies of Supply-Side Economics Viewed From an Austrian Perspective,” unpublished manuscript, September 28, 1990.

100 Michael K. Evans, “New Developments in Econometric Modelling: Supply-Side Economics,” in Fink, *Supply-Side Economics: A Critical Appraisal*.

APPENDIX 2: Taxes Reduce Savings and Investment

- X In a book on taxes and capital formation, Norman B. Ture and B. Kenneth Sanden noted, "The bias against saving in the present tax system results from the fact that, with few exceptions, taxes are imposed both on the amount of current saving and on the future returns to such saving, whereas the tax falls only once on income used for consumption."¹⁰¹
- X Economist John Shoven estimates that a reduction of 20 percent in the top rate for capital gains would cause the stock market to rise by 3 percent.¹⁰²
- X Undersecretary of the Treasury Lawrence H. Summers has written that "increases in the real after-tax rate of return received by savers would lead to substantial increases in long-run capital accumulation." Further, "bequests may account for a large fraction of national capital formation," which strengthens the argument that taxes influence savings.¹⁰³
- X A study in *The American Political Science Review* noted that "Nations...where the extractive [tax] capacity of government did not significantly increase, relative to the economic product, have, in a sense, opted for...an increasing rate of private capital accumulation."¹⁰⁴
- X Analyzing the decline in savings, a study by three experts concluded that Social Security and other transfer programs have led to a "decline in U.S. saving."¹⁰⁵
- X Two other economists also concluded that Social Security reduces savings because workers no longer worry as much about retirement.¹⁰⁶
- X Econometric results, according to a study published in the *Journal of Public Economics*, "suggest that dividend taxes have important effects on investment decisions" and that "an increase of 10 percent in the stock market would raise the investment rate by about 15 percent."¹⁰⁷

101 Norman B. Ture and B. Kenneth Sanden, *The Effects of Tax Policy on Capital Formation* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1977).

102 John B. Shoven, "Alternative Tax Policies to Lower the U.S. Cost of Capital," in *Business Taxes, Capital Costs and Competitiveness*, American Council for Capital Formation Center for Policy Research.

103 Lawrence H. Summers, "The After-Tax Rate of Return Affects Private Savings," *American Economic Review*, Vol. 74, No. 2 (May 1984), pp. 249-253.

104 David Cameron, "The Expansion of the Public Economy: A Comparative Analysis," *The American Political Science Review*, Vol. 72 (1978), pp. 1243-1261.

105 Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in United States Saving: A Cohort Analysis," unpublished manuscript, November 1994.

106 Lawrence H. Summers and Chris Carroll, "Why Is United States National Saving So Low," *Brookings Papers on Economic Activity*, Vol. 2 (1987), pp. 607-635.

107 James M. Poterba and Lawrence H. Summers, "Dividend Taxes, Corporate Investment, and 'Q'," *Journal of Public Economics* 22 (1983), pp. 135-167.

X Writing in the *National Tax Journal*, three economists found “significant effects for the after-tax return on saving, after-tax cost of borrowing, or both.” The Reagan tax cuts “had a major impact on U.S. economic growth.”¹⁰⁸

108 Allen Sinai, Andrew Lin, and Russell Robins, “Taxes, Saving, and Investment: Some Empirical Evidence,” *National Tax Journal*, Vol. XXXVI, No. 3 (1983), pp. 321-345.

APPENDIX 3: Growth Is Weaker When Government Penalizes Economic Behavior

- X A 1983 World Bank study of twenty countries found that low-tax nations experience faster growth, generate more investment, and enjoy more rapid increases in productivity and standards of living than high-tax nations.¹⁰⁹
- X The tax system imposes between 22 cents and 54 cents of losses for every dollar raised, according to a labor-supply economist. For working wives, the losses are even higher: more than 58 cents for every dollar of tax revenue.¹¹⁰
- X Another study found that each 1.0 percent increase in the federal tax burden reduces economic growth by 1.8 percent and lowers national employment by 1.14 percent.¹¹¹
- X According to a statistical study published in the *American Economic Review*, for every dollar paid to the federal government in taxes, 33.2 cents is lost to the economy.¹¹²
- X The increased tax burden between 1965 and 1980 drove an estimated 1.9 million people out of the U.S. labor force.¹¹³
- X Statistical research published in *Lloyd's Bank Review* has found that in the U.K. each one percent rise in payroll taxes causes hiring to fall by approximately 1.4 percent. The same study estimated that each \$1 of additional tax revenue costs \$3 in lost economic output.¹¹⁴
- X A study printed in the *American Sociological Review* concluded that "Increases of one percent in the tax burden relative to household income are directly associated with a 2.8 percent decline in economic growth over three years, or just under one percent annually."¹¹⁵
- X An *American Economic Review* study found that every dollar of taxes could impose as much as \$4 of lost output on the economy, with the probable harm ranging between \$1.32 and \$1.47.¹¹⁶

109 Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence," World Bank Staff Working Paper No. 605, 1983.

110 Hausman, "Labor Supply."

111 William C. Dunkelberg and John Skorburg, "How Rising Tax Burdens Can Produce Recession," Cato Institute *Policy Analysis* No. 148, February 21, 1991.

112 C. L. Ballard, J. B. Shoven, and J. Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, Vol. 75, No. 1 (1985), pp. 128-138.

113 Otto Eckstein, "Tax Policy and Core Inflation, A Study Prepared for the Use of the Joint Economic Committee" (Washington, D.C.: U.S. Government Printing Office, 1980). See also L. Godfrey, "Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour" (Paris: Organization for Economic Cooperation and Development, 1975).

114 Michael Beenstock, "Taxation and Incentives in the U.K.," *Lloyds Bank Review*, No. 134 (October 1979), pp. 1-15.

115 Roger Friedland and Jimmy Sanders, "The Public Economy and Economic Growth in Western Market Economies," *American Sociological Review*, Vol. 50 (August 1985), pp. 421-437.

- ✗ A 1981 analysis of the Swedish economy in the *Journal of Political Economy* found that “The estimated long-run effects [of high marginal tax rates] are sufficient to explain up to 75 percent of the recent decline in the measured growth of the Swedish GNP.”¹¹⁷
- ✗ According to a former Treasury Department official, between 75 percent and 80 percent of the additional wealth generated by increased savings and investment goes to workers.¹¹⁸
- ✗ Another study in the *Journal of Political Economy* estimated that the corporate income tax costs more in lost output than it raises for the government. The “excess burden” is “123 percent of revenue.”¹¹⁹
- ✗ A 1984 study in the *American Economic Review* estimated “20.7 cents of welfare loss per additional dollar of tax revenue.”¹²⁰
- ✗ A study of U.S. taxes at the state level found that low-tax states grew 35 percent faster than high-tax states between 1970 and 1980.¹²¹ The relationship between growth and taxes among the states has been shown in literally dozens of studies.¹²²
- ✗ Another economist was able to illustrate a very strong inverse relation between average per capita growth rates and average tax rates on income and profits in developed countries.¹²³
- ✗ According to an article in the *Journal of Political Economy*, based on worldwide data, increasing the tax burden by ten percentage points will reduce annual growth by two percentage points.¹²⁴
- ✗ In a paper presented at the World Bank, two economists uncovered an “impressive negative relation between the rate of growth and the ratio of tax revenue to

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- 116 Edgar K. Browning, “On the Marginal Welfare Cost of Taxation,” *American Economic Review*, Vol. 77, No. 1 (March 1987), pp. 11-23.
- 117 Charles E. Stuart, “Swedish Tax Rates, Labor Supply, and Tax Revenues,” *Journal of Political Economy*, Vol. 89, No. 5 (1981), pp. 1020-1038.
- 118 Norman B. Ture, “Supply Side Analysis and Public Policy,” in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1982).
- 119 Jane G. Gravelle and Laurence J. Kotlikoff, “The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good,” *Journal of Political Economy*, Vol. 97, No. 4 (1989), pp. 749-780.
- 120 Charles Stuart, “Welfare Costs per Dollar of Additional Tax Revenue in the United States,” *American Economic Review*, Vol. 74, No. 3 (June 1984), pp. 352-362.
- 121 Richard K. Vedder, “Rich States, Poor States: How High Taxes Inhibit Growth,” *Journal of Contemporary Studies*, Fall 1982, pp. 19-32.
- 122 See Bruce Bartlett, “Impact of State and Local Taxes on Growth: Bibliography,” Alexis de Tocqueville Institution, 1995, and Richard K. Vedder, “Do Tax Increases Harm Economic Growth and Development?” *Arizona Issue Analysis*, Report No. 106, September 20, 1989 (Annotated Bibliography).
- 123 Charles Plosser, “The Search for Growth,” unpublished manuscript, August 1992.
- 124 Robert G. King and Sergio Rebelo, “Public Policy and Economic Growth: Developing Neoclassical Implications,” *Journal of Political Economy*, Vol. 98 (October 1990), pp. S126-S150.

GDP” as well as a “negative association between growth and...the ‘marginal’ income tax rate.”¹²⁵

- X Of the explosive growth of Hong Kong, Taiwan, Singapore, and South Korea, Hoover economist Alvin Rabushka has written that

The four Asian tigers adopted supply-side tax policies decades before the Reagan and Thatcher revolutions. Finance ministers oversaw systems of taxation that featured low rates and/or low levels of direct taxation of individuals and businesses, the absence of or very light charges on capital income (interest, dividends, capital gains), and a smorgasbord of inducements for domestic and foreign enterprises to invest and reinvest in each economy.¹²⁶

Other studies have found that the economy is harmed when government spends tax revenue:

- X A National Bureau of Economic Research study, using worldwide data, found that an increase “in government spending and taxation of 10 percentage points was predicted to decrease long-term growth rates by 1.4 percentage points.”¹²⁷
- X According to Daniel Landau, “The results of this study [published in the *Southern Economic Journal*] suggest a negative relationship exists between the share of government consumption expenditure in GDP and the rate of growth of per capita GDP.”¹²⁸
- X Two economists found that increases in U.S. government outlays for social programs “are associated with reductions in the growth rate.”¹²⁹

125 William Easterly and Sergio Rebelo, “Fiscal Policy and Economic Growth: An Empirical Investigation,” unpublished manuscript, March 1993.

126 Alvin Rabushka, “Tax Policy and Economic Growth in the Four Asian Tigers,” *Journal of Economic Growth*, Vol. 3, No. 1.

127 Eric M. Engen and Jonathan Skinner, “Fiscal Policy and Economic Growth,” *Working Paper Series*, No. 4223, National Bureau of Economic Research, December 1992.

128 Daniel Landau, “Government Expenditure and Economic Growth: A Cross-Country Survey,” *Southern Economic Journal*, Vol. 49 (January 1983), pp. 783-792.

129 John McCallum and Andre Blais, “Government, Special Interest Groups, and Economic Growth,” *Public Choice*, Vol. 54 (1987).

