4. The Flat Tax and the Economy

TAX REFORM ALONG the lines of our simple tax will influence the American economy profoundly: Improved incentives for work, entrepreneurial activity, and capital formation will substantially raise national output and the standard of living. Everyone would favor such an economic renaissance. But what about some of the other effects of tax reform? Is it a giveaway to the rich? Will it destroy the housing market by ending mortgage deductions? Can charitable institutions survive without tax deductions for gifts? Can the flat tax end the federal deficit? These questions have occurred to almost everyone who ponders our radical reform, and we take those questions seriously. This chapter tries to take an honest look at those major economic issues.

STIMULUS TO GROWTH

The flat tax, at a low, uniform rate of 19 percent, will improve the performance of the U.S. economy. Improved incentives to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxes on entrepreneurial effort will enhance this critical input to the economy.

Work Effort

About two-thirds of today's taxpayers enjoy the low income tax rate of 15 percent enacted in 1986. Under the flat tax, more than half of these taxpayers would face zero tax rates because their total family earnings would fall short of the exemption amount ($25,500 for a family of four). The other half would face a slight increase in their tax rate on the margin, from 15 percent to 19 percent. In 1991, the remaining third of taxpayers were taxed at rates of 28 and 31 percent, and the addition of the 39.6 percent bracket in 1993 worsened incentives further. Heavily taxed people earn a disproportionate share of income: In 1991, 58 percent of all earnings were taxed at rates of 28 percent or higher. The net effect of the flat tax, with marginal rates of 0 and 19 percent, would be to dramatically improve incentives for almost everyone who is economically active.

One point we need to emphasize is that a family's marginal tax rate determines its incentives for all types of economic activity, which has caused some confusion. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of a married woman's earnings is the same as the marginal tax on the last dollar of her husband earnings. It is true that work incentives for a woman with a well-paid husband are seriously eroded by high tax rates. But so are her husband's incentives. What matters to both of them is how much of any extra dollar of earnings they will keep after taxes. Under the U.S. income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

Sheer hours of work make up one of the most important dimensions of productive effort and one that is known to be sensitive to incentives. At first, it may seem difficult for people to alter the amount of work they supply to the economy. Aren't most jobs forty hours a week, fifty-two weeks a year? It turns out that only a fraction of the workforce is restricted in that way. Most of us face genuine decisions about how much to work. Teenagers and young adults—in effect anyone before the responsibilities of parenthood—typically work much less than full time for the full year. Improving their incentives could easily make them switch from part-time to full-time work or cause them to spend less time taking it easy between jobs.

Married women remain one of the largest underutilized resources in the U.S. economy, although a growing fraction enters the labor market each year. In 1993, only 58 percent of all women over fifteen were at work or looking for work; the remaining 42 percent were spending their time at home or in school but could be drawn into the market if the incentives were right. There is no doubt about the sensitivity of married women to economic incentives. Studies show a systematic tendency for women with low after-tax wages and high-income husbands to work little. Those with high after-tax wages and lower-income husbands work a lot. It is thus reasonable to infer that sharply reduced marginal tax rates on married women's earnings will further stimulate their interest in the market.

Another remarkable source of unused labor power in the United States is men who have taken early retirement. Although 92 percent of men aged twenty-five to fifty-four are in the labor force, only 65 percent of those from fifty-five to sixty-four are at work or looking for work—just 17 percent of those over sixty-five. Again, retirement is a matter of incentives. High marginal taxes on earnings discourage many perfectly fit men from continuing to work. Because mature men are among the best paid in the economy, a great many of them face marginal tax rates of 28, 36, or even 40 percent. A uniform 19 percent rate could significantly reduce early retirement and make better use of the skills of older men.

Economists have devoted a great deal of effort to measuring the potential stimulus to work from tax reform. Their consensus is that all groups of workers would respond to the flat tax by raising their work effort. A few workers would reduce their hours either because the flat rate would exceed their current marginal rate or because the reform would add so much to their incomes that they would feel that earning was less urgent. But the great majority would face much improved incentives. The smallest responses are from adult men and the largest from married women.

In the light of the research on labor supply, were we to switch from the current tax law to our proposed flat tax, a reasonable projection is an increase of about 4 percent in total hours of work in the U.S. economy. That increase would mean about one and a half hours a week on average but would take the form of second jobs for some workers, more weeks of work a year for others, and more hours a week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 3 percent, or almost $200 billion. That is nearly $750 per person, an astonishing sum. Of course, it might take some time for the full influence of improved incentives to take effect. But the bottom line is unambiguous: Tax reform would have an important favorable effect on total work effort.

Capital Formation

Economists are far from agreement on the impact of tax reform on investment. As we stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. Erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level, however, combine to limit the adverse impact. The current tax system subsidizes investment through tax-favored entities such as pension funds, while taxing capital formation heavily if it takes the form of new businesses. The result has been to sustain capital formation at reasonably high levels but to channel the investment into inefficient uses.

The most important structural bias of the existing system is the double taxation of business income earned in corporations and paid out to shareholders. Double taxation dramatically reduces the incentive to create new businesses in risky lines where debt financing is not available. On the other side, the existing system places no current tax on investments that can be financed by debt and where the debt is held by pension funds or other nontaxed entities. The result is a huge twist in incentives, away from entrepreneurial activities and toward safe, debt-financed activities.

The flat tax would eliminate the harmful twist in the current tax system. The flat tax has a single, uniform incentive for investment of all types—businesses would treat all purchases of capital equipment and buildings as expenses. As we noted in the last chapter, allowing an immediate write-off of investment is the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Public finance economists Alan Auerbach and Laurence Kotlikoff estimate that using a flat-rate consumption tax in place of an income tax would raise the ratio of capital stock to GDP from 5.0 to 6.2. Other economists are less optimistic that correcting the double taxation of saving would provide the resources for this large an increase in investment. But all agree that there would be *some* favorable effect on capital formation.

In terms of added GDP, the increase in the capital stock projected by Auerbach and Kotlikoff would translate into 6 percent more goods and services. Not all this extra growth would occur within the seven years after the flat tax goes into effect. But, even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict a 2 to 4 percent increase in GDP on account of added capital formation within seven years.

Tax reform would improve the productivity of capital by directing investment to the most productive uses. Auerbach has demonstrated, in a paper published by the Brookings Institution, that the bias of the current tax system toward equipment and away from structures imposes a small but important burden on the economy. The flat tax would correct this bias. Auerbach estimates that the correction would be equivalent to a 3.2 percent increase in the capital stock. GNP would rise on this account by 0.8 percent.

Entrepreneurial Incentives and Effort

U.S. economic growth has slowed in the past two decades, and surely one reason is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There are no scholarly studies with quantitative conclusions on the overall benefits from a fundamental shift, but they could be large.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and those individuals who have figured out how to avoid paying income tax on their interest. These people do not like to make loans to new businesses based on great new ideas. They do like making loans that are secured to readily marketable assets by mortgages or similar arrangements. It is easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds will not lend money to entrepreneurs with new ideas because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture-capital market operates for exactly this purpose. But the cost to the entrepreneur is high—the ownership given to the financial backers deprives the entrepreneur of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky, innovative business. Even with the best tax system, or no taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and thus capture the entire future profits of a new business. Equity participation by investors is a fact of life. But the perverse tax system greatly worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments is actually close to confiscation. The owners of a successful new business are taxed first when the profits flow in, at 34 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 40 percent personal income tax bracket, making the combined effective tax rate close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners who put up the capital and then surrenders well over half the remainder to the government.

The prospective entrepreneur will likely be attracted to the easier life of the investor who uses borrowed money. How much easier it is to put up a shopping center, borrow from a pension fund or insurance company, and deduct everything paid to the inactive investor.

Today's absurd system taxes entrepreneurial success at 60 percent while actually subsidizing some leveraged investments. Our simple tax would put the same low rate on both activities. A huge redirection of national effort would follow that could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle; but tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, the areas where confiscatory taxation has discouraged investment. The contribution to income from new resources will be correspondingly high.

Total Potential Growth from Improved Incentives

We project a 3 percent increase in output from increased total work in the U.S. economy and an additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 6 percent is our best estimate of the improvement in real incomes after the economy has had seven years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative.

Even this limited claim for economic improvement represents enormous progress. By 2002, it would mean each American will have an income about $1,900 higher, in 1995 dollars, as a consequence of tax reform.

INCOME DISTRIBUTION AND FAIRNESS

The flat tax would not make everyone better off straightaway. Today, heavy taxation of successful salary earners and entrepreneurs yields quite a bit of revenue, pushing these people out of their most productive undertakings and diverting their attention to tax avoidance. Until a response to improved incentives takes place, the lower taxes on some people will have to be made up by higher taxes on others. If tax reform were a zero-sum process, giving relief to some by raising taxes on others, it would be unlikely to occur. Revitalizing the economy, with more income to divide between the big earners and the rest, is the point of tax reform. Our flat tax, however, is designed to be fair from the start. It will insulate the poor from all taxation and will dramatically limit the taxation of wages and salaries, especially among those who are most successful and productive. It will pay for these tax reductions by imposing a sensible tax at a low rate on business income, thus *raising* the amount of federal revenue collected from businesses.

Table 4.1 Comparison of Current Tax and Flat Tax by Earnings

Earnings	*Current Tax*	*Flat Tax*
$7,800	$7	$0
12,500	157	0
17,500	567	0
22,500	1,346	525
27,500	2,020	1,483
35,000	3,027	2,894
44,500	4,375	4,758
60,000	7,338	7,734
85,000	12,786	12,475
130,000	23,554	21,028

Taxes on Wages and Salaries

We will now compare the current tax with the flat tax for families who have nothing but wage income; these comparisons are relevant for the great majority of Americans.

Table 4.1 shows the taxes that would have been paid under the 1991 personal income tax and under the flat-tax system (with the 1991 levels of personal allowances) by a married couple. (We have to go back to 1991 because it is the last year for which income tax data are available as we write.) At each earnings level, the current tax is the average amount of tax paid by married taxpayers with that income (defined as adjusted gross income). To calculate the flat tax that would have been paid by the typical family, we assumed that each family had 1.1 dependents, the actual average in 1991.

The table shows that people at every level of earnings will pay about the same or less under the flat wage tax than under the current personal income tax. Below about $10,000, neither tax system imposes any significant tax, in line with the national consensus that the poor should be excused from taxation. For earnings in the range of $10,000 to $30,000, the flat tax is substantially less than the current tax. The flat tax's generous allowances of $16,500 for a married couple plus $4,500 a child keep the middle-income tax burden at a low level. The flat tax is a little higher than the current income tax in the range from $30,000 to $90,000. For earnings of more than $100,000, the flat tax is lower because the current income tax has higher tax brackets that take effect in those income ranges.

Thus we see that high-salaried employees get a break under the flat tax in comparison to the current tax. Why do we advocate such a generous break for people who are well off? Incentives are the answer. To collect $23,554 from an individual with $130,000 in earnings, the 1991 system had to impose a marginal tax rate of 31 percent. For each dollar of extra pay for extra work, this person keeps only sixty-nine cents after income tax. Furthermore, even that high tax rate is no guarantee that anything like this much revenue will actually be collected from a family with this much salary. Remember that these computations refer to a family with no income apart from salary. In 1993, the situation was made worse by the addition of a new tax bracket with a 39.6 percent tax rate.

Recall that the flat-tax system will raise the same revenue as the current system. The individual wage tax component of the flat tax, however, will raise less revenue than the personal income tax, and, correspondingly, the business tax component of the flat tax will raise more revenue than the existing corporate income tax. Comparisons like the one we have just made are not the end of the story. For those families with interest, dividends, and other business income, we need to think about the taxes that they currently pay on that income under the present personal and corporate income taxes. We also need to think about the taxes they would pay under the flat business tax.

As we have stressed throughout this book, taxing business income under the present system is a complete mess. Despite the burdensome tax rates imposed on business income by the combination of the corporate and personal income taxes, the total amount of tax collected on business income is remarkably small. In 1991, revenue from the corporate income tax was only $98 billion. In addition, the tax paid on all nonwage income reported for the personal income tax was no more than $158 billion. Total revenue from business taxation was no more than $256 billion. By contrast, revenue from taxes on wages under the personal income tax was $290 billion. The average tax rate on business income (as defined for the flat tax) was 15.0 percent, and the average rate on wages was 10.4 percent.

The flat tax would put higher taxes on business income and lower taxes on wage income. The average tax rate on wages would be 8.5 percent (19 percent on the margin but less on the average because of the allowances). The average tax rate on business income would be exactly 19 percent. At 1991 levels, business tax revenue would rise from $256 billion under the present tax to $325 billion under the flat tax.

Ideally, we could calculate the impact of the shift to the flat tax on families with various levels of income. The wealthy family with large amounts of business income would pay more tax than at present because of the increase in the average tax rate from 15 percent to 19 percent. Unfortunately, we do not know much about the distribution of business income in the United States. A good deal but not all business income goes to the very rich. In that respect, a shift away from wage taxation and toward business taxation would be a progressive move.

Are there enough middle-income families with business income so that their total tax burden, counting both wage and business taxes, would rise after the shift to the flat tax? There is no way to tell. Data from income tax returns show a reasonable number of families whose reported incomes are in the range of $50,000 to $100,000 and who receive substantial business income. But we have no way of knowing how many of them are really middle income and how many are actually rich but have succeeded so well in understating their business income that they appear to be middle income.

There have to be quite a few families whose business incomes are grossly understated in their income tax returns. A total of $1,709 billion in business income was earned in the United States in 1991, but only $791 billion in business income was reported on individual returns that year. The chance that a dollar of business income would actually be reported was less than half. On the average, a family whose true business income was $120,000 reported only $55,000 in business income.

We summarize our conclusions about the distributional fairness of the flat tax as follows:

- The current personal and corporate taxes tax wages heavily and business income lightly. The flat tax would reverse this inequity and benefit the great majority of Americans, whose income comes almost entirely in the form of wages.
- In comparison to the current personal income tax on wages, the flat tax would impose a lower burden on both low earners and high earners.
- We can't tell if there are any income groups who would pay significantly higher taxes, including the wage taxes they would pay directly and the business taxes they would pay indirectly. This group could not include the poor, who receive almost no business income.

If we are right that improved incentives will actually raise real incomes by 6 percent after seven years, then it won't take long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax would be to reduce the after-tax incomes of people who have been aggressive and successful in keeping business income out of the hands of the IRS. The tax rates on their business incomes will rise to 19 percent. But these people are also likely to be able to take advantage of the growth of the economy stimulated by improved taxation.

Why Do Critics Say the Flat Tax Is Unfair?

Our flat-tax plan frequently encounters the criticism that it is unfair. Some economists claim that a flat tax inevitably hurts middle-income families, that a generous allowance will help the poor and low marginal rates will help the rich, but that the middle class bears the burden of tax reform under the flat tax. The critics are wrong because they fail to understand how unfair our current tax system is. Their calculations invariably take the adjusted gross incomes reported by taxpayers as if they were their true incomes. They fail to come to grips with the shocking fact that over half of all business income never shows up in anyone's adjusted gross income.

Because the critics are unaware of the additional revenue available from effectively taxing business income at a rate of 19 percent, they examine flat- rate plans that extract excessive revenue from working people and find that those plans put a heavy burden on middle-income wage and salary earners. They do not consider the option of raising a suitable amount of revenue from business income; instead, they propose to continue the current practice of generating almost all revenue by taxing wages and salaries. By letting business income continue to go virtually untaxed, they perpetuate the unfairness of the current tax system.

INTEREST RATES

The flat tax would pull down interest rates immediately. Today's high interest rates are sustained partly by the income tax deduction for interest paid and the tax on interest earned. The tax benefit ameliorates much of the pain of high interest, and the IRS takes part of the income from interest. Borrowers tolerate high interest rates and lenders require them. The simple tax would permit no deduction for interest paid and put no tax on interest received. Interest payments throughout the economy will be flows of after-tax income, thanks to taxation of business income at the source.

With the flat tax, borrowers will no longer be so tolerant of interest payments and lenders will no longer be concerned about taxes. The meeting of minds in the credit market, where borrowing equals lending, will inevitably occur at a lower interest rate. Potentially, the fall could be spectacular. Much borrowing comes from corporations and wealthy individuals who face marginal tax rates of 34 and 40 percent. The wealthy, however, almost by definition, are the big lenders in the economy. If every lender and every borrower were in the 40 percent bracket, a tax reform eliminating deduction and taxation of interest would cut interest rates by four-tenths—for example, from 10 to 6 percent. But the leakage problem in the United States is so great that the actual drop in interest would be far short of this huge potential. So much lending comes through the devices by which the well-to-do get their interest income under low tax rates that a drop of four-tenths would be impossible. Lenders taxed at low rates would be worse off if taxation were eliminated but interest rates fell by that much. In an economy with lenders enjoying low marginal rates before reform, the meeting of the minds would have to come at an interest rate well above six-tenths of the prereform level. But the decline would be at least a fifth—say from 10 percent to 8 percent. Reform would thus bring a noticeable drop in interest rates.

One direct piece of evidence is municipal bonds, which yield interest not taxed under the federal income tax. Tax reform would make all bonds like tax-free municipals, so the current rates on municipals may tell us something about the level of all interest rates after reform. In 1994, municipals yielded about one-sixth less interest than comparable taxable bonds. But this is a conservative measure of the likely fall in interest rates after reform. Today, tax-free rates are kept high because there are so many opportunities to own taxable bonds in low-tax ways. Why buy a bond from the city of Los Angeles paying 6 percent tax-free when you can create a personal pension fund and buy a Pacific Telesis bond paying 7 percent? Interest rates could easily fall to three-quarters of their present levels after tax reform; rates on tax-free securities would then fall a little as well.

The decline in interest rates brought about by putting interest on an after-tax basis would not by itself change the economy very much. To Ford Motors, contemplating borrowing to finance a modern plant, the attraction of lower rates would be offset by the cost of lost interest deductions. But the flat tax will do much more than put interest on an after-tax basis. Tax rates on corporations will be slashed to a uniform 19 percent from the double taxation of a 34 percent corporate rate on top of a personal rate of up to 39.6 percent. And investment incentives will be improved through first-year write-off. All told, borrowing for investment purposes will become a better deal. As the likely investment boom develops, borrowing will rise and tend to push up interest rates. In principle, interest rates could rise to their prereform levels, but only if the boom is vigorous. We cannot be sure what will happen to interest rates after tax reform, but we can be sure that high-interest, low-investment stagnation will not occur. Either interest rates will fall or investment will take off.

As a safe working hypothesis, we will assume that interest rates fall in the year after tax reform by about a fifth, say from 10 to 8 percent. We assume a quiescent underlying economy, not perturbed by sudden shifts in monetary policy, government spending, or oil prices. Now, let us look at borrowing decisions before and after reform. Suppose a prereform entrepreneur is considering an investment yielding $1 million a year in revenue and involving $800,000 in interest costs at 10 percent interest. Today the entrepreneur pays a 40 percent tax on the net income of $200,000, giving an after-tax flow of $120,000. After reform, the entrepreneur will earn the same $1 million and pay $640,000 interest on the same principal at 8 percent. There will be a 19 percent tax on the earnings ($190,000), without deducting interest. After-tax income is $1,000,000 minus $640,000 minus $190,000, which equals $170,000, well above the

$120,000 before reform. Reform is to the entrepreneur's advantage and to the advantage of capital formation. Gains from the lower tax rate more than make up for losses from denial of the interest deduction.

How can it be that both the entrepreneur and the government come out ahead from the tax reform? They don't—there is one element missing from this accounting. Before the reform, the government collected some tax on the interest paid by the entrepreneur—potentially as much as 40 percent of the $800,000, but, as our stories about leakage make clear, the government is actually lucky to get a small fraction of that potential.

To summarize, the flat tax automatically lowers interest rates. Without an interest deduction, borrowers require lower costs. Without an interest tax, lenders are satisfied with lower payments. The simple flat tax will have an important effect on interest rates. Lower interest rates will also stimulate the housing market, a matter of concern to almost everyone.

Housing

Everyone who hears about the flat tax, with no deductions for interest, worries about its effect on the housing market. Won't eliminating the deduction depress the prices of existing houses and impoverish the homeowner who can only afford a house because of its interest deductions? Our answer to all of these questions is no, but we freely concede that there is a significant issue here.

In all but the long run, house prices are set by the demand for houses because the supply can only change slowly. If tax reform increases the cost of carrying a house of given value, then demand will fall and house prices will fall correspondingly. For this reason, we are going to examine what happens to carrying costs before and after tax reform.

If tax reform had no effects on interest rates, its adverse effect on carrying costs and house values would be a foregone conclusion. A $200,000 house with a $120,000 mortgage at 10 percent has interest costs of $12,000 a year before deductions and $8,640 after deductions (for someone in the 28 percent tax bracket). The monthly carrying cost is $720. Take away the deductions and the carrying cost jumps to $12,000 per year, or $1000 per month. Inevitably, the prospective purchaser faced with this change would have to settle for a cheaper house. Collectively, the reluctance of purchasers would bring house prices down so that the buyers could afford the houses on the market.

As we stressed earlier, our tax reform will immediately lower interest rates. And lower rates bring higher house prices, a point dramatically impressed on homeowners in reverse in the early 1980s, when big increases in interest severely dampened the housing market. The total effect of reform will depend on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest. On the one hand, we have already indicated that there are good reasons to think interest rates would fall by about 2 percentage points—say from 10 to 8 percent for mortgages. The value of the lost deduction, on the other hand, depends on just what fraction of a house a prospective purchaser intends to finance. First-time home buyers typically, but not always, finance three-quarters or more of the price of a house. Some of them have family money or other wealth and make large down payments. Families moving up by selling existing houses generally plan on much larger equity positions in their new houses. Perhaps a down payment of 50 percent is the average, so families are paying interest (and deducting) on $500 per thousand dollars of house.

A second determinant of the carrying cost is the value of the deduction set by the marginal tax rate. Among homeowners, a marginal rate of 28 percent is typical, corresponding to a taxable income of $37,000 to $89,000. Interest carrying costs per thousand dollars of house are $50 a year before taxes ($500 borrowed at 10 percent interest) and $36 a year after taxes. When tax reform comes, the interest rate will fall to 8 percent and carrying costs will be $40 a year ($500 at 8 percent) both before and after taxes. Tax reform will put this buyer behind by $4 per thousand dollars of house a year, or $800 a year for the $200,000 house.

If this $800 a year were the end of the story, it would bring a modest decline in house prices. But there is another factor we haven't touched on yet. The buyer's equity position—the down payment—must come from somewhere. By putting wealth into a house, the buyer sacrifices the return that wealth would have earned elsewhere. The alternative return from the equity in the house is another component of the carrying cost. Tax reform almost surely reduces that component. As just one example, take a couple who could put wealth into an untaxed retirement fund if they didn't put it into a house. The fund holds bonds; after reform, the interest rate on bonds would be perhaps 3 percentage points lower, and so the implicit cost of the equity would be lower by the same amount.

To take a conservative estimate, tax reform might lower the implicit cost of equity by 1 percentage point as interest rates fall. Then the carrying costs of the buyer's equity would decline by $5 ($500 at 1 percent) per thousand dollars of house a year. Recall that the buyer has come out behind by $4 on the mortgage-interest side. On net, tax reform would *lower* the carrying costs by $5 minus $4, which equals $1 per thousand, or $200 a year for the $200,000 house. Then housing prices would actually rise a tiny amount under the impetus of tax reform.

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small—small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects—reducing interest rates and related costs of funds (thus stimulating housing and other asset markets) and denying interest deductions (depressing housing). To a reasonable approximation, then, these influences will cancel each other out.

If tax reform sets off a rip-roaring investment boom, interest rates might rise in the years following the immediate drop at the time of the reform. During this period, when corporations will be competing strongly with home buyers for available funds, house prices would lag behind an otherwise brisk economy. The same thing happened in the great investment boom of the late 1960s. But to get the strong economy and new jobs that go with an investment boom, minor disappointments in housing values would seem a reasonable price. In the long run, higher incomes will bring a stronger housing market.

What about the construction industry? Will a slump in new housing accompany a tax reform that banishes interest deductions, as the industry fears? The fate of the industry depends intimately on the price of existing housing. Were tax reform to depress housing by raising carrying costs, the public's interest in new houses would fall in parallel with its diminished enthusiasm for existing houses. Because tax reform will not dramatically alter carrying costs in one direction or another, it will not enrich or impoverish the construction industry.

So far, we have looked at the way prospective buyers might calculate what value of house they can afford. These calculations are the proximate determinants of house prices. But they have no bearing on the situation of an existing homeowner who has no intention of selling or buying. To the homeowner, loss of the tax deduction would be pure grief.

Our transition proposal takes care of the problem of existing mortgages without compromising the principles of the flat tax or diminishing its revenue. Homeowners would have the right to continue deducting 90 percent of their mortgage interest. Recall that the bank would then be required to pay tax on the interest it received, even though interest on new mortgages would be untaxed. Homeowners could expect to receive attractive propositions from their banks to rewrite their mortgages at an interest rate about 3 percentage points lower, but without tax deductibility. Even if banks and homeowners could not get together to lower rates, the homeowner could still deduct 90 percent of what he deducted before.

CHARITABLE CONTRIBUTIONS

Deducting contributions to worthy causes would be a thing of the past under our tax reform. Will the nation stop supporting its churches, hospitals, museums, and opera companies when the tax deduction disappears? We think not. But we should also be clear that incentives matter—the current tax system with high marginal rates and tax deductions provides inappropriately high incentives for some contributions. The immediate effect of tax reform may be a small decline in giving. Later, as the economy surges forward under the impetus of improved incentives for productive activity, giving will recover and likely exceed its current levels.

In 1991, total cash contributions to charitable causes were about $117 billion. Of this, only $61 billion was deducted on personal tax returns. Almost half of all contributions were not affected by the law permitting deduction. We confidently expect that the $56 billion in contributions being made today without any special tax benefits will continue. Further, the bulk of contributions are from people in modest tax brackets—only $28 billion in contributions were deducted in 1991 by families with taxable incomes of more than $75,000. In this connection, it is important to understand that well more than half of all cash contributions go to churches and that these gifts are generally from the middle of the income distribution.

Churches have nothing to fear from tax reform and, like most people and institutions, would have much to gain from better economic conditions brought about by reform. Despite their dominant position in gifts, churches are not the leaders in fighting a tax reform that denies deductions. Instead, institutions serving the absolute economic and social elite—universities, symphonies, opera companies, ballets, and museums—are protesting the loudest. No compelling case has ever been made that these worthy undertakings should be financed by anyone but their customers. A glance at the crowd in any of them will tell you that it is perverse to tax the typical American to subsidize the elite institutions. But granting tax deductions for gifts is precisely such a subsidy.

Tax reform will be a tremendous boon to the economic elite from the start. After all, those with high salaries will benefit directly and immediately from the reduction in the tax rate from 39.6 percent to 19 percent. Those with lightly taxed business income stand to benefit more indirectly in that their economic activities are severely distorted by the devices and activities they have adopted to avoid taxes. Freed from these distortions, they may well become better off even though they are paying more taxes. For both groups, removing tax deductions from their favorite cultural activities is a reasonable price to pay. With substantially higher after-tax incomes among their customers as well as donors, universities and other institutions will make up part or perhaps all of the ground they will lose when tax deductions disappear.

Major tax cuts in 1981 and 1986 cut the top marginal tax rate from 70 percent to 50 percent and then to 28 percent. As a result, major donors shifted from spending thirty-three-cent dollars to spending fifty-cent and then seventy-two-cent dollars for tax-deductible gifts. Despite these major reductions in incentives for the rich to give, donations to charity grew robustly (see table 4.2). Thus, there is a sound basis for our projection that contributions will not decline when the tax incentive diminishes.

THE FEDERAL DEFICIT

The federal deficit is one of the most conspicuous problems of the American economy. In 1993, the government spent about $255 billion more than it took in. The same thing seems likely to happen in future years. Is the federal government headed for bankruptcy? Is it essential to raise additional revenue in the near future in order to close the deficit? Would the flat tax be a better vehicle for raising the needed revenue?

Barring a miracle, the federal government will continue to operate seriously in the red for the rest of the 1990s. Experience in the past two decades shows that the federal government inevitably runs a deficit. Should the deficit threaten to shrink, politicians will rush in with tax cuts and spending increases to push the deficit

Table 4.2 Total Charitable Contributions versus Amount Deducted

Year	*Total Gifts (billions of dollars)*	*Tax Deductions (billions of dollars)*
1979	$43	$24
1980	49	26
1981	55	31
1982	59	33
1983	63	38
1984	69	42
1985	73	48
1986	84	54
1987	90	50
1988	98	51
1989	107	55
1990	112	57
1991	117	61
1992	122	Not available
1993	126	Not available

back to its normal high level. Because both tax rates and spending respond to the economic and political environment, no change in the tax system could make a permanent change in the deficit. Still, there are two ways that the flat tax would alter the environment. First, the flat tax will lower interest rates. Under our transition proposal, the government's outstanding debt would benefit immediately from the lower interest rates that would automatically accompany a reform that put interest on an after-tax basis. Second, the flat tax will stimulate economic growth. Because growth raises revenue more quickly than spending, it will further help reduce the deficit or permit lower taxes or higher spending.

If we are right that a chronic deficit is the inevitable result of political equilibrium, the effect of higher tax rates under either the current tax or the flat tax is more spending, not a lower deficit. Only a constitutional change in the taxing and spending system could alter the political equilibrium, not a switch to the flat tax.

LIFE IN A 19 PERCENT WORLD

What would life be like in a world with a 19 percent flat tax? The most important change is that we would spend time thinking about producing goods and services and improving productivity instead of remaining obsessed with exploiting tax-advantaged opportunities. With 40 percent top marginal rates, many high-income people feel that they cannot afford to reveal *any* significant income to the IRS. They put great effort into reducing taxable income and diverting their incomes to tax-free destinations. At 40 cents on the dollar, dishonesty is lucrative. At 19 percent, most people would relax. Evasion and avoidance are far less profitable at 19 percent than at 40 percent. Conversely, keeping eighty-one cents of every additional dollar of income is a stimulus to produce as much as possible. With taxes taking no more than nineteen cents from each additional dollar at every income level, most people will pursue those economic activities that bring the highest return and the most satisfaction, rather than the ones that minimize taxable income.

Think of the everyday kinds of decisions most people make that are governed by a steeply graduated tax-rate structure. Tickets for box seats at baseball stadiums, club memberships, business travel, company cars, and a host of other business outlays that incorporated and unincorporated firms regularly purchase would now cost the owners of that business eighty-one cents of after-tax income, rather than the current sixty cents. Business would be expected to run a tighter ship with the much higher returns that a 19 percent rate affords over current high rates.

Those who believe that life would grind to a halt with the loss of deductions for interest and charitable contributions need to consider how they would alter their lives the morning the flat tax took effect. They would fire their lawyers and accountants and instead seek advice and information on sound economic investments. Perhaps most important for the ordinary working American, the 19 percent world would abolish the annual nightmare of tax-return preparation in April. Both Forms 1 and 2 could be filled out in a few minutes on the basis of records that everyone keeps anyway.