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WHY LIBERALS SHOULD SUPPORT THE FLAT TAX

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The flat tax continues to gain support across the country as more and more Americans realize that the existing tax code cannot be fixed and should be replaced by a fair and simple tax code. Polls show that workers, investors, savers, entrepreneurs, farmers, small business owners, and the elderly are among the groups of Americans drawn to the proposal because they feel they will pay less in taxes, benefit from a faster growing economy, or simply avoid the hassle of today's mind-numbing tax code.

There is one group, however, which should support the flat tax but has yet to do so: liberals. Consider the following eight features and consequences of a flat tax which one would expect to appeal specifically to this group:

- ❶ **The key philosophical principle of the flat tax is equality.** All taxpayers play by the same rules, no matter how wealthy they are.
- ❷ **Lower rates result in the rich shouldering more of the tax burden.** This happened in the 1920s, the 1960s, and the 1980s.
- ❸ **Deductions disproportionately benefit the wealthy and others able to exploit loopholes.** Eliminating them with a flat tax allows for a lower rate for those with lower incomes.
- ❹ **Radically simplifying the code with a flat tax will help end the corrupting effect** of tax lobbyists and prevent politicians from exploiting the tax system to generate campaign contributions.
- ❺ **Because of a generous family-based allowance, the poor are shielded from the income tax burden.** A family of four pays no income tax on their first \$33,000.
- ❻ **The flat tax will boost wages and income for lower-income and middle-income workers** by eliminating the double, triple, and sometimes quadruple taxation of capital.
- ❼ **A pro-growth tax system will reduce the budget deficit** by increasing the tax base and reducing demands for government spending.
- ❽ **Lower-income and middle-income taxpayers will enjoy a more financially secure retirement** if they are not forced to pay a double tax on their savings.

A Brief Description of the Flat Tax

The most notable feature of a flat tax is that all income is taxed, but only once. Another major feature is “neutrality,” the term economists use when referring to a tax system which applies the same tax regardless of the source of income or how that income is spent. The third major feature is simplicity—for example, the two postcards which would replace the current system’s more than 600 forms if the Arme-y-Shelby flat tax is enacted.

Tax Forms on a Postcard: The Arme-y-Shelby Flat Tax

Form 1		Individual Wage Tax	1998
Your first name and initial (if joint return, also give spouse's name and initial)	Last name	Your social security number	
Home address (number and street including apartment number or rural route)		Spouse's social security number	
City, town, or post office, state and ZIP code		Your occupation	
		Spouse's occupation	
1 Wages and salary and Pensions		1	
2 Personal allowance			
(a) \$22,700 for married filing jointly		2(a)	
(b) \$11,350 for single		2(b)	
(c) \$14,850 for single head of household		2(c)	
3 Number of dependents, not including spouse		3	
4 Personal allowances for dependents (line 3 multiplied by \$5,300)		4	
5 Total personal allowances (line 2 plus line 4)		5	
6 Taxable wages (line 1 less line 5, if positive; otherwise zero)		6	
7 Tax (17% of line 6)		7	
8 Tax already paid		8	
9 Tax due (line 7 less line 8, if positive)		9	
10 Refund due (line 8 less line 7, if positive)		10	

Form 2		Business Tax	1998
Business name		Employer identification number	
Street address		County	
City, town, or post office, state and ZIP code		Principal product	
1 Gross revenue from sales		1	
2 Allowable costs			
(a) Purchases of goods, services, and materials		2(a)	
(b) Wages, salaries, and retirement benefits		2(b)	
(c) Purchases of capital equipment and land		2(c)	
3 Total allowable costs (sum of lines 2(a), 2(b), and 2(c))		3	
4 Taxable income (line 1 less line 3)		4	
5 Tax (17% of line 4)		5	
6 Carry-forward from 1997		6	
7 Interest on carry-forward (6 percent of line 6)		7	
8 Carry-forward into 1998 (line 6 plus line 7)		8	
9 Tax due (line 5 less line 8, if positive)		9	
10 Carry forward to 1999 (line 8 less line 5, if positive)		10	

Source: Office of Representative Dick Arme-y.

History illustrates that a flat tax will generate immense benefits for Americans of all backgrounds and incomes.¹ Honest liberals—those who are genuinely concerned about helping the less fortunate and who favor eliminating special advantages for the rich and powerful—should be among the strongest supporters of sweeping tax reform. There are some on the left, however, who oppose the flat tax in the belief that some short-term political advantage can be gained from fomenting class warfare—even if the ultimate victims are those who have the most to gain from a more rapidly growing economy.

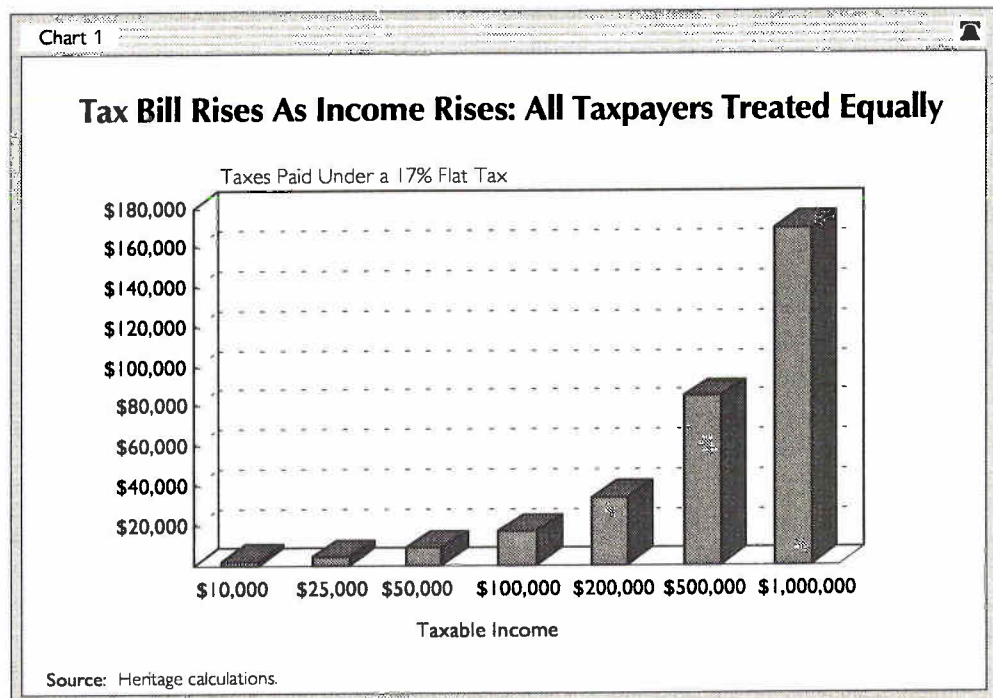
EIGHT REASONS FOR LIBERALS TO SUPPORT A FLAT TAX

1. A flat tax promotes equality.

Liberals often say they are fighting for equality. No other word better describes the flat tax, whose key principle is that the law should apply equally to all taxpayers and all income. More specifically, supporters of the flat tax believe all taxpayers should play by the same rules and that government should not grant special preferences or impose special penalties based on how income is earned or spent. Equality under the law means a tax system with just one rate for all levels of income. Anything else explicitly allows the government to discriminate among taxpayers and ultimately is self-defeating.

Chart 1 shows how the principle of equality applies to taxpayers with different

taxable incomes. Under a system that treats citizens equally, a taxpayer with twice as much taxable income as his neighbor pays twice as much in taxes.



2. The rich pay more.

Liberals often equate a fair tax system with one that results in the rich paying more. If so, the flat tax is the answer to their prayers. Why? While the flat tax is designed to treat all taxpayers equally, history strongly suggests that one effect of moving to a flat tax is that the share of the income tax burden borne by the rich actually will increase. America has had three major episodes of tax rate reduction—in the 1920s, 1960s, and 1980s. In each case, lower tax rates removed incentives to hide income, shelter income, reduce earnings, and transfer money overseas. The result: Upper-income

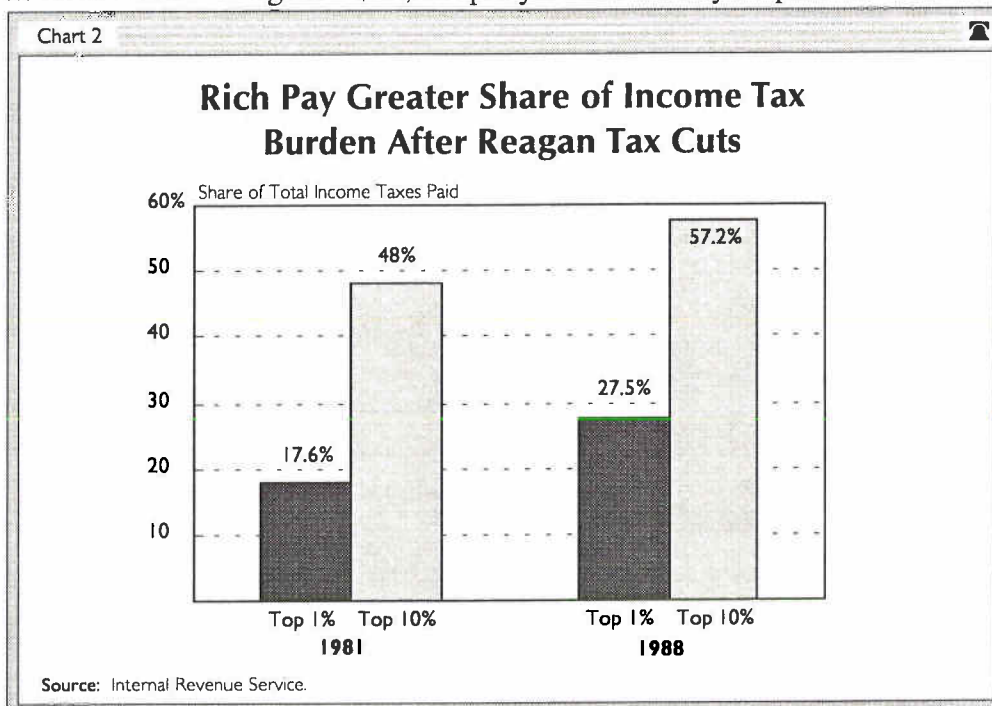
1 See, for example, Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995; see also Kemp Commission Report and Background Papers, *Tax Notes*, Vol. 70, No. 4 (January 22, 1996).

taxpayers were willing to earn and report more taxable income, and the amount of tax they paid increased. The evidence speaks for itself.

✓ **In the 1920s**, tax rates were reduced from a high of 73 percent to 25 percent between 1921 and 1926. Did the rich get a free ride? Hardly: The share of the tax burden paid by those making more than \$50,000—a great deal of money back then—rose dramatically, climbing from 44.2 percent in 1921 to 78.4 percent in 1928.²

✓ **In the 1960s**, the Kennedy tax cuts lowered the top rate from 91 percent to 70 percent. The result: Tax collections from those making over \$50,000 per year climbed by 57 percent between 1963 and 1966, while tax collections from those earning below \$50,000 rose 11 percent. As a result, the rich saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent.³

✓ **In the 1980s**, Ronald Reagan reduced the top rate from 70 percent in 1980 to 28 percent in



1988. The share of income taxes paid by the top 10 percent of earners jumped significantly, climbing from 48 percent in 1981 to 57 percent in 1988 (see Chart 2).⁴

3. Deductions help the rich.

Liberals presumably do not favor laws that confer special advantages on those with more income. Thus, the elimination of all loopholes, preferences, credits, exclusions, subsidies, and deductions under the flat tax should be particularly attractive to them. As Chart 3 illustrates, the three best-known deductions offer almost no benefit to the poor and middle class. Upper-income and wealthy taxpayers, by contrast, benefit immensely.

4. A flat tax ends special-interest tax lobbying.

There are 12,609 special interests officially registered to lobby in Washington, and the tax code is one of their chief targets.⁵ Former Members of Congress, former legislative staff members, consulting firm employees, and law firm partners are among those who can earn up to \$500 an hour wielding influence in the tax-writing committees of Congress. It is precisely this process that has caused

2 Staff study, *The Mellon and Kennedy Tax Cuts: A Review and Analysis*, Subcommittee on Monetary and Fiscal Policy, Joint Economic Committee, June 18, 1982.

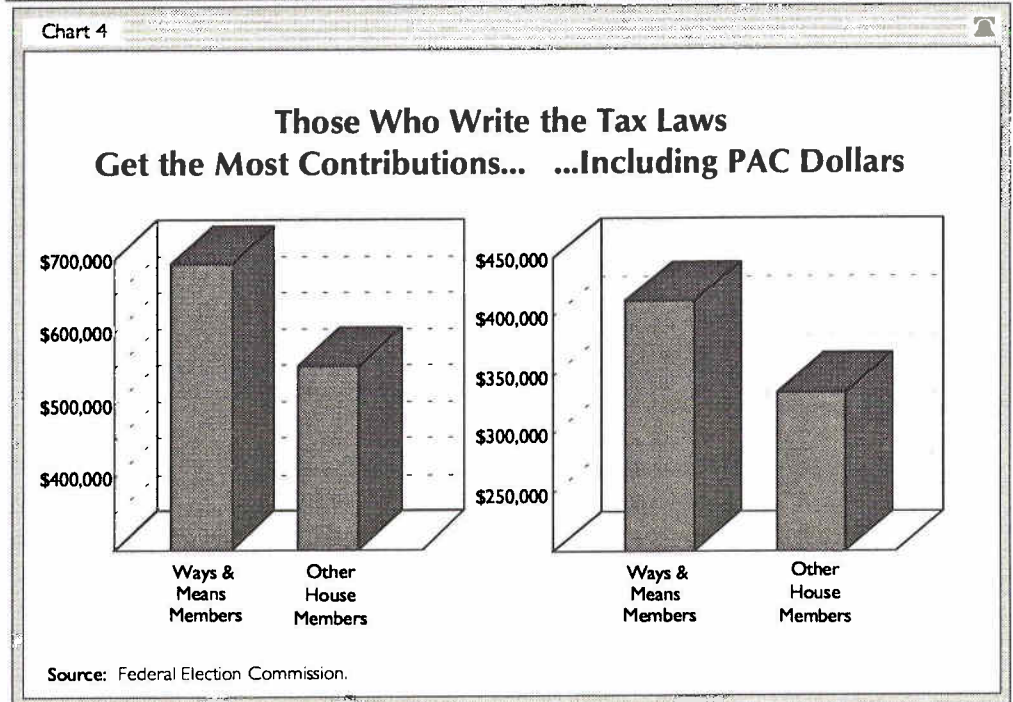
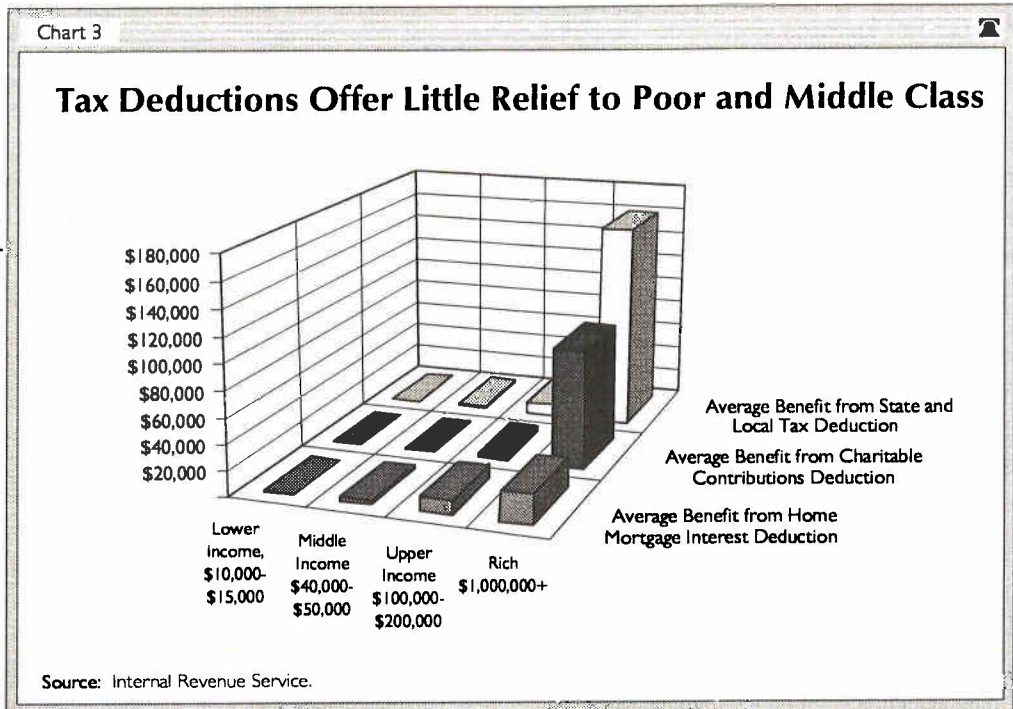
3 *Ibid.*

4 Tax Foundation *Tax Features*, various issues.

5 Based on information on file in office of the Clerk of the U.S. House of Representatives.

America's tax system, which began in 1913 with one simple form, to turn into a monstrosity encompassing more than 600 forms in which even the simplest—the 1040EZ—is accompanied by 33 pages of fine-print instructions.

While lobbyists are very well compensated for their efforts (and not all of them are looking for special loopholes; some are fighting to keep their tax bills from increasing), the biggest winners from the convoluted tax code are the politicians. Chart 4 shows the average contribution levels for members of the House tax-writing committee compared with the average for other House members. This is one reason why the House Ways and Means and Senate Finance Committees are considered the plum assignments for new Members of Congress.



5. The poor pay no tax.

The only loophole in the flat tax is the one that protects the poor. Under the Arney-Shelby proposal (H.R. 2060, S. 1050), a family of four does not pay the 17 percent rate until its annual income reaches \$33,300. This personal allowance, which is indexed to inflation to prevent bracket creep, is considerably above the poverty level and will ensure that even the low rate of a flat tax is not an impediment to those trying to climb the economic ladder.

As Chart 5 illustrates, the personal allowance also has the effect of making the tax system progressive. The tax rate on a family of four with \$30,000 of income would be zero compared to an effective rate of 2.8 percent for a family with \$40,000 of income and 5.7 percent for a family with earnings of \$50,000. The effective rate continues to rise with income, reaching 9.5 percent on

\$75,000 of income, 11.3 percent on \$100,000 of income, and 14.2 percent for a family with income of \$200,000. For the well-to-do, the effective rate approaches 17 percent, as families with \$500,000 of income pay 15.9 percent and a millionaire's household would pay 16.4 percent.

6. A flat tax promotes higher wages.

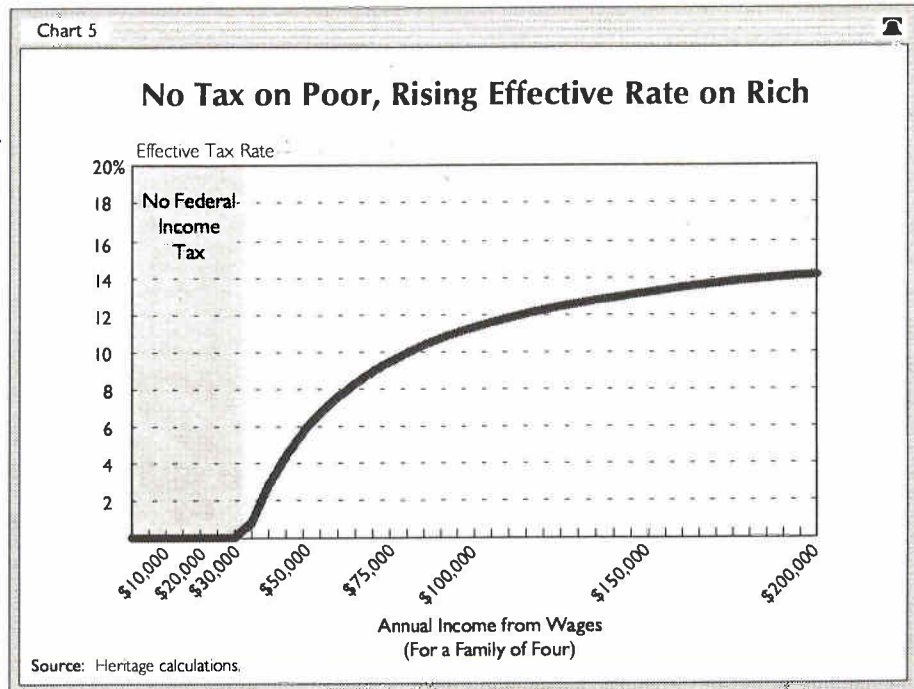
Considerable discussion has been devoted to the plight of the middle class. While some assertions are false (for example, middle-class incomes have not fallen over the last 20 years), there is no question that earnings could and should be rising at a faster rate. Fortunately, there is widespread agreement among all economists that the way to increase incomes is to make workers more productive by giving them more and better tools with which to produce. As liberal economist Paul Samuelson 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.⁶

Or consider the views of the White House. In the 1994 Economic Report of the President, the Administration noted that:

The reasons for wanting to raise the investment share of the GDP [gross domestic product] are straightforward: Workers are more productive when they are equipped with more and better capital, more productive workers earn higher real wages, and higher real wages are the mainspring of higher living standards. Few economic propositions are better supported than these—or more important.

History shows a very close relationship between worker income and productivity, indicating the importance of capital formation. Since the flat tax eliminates the multiple taxation of capital income, levels of savings and investment will climb, worker productivity will increase, and wages will rise.⁷



⁶ Paul A. Samuelson and William D. Nordhaus, *Economics*, 12th Edition (New York: McGraw-Hill, 1985), p. 789.

⁷ Even a small reduction in the excess tax burden on capital would have a pronounced effect. The modest capital gains provision in the vetoed Balanced Budget Act would have added \$80 billion to the economy over seven years. See William W. Beach, "Balanced Budget Talking Points #2: Who Will Benefit from Cuts in Capital Gains Taxes?" Heritage Foundation *F.Y.I.* No. 76, December 4, 1995.

7. Budget deficits are reduced.

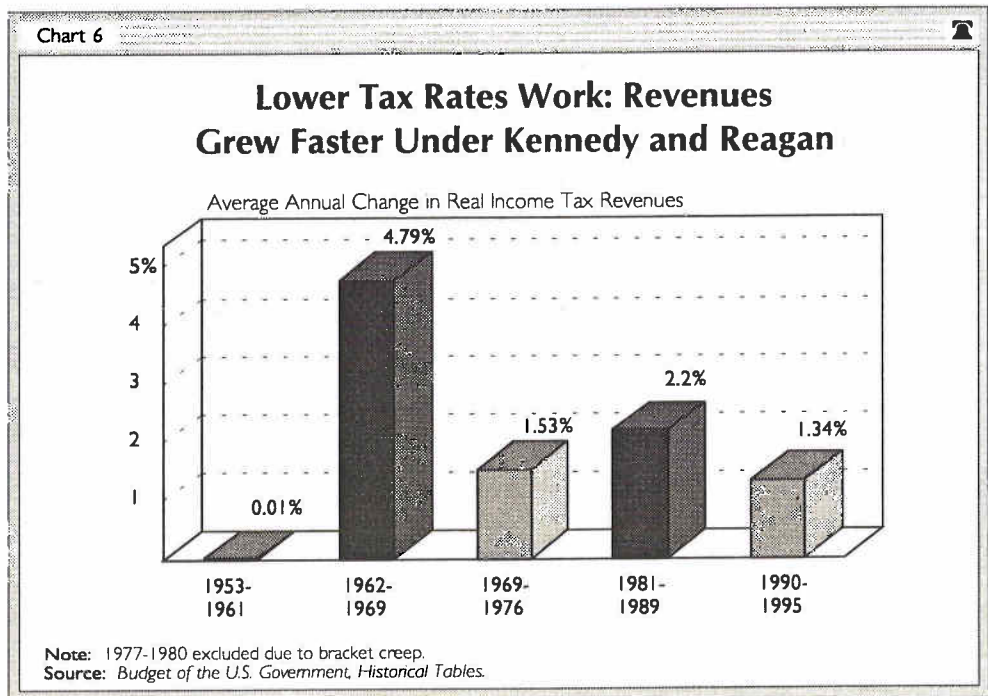
Another desirable feature of the flat tax, at least for liberals, is that government revenues will rise. As discussed earlier, the United States has had three major periods of tax rate reduction—the 1920s, 1960s, and 1980s. In addition to the fact that the rich paid a greater share of the tax burden and the economy boomed, these reductions resulted in dramatic increases in tax revenues.

✂ **In the 1920s, the top tax rate was slashed from 73 percent in 1921 to 25 percent by 1926.** Because of improved incentives to work, save, and invest, income tax revenues increased substantially, rising from \$719 million in 1921 to nearly \$1.2 billion in 1928, an increase of more than 61 percent during a period of virtually no inflation.

The White House today would do well to heed the words of then Treasury Secretary Andrew Mellon, who wrote that “The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being diverted into channels which yield neither revenue to the Government nor profit to the people.”⁸

✂ **In the 1960s, President John F. Kennedy proposed a series of tax rate reductions that resulted in legislation which reduced the maximum rate from 91 percent in 1963 to 70 percent by 1965.** Just as happened in the 1920s, tax revenues again grew significantly, rising by more than 16 percent between 1963 and 1966.⁹

As President Kennedy remarked in 1962, “an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget just as it will never produce enough jobs or enough profits.... In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now.”¹⁰



8 Andrew W. Mellon, *Taxation: The Peoples Business* (New York: Macmillan, 1924).

9 *The Mellon and Kennedy Tax Cuts: A Review and Analysis*.

10 John F. Kennedy, speech to Economic Club of New York, December 14, 1962.

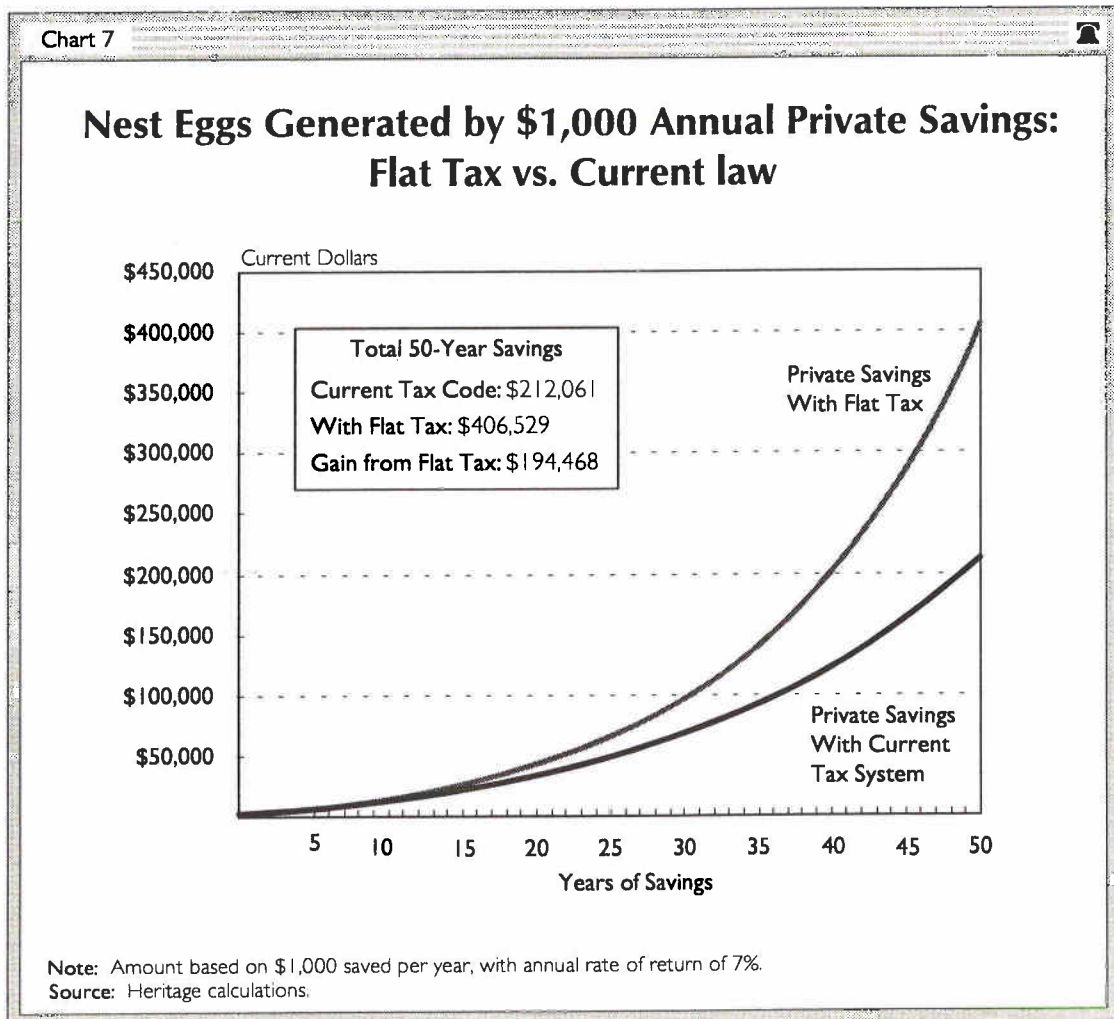
✂ In the 1980s, President Ronald Reagan presided over two major pieces of tax legislation which together reduced the top tax rate from 70 percent in 1980 to 28 percent by 1988. As supporters predicted, the tax cuts triggered the longest peacetime expansion of the economy in the nation's history. Critics charge, however, that Reagan's program caused big deficits.

These accusations may resonate politically in some quarters, but they are false. Reagan's critics conveniently forget that the first tax rate reductions, in 1981 and 1982, were offset by bracket creep and previously legislated payroll tax increases. Once the economy received an unambiguous tax cut, beginning in January 1983, income tax revenues climbed dramatically, increasing by more than 54 percent (28 percent after adjusting for inflation) by 1989.¹¹

8. Americans will have a more secure retirement.

America's Social Security system is in deep trouble. The bipartisan entitlement commission estimates the system's unfunded liability (the differences between how much is promised and how much will be available)

at a staggering \$7.3 trillion. With the baby boom generation approaching retirement, the Social Security Administration projects that the system will begin to run a deficit in less than 15 years. While there are ways to avert this upcoming catastrophe (the best option would be to follow the Chilean example of privatization),¹² it is widely expected that lawmakers will be reluctant to address such a politically charged issue.



11 Office of Management and Budget, *Budget of the United States Government, Historical Tables, FY 1996*.

12 Testimony of Michael Tanner, Director of Health and Welfare Studies, Cato Institute, before Subcommittee on Social Security and Family Policy, Committee on Finance, U.S. Senate, August 2, 1995.

This approach, unfortunately, means that the so-called baby boomers will face significant benefit reductions compared with what they are being promised and will be forced to augment their retirement income with private savings. The current tax system, however, punishes those who attempt to save and invest by imposing double, triple, and even quadruple taxation of savings and investment income. Even if income is “only” double-taxed, the effect on savings is dramatic. Chart 7 shows the difference in the nest eggs of someone who saves \$1,000 a year under the current system and someone who saves the same amount in a flat tax world in which income is taxed just once. As shown, the double tax on interest income imposed by today’s code dramatically reduces the amount which can be saved for retirement. By taxing income only once, the flat tax would allow interest earnings to compound, resulting in a nest egg almost 92 percent larger than the same amount of savings would generate under current law.

CONCLUSION

The U.S. tax system ostensibly is designed to make the rich pay more and improve living standards for those with lower incomes. Even a cursory examination of the facts, however, underscores that the biggest victims of a progressive income tax which punishes success are precisely those who are on the bottom rungs of the economic ladder. By achieving the effects outlined above, a flat tax therefore should attract the support of well-meaning people of all ideological persuasions.

This is a particularly important test for liberals. They must decide which is more important: maintaining lobbying power in Washington and keeping a tax system that may satisfy an ideological impulse to punish success, or adopting a system that ends special-interest corruption and helps boost the living standards of the less fortunate.

What Liberals Say About the Flat Tax

“The public, it seems, is thoroughly fed up with a tax system that is not only of baroque complexity, but also downright arbitrary in impact. Replacing the system with a low-rate tax on income—with few, if any, exclusions allowed—is an idea that, by promising efficiency, equity, and simplicity, appeals to all parts of the political spectrum.”

Washington Post Editorial
June 3, 1982

“The ideal income tax would be a flat percentage of all income above an arbitrary threshold of, say, \$10,000 a year. It would be simple, quick, and easy. As for fairness, it would be no less fair than the present tangle of exemptions, deductions, and credits that are currently producing not equity but a widespread public cynicism and hostility. The flat tax is the obvious remedy.”

Washington Post Editorial
April 15, 1982

“I believe what the country needs—and what the American people want—is a return to a fair and simple system of taxation. The legislation I am introducing today, the Income Tax Simplification Act of 1982, would eliminate virtually all deductions, credits, and exclusions. Instead of the current tax rate that ranges from 12 to 50 percent, it would establish a flat rate tax of 19 percent on gross income minus basic business expenses.”

Then-Congressman Leon Panetta
Current Chief of Staff, Clinton White House
April 5, 1982

“Remarkably, there is a reform that achieves all these objectives [integration, simplification, help the poor]. Robert Hall and Alvin Rabushka, economists at the Hoover Institution, have proposed an integrated code that applies a single rate to both personal and corporate income. Their plan wipes away most deductions and exemptions, permitting a low tax rate of 19 percent...a superb idea....”

New York Times Editorial
March 27, 1992

“A flat tax...would eliminate the parasitic class of tax-fixers who exempt the rich and the corporations from their fair share, and also eliminate the pulverizing bureaucracy which keeps people in permanent, servile confusion about whether or not they have complied with the law.”

Christopher Hitchens
The Nation, December 12, 1994

“[The flat tax] offers something we on the left should always welcome: an opportunity to think about fundamental change. The plan has its flaws, some of them serious. But the intent—to clean the Augean stables of the present tax code, with its labyrinth of exemptions, exclusions and credits, producing a revenue loss, at \$393 billion, equal to the federal deficit—is entirely laudable.”

“Why the Left Should Support the Flat Tax”
Alexander Cockburn and Robert Pollin
The Wall Street Journal, April 2, 1992