# 2. What's Fair about Taxes?

ECONOMISTS AND POLITICIANS of all persuasions agree on three points. One, the federal income tax is not simple. Two, the federal income tax is too costly. Three, the federal income tax is not fair. However, economists and politicians do not agree on a fourth point: What does fair mean when it comes to taxes? This disagreement explains, in large measure, why it so difficult to find a replacement for the federal income tax that meets the other goals of simplicity and low cost.

In recent years, the issue of fairness has come to overwhelm the other two standards used to evaluate tax systems: cost (efficiency) and simplicity. Recall the 1992 presidential campaign. Candidate Bill Clinton preached that those who "benefited unfairly" in the 1980s [the Tax Reform Act of 1986 reduced the top tax rate on upper-income taxpayers from 50 percent to 28 percent] should pay their "fair share" in the 1990s. What did he mean by such terms as "benefited unfairly" and should pay their "fair share?" Were the 1985 tax rates fair before they were reduced in 1986? Were the Carter 1980 tax rates even fairer before they were reduced by President Reagan in 1981? Were the Eisenhower tax rates fairer still before President Kennedy initiated their reduction? Were the original rates in the first 1913 federal income tax unfair? Were the high rates that prevailed during World Wars I and II fair? Were Andrew Mellon's tax rate cuts unfair? Are the higher tax rates President Clinton signed into law in 1993 the hallmark of a fair tax system, or do rates have to rise to the Carter or Eisenhower levels to be fair?

No aspect of federal income tax policy has been more controversial, or caused more misery, than allegations that some individuals and income groups don't pay their fair share. This is especially true when it comes to the flat tax, which has been a centerpiece of tax policy debate since 1981 and which has been introduced in almost every Congress since 1982. Few economists or politicians challenge the flat tax on grounds of simplicity or efficiency; rather, their critiques rest primarily on one emotionally laden charge: It would give a windfall to the rich and, therefore, is unfair to the poor and the middle class. Opponents of the flat tax claim that it shifts the tax burden from wealthier to lower- and middle-income households.

Few critics of the flat tax defend the current system as fair. It's hard to imagine that any reasonable person would describe as fair an incomprehensible, costly system that requires professional advice, costs taxpayers and the economy hundreds of billions of dollars, treats taxpayers with similar incomes in radically different ways, and puts taxpayers at a severe disadvantage in dealing with the IRS. An NBC News/*Wall Street Journal* poll conducted during July 23—26, 1994, asked the following question: "Do you think that the current income tax system is basically fair, or basically unfair?" Fifty-nine percent replied "basically unfair"; only 38 percent said it was "basically fair." Two-thirds of those who said it was unfair thought it could only be made fair with a complete overhaul, not with some minor adjustments. This pattern of response was roughly similar between men and women, whites and blacks, all main occupational groups, Democrats and Republicans, Bush and Clinton voters, and liberals and conservatives. Perot voters, political independents, and those without college degrees said it was unfair in higher percentages. The only majority that said it was fair were those sixty-five and over.

Because of the virtual consensus on the efficiency and simplicity of the flat tax, the debate about the merits of a flat tax boils down to, Can it be fair? Can it be at least as fair, or more fair, than the current system? Is it more or less fair than other proposals that try to reduce the costs and complexities of the current system?

A flat rate of taxation is not a novel idea. Flat rates are in wide use throughout the United States. The best example is the Social Security tax, which levies one uniform rate on all employees and the self-employed. All workers are subject to a uniform tax rate for Medicare. The sales tax rate is the same for all consumers, rich and poor alike. Property tax rates on assessed valuations of real property are the same for all homeowners. All these tax rates are proportional to income, purchases, or property values. In general, government licenses and fees for government services are fixed regardless of income or wealth. Except for income taxes, flat-rate taxes are in wide use by, and supply most of the revenues for, all levels of government in the United States.

This chapter makes three important points. First, the flat tax is fair on the basis of historical and commonsense notions of fairness. Second, the flat tax is fair based on who pays, especially when compared with the current U.S. federal income tax system. Third, the flat tax enjoys wide support from all sides of the political spectrum and the media.

### WHAT'S FAIR?

Are there any objective definitions or standards of fairness we can use to choose among tax systems? Is one person's claim about what's fair just as valid as any other's? How can we apply a standard of fairness unless we know what it means?

Concepts of fairness can be found in popular, everyday usage as well as in formulations among lawyers, economists, philosophers, and theologians. All these can be found in the lengthy definitions found in most dictionaries. Here are some of the definitions of the adjectival use of *fair* that appear on pages 490 and 491 in the third edition of Houghton Mifflin's 1993 *American Heritage College Dictionary:* 6.a. Having or exhibiting a disposition that is free of favoritism or bias; impartial; 6.b. Just to all parties; equitable: *a fair deal*; 7. Being in accordance with relative merit or significance: *her fair share*; 8. Consistent with rules, logic, or ethics; 9. Mildly good; mildly satisfying; 10. Superficially true or appealing; specious.

The idiom *fair and square* is defined as "just and honest," while the idiom *no fair* means "something contrary to the rules." The list of synonyms further describes what is meant by fair: *just*, *equitable*, *impartial*, *unprejudiced*, *unbiased*, *objective*, *dispassionate*. All these words mean free from favoritism, self-interest, or bias in general. The dictionary states that the word *fair* is the most general of these terms. "*Just* stresses conformity with what is legally or ethically right or proper." "*Equitable* implies justice dictated by reason, conscience, and a natural sense of what is fair to all concerned." The other terms mean "lack of favoritism, detachment that permits impersonal judgment, or free from strong emotions." On the last meaning, President Clinton's denunciation of the Tax Reform Act of 1986, charging that "the rich benefited unfairly in the 1980s," epitomizes the expression of strong emotions.

Some comments on these definitions: Number 10 fits much of the political discourse that mars the discussion of tax policy and contradicts numbers 6 through 8, which get at the commonsense notion of fair. Number 9 is so subjective and personal that it is of no use in choosing among tax systems. Numbers 6—8 best capture what most people take fair to mean: impartial, equitable, in accordance with merit or significance, and consistent with rules, logic, and evidence. In short, everyone should receive the same, or equal, treatment.

Taking stock, we cannot find anything in the etymologies or meanings of any of these words that says or implies that a flat rate of taxation is unfair or that a graduated, multiple-rate tax structure is more fair than a single rate. On the contrary, we would argue that the meanings of *even*, *just*, and *equal*, in keeping with rules and logic, better fit a flat rate of taxation than any multiple-rate system that discriminates among different classes of taxpayers.

### FAIRNESS AND ECONOMISTS

When economists make judgments about fairness, they most often invoke the concept of equity. As it applies to taxation, and tax burdens in particular, equity has historically meant equal treatment of equals. This usage conforms to American constitutional guarantees of equal treatment before the law. To discriminate among equal classes of taxpayers is arbitrary, capricious, and generally regarded as wrong. In the dictionary senses listed above, discriminatory treatment is not just, impartial, or consistent with logic or a set of rules. So, for example, if two families earn identical incomes, the doctrine of equity implies that each should pay identical amounts in taxes.

In law, equity has a different, specific meaning. Here, *equity* refers to justice applied in circumstances covered by law yet influenced by principles of ethics and fairness, which serve to modify the rigor of common law. As applied to the example of two households with identical incomes, a wise tax system might want to reduce the tax burden of one family that incurred heavy medical expenditures, suffered the ravages of storm damage, or bore costs to move to a new job, compared with the other family that had no unusual expenditures. Applying different tax rates to the two families in similar circumstances, however, is an entirely different matter and would violate the norm of equity predicated on equal treatment under the law.

Economists use the term *horizontal equity* to mean that people under similar circumstances should bear equal tax burdens. As a general principle, a flat tax (also called a uniform, proportional, or single-rate tax) satisfies this norm. Even Harvard philosopher John Rawls, a fervent advocate of redistribution, concludes in his controversial book *A Theory of Justice* that "a proportional expenditure tax may be . . . the best tax scheme." The principle of equity embodied in the flat tax is that every taxpayer pays taxes in direct proportion to his income. As incomes double, triple, or grow tenfold, tax obligations double, triple, or rise tenfold. Those who earn more pay more.

In practice, the horizontal equity norm invariably includes a provision for exempting low-income families from income taxes. Today, this provision takes the form of a combination of personal exemptions and the standard deduction.

As recently as 1929, federal taxes from all sources amounted to a modest 3 percent of the gross national product (GNP). Since the end of the Korean War, federal taxes have averaged about 19 percent of GNP (regardless of the number of tax brackets and the level of the top marginal rate), a more than sixfold rise. Something dramatic happened during the years between the beginning of the Great Depression and the beginning of the New Deal to change the national political consensus on low taxation and limited government that prevailed during the first 175 years of our country's existence.

The dramatic growth in government went hand in hand with the belief that fiscal policy could be a tool for redistributing income. First, a huge increase in federal tax burdens was deemed essential to finance transfer payments and large government programs. Second, the imposition of steeply graduated tax rates was seen by many as a desirable way to achieve greater equality in the distribution of after-tax income. Those in charge of this intellectual and political transformation found a new norm of *vertical equity* with which to replace the former, established norm of horizontal equity. They called this new norm the *ability to pay*.

It is important to keep in mind that this new interpretation of equity, a redistributionist approach to achieving tax fairness, is not rooted in the philology of, or in traditional approaches to, fairness. The new approach, a twentieth-century phenomenon about a half century old, has come to mean that successful people, with above-average incomes, should have to pay higher fractions of their incomes in taxes. The penalty is imposed by applying a series of graduated tax rates in which additional chunks of income are taxed at steadily higher and higher rates. The 1993 tax bill, to illustrate the point, has five tax brackets. Married couples filing jointly pay 15 percent on the first $36,900 of taxable income, 28 percent on income between $36,900 and $89,150, 31 percent on the next $50,850 up to $140,000, 36 percent on the next $110,000 up to

$250,000, and 39.6 percent on all taxable income over $250,000.

Vertical equity does not fare well in practice. Despite attempts to equalize after-tax incomes through steeply graduated tax rates, one Congress after another has riddled the tax code with hundreds of loopholes that permit some millionaires to pay no income taxes whatsoever and some high earners to pay low taxes. Good examples are tax-free municipal bonds and charitable contributions. Other loopholes permit the wealthy to exploit tax shelters that reduce large incomes to modest levels of taxable income. One historian of the income tax, John Witte, has concluded that "there is no evidence that the income tax significantly redistributes income." The reason is that every time tax rates are increased, Congress, in response to political pressures from organized interest groups, inserts new deductions and loopholes into the tax code to offset the effects of higher rates. The ideology of vertical equity, or ability to pay, runs smack into the economic and political realities of economic distortions and well-organized interests.

More fundamentally, we believe that high tax rates abridge individual liberty in a free society. Politicians and intellectuals who support high tax rates to redistribute income to attain their egalitarian goals threaten individual freedom and self-reliance.

What is the correct amount of fairness based on the new doctrine of vertical equity? What share of total taxes should be borne by each income category? No one really seems to know, and the numbers change every few years. Politicians and intellectuals have trouble making up their minds on the right amount of fairness because there is no objective standard and because fairness is not cost-free. High tax rates reduce economic output. They also foster tax avoidance and evasion (see chapter 1). Concern with the disincentive costs of high tax rates has prompted successive presidents and Congresses to reduce the top tax bracket from 92 percent in the 1950s to 70 percent in the 1960s to 50 percent in the early 1980s to 28 percent in 1986. Each cut in the top bracket moved the norm of fairness closer to its historical meaning of horizontal equity.

So far we've talked about taxes in simple, everyday language. But some aspects of taxation are technical and require precise terminology. It may be useful here, and valuable in trying to understand the problems in the current U.S. income tax code and the benefits of our proposed flat-tax plan, to present concepts and definitions of tax jargon in ordinary English.

## TERMINOLOGY OF TAXATION— UNDERSTANDING TAXES

We begin with the *tax rate*. There are two notions of tax rate: *average*, or effective, tax rate and *marginal* tax rate. A taxpayer's average tax rate is the fraction of income paid in taxes. To calculate the average tax rate, divide taxes paid by income. For example, $1,000 paid in taxes on an income of $10,000 yields a 10 percent average tax rate. The average tax rate is sometimes defined as the tax *level* or tax *burden*. These three terms are often used interchangeably and can refer to one taxpayer, a group of taxpayers, or all taxpayers in the economy. The marginal tax rate, in contrast, applies to the last dollar earned. If the person earning \$10,000 gets \$11,000 and then pays \$1,200 in taxes, the tax on the extra \$1,000 is \$200 and the marginal rate is 20 percent. The average rate in this example rises from 10 to 10.9 percent. To use other popular terminology, the person's tax burden amounts to 10.9 percent, but he faces a marginal rate of 20 percent on his last chunk of income. It this example, as in most tax systems, the marginal rate exceeds the average rate.

The U.S. individual income tax system contains five tax brackets, ranging from a low of 15 percent to a high of 39.6 percent. (In 1985, it contained fourteen brackets that ranged between 11 and 50 percent, while in 1987, it contained only two brackets, 15 and 28 percent.) As increases in income push people into higher tax brackets, a greater proportion of each additional dollar of income is paid in taxes. Someone paying a marginal tax rate of 15 percent gets to keep 85 cents of each additional dollar; at 28 percent, 72 cents are left. At the current top rate of 39.6 percent, 60.4 cents are left. Under current law, a family with a taxable income of \$50,000 pays an average rate of 18 percent and faces a marginal rate of 28 percent. It is the top marginal rate, the tax on the last dollar earned, not the average rate (or tax burden), that sets incentives. The marginal rate determines whether the taxpayer decides to work overtime, search for a tax shelter, cheat on taxes, or go fishing.

The income tax has changed dramatically over time. Rates in the 1961 tax code ranged from 20 to 91 percent. However, 88 percent of all tax returns paid a marginal rate in the 20 to 22 percent category. Ten percent were in the 23 to 31 percent range, and only 2 percent exceeded 32 percent. For almost 90 percent of the taxpaying population, the 1961 tax code amounted to a 22 percent flat tax. By 1979, the picture was totally transformed: 45 percent of all taxpayers paid marginal tax rates of more than 23 percent. Millions of American taxpayers paid marginal rates that had been intended only for the very rich just two decades earlier.

What happened? Inflation pushed taxpayers into tax brackets with higher marginal rates, a phenomenon that is termed *bracket creep*. Even with no change in purchasing power (that is, the real purchasing power that remains after taxes and the effects of inflation are removed), taxpayers were pushed into ever-higher marginal tax brackets and their incentives were adversely affected.

The Economic Recovery Tax Act of 1981, recognizing the dangers of bracket creep, included a provision for indexing tax brackets, the personal exemption, and the standard deduction, or zero bracket, to offset the effects of inflation. Once indexing provisions were put in place, taxpayers would face higher tax brackets only when their real purchasing power increased.

Even without inflation, bracket creep is the effect of a *graduated tax rate structure*, which means that as a family's real income rises, it has to share an increasing fraction of each increment with the tax collector. Tax systems that aggressively try to redistribute income typically have heavily graduated rates. A graduated tax rate structure has the effect of cutting the government in on the growth of the economy, thereby transferring more and more of the national income into public hands, unless the government enacts tax reduction legislation—cutting rates or adding loopholes—to offset the trend. The dramatic rise in tax shelters, or what the government calls tax expenditures, in the 1970s was a direct consequence of the combined effect of inflation and graduated tax rates pushing taxpayers into higher brackets.

Indexing is a recent but not permanent feature of the income tax. Take the 1993 tax increase, for example. The new rates, reaching to 39.6 percent, took effect in the 1993 taxable year. However, the law provided that the two new brackets of 36 percent and 39.6 percent would not be indexed for inflation until after December 31, 1994, which meant that the 36 percent rate would affect taxpayers in the 1995 tax year at about \$135,000 in real, inflation-adjusted 1993 dollars (compared with \$140,000 stated in the law) and that the 39.6 percent rate would affect taxpayers in 1995 at about \$240,000 in real 1993 dollars (\$250,000 in the law). Inflation exceeding 4 percent would further exacerbate the impact of bracket creep. Moreover, it is possible that Congress will further postpone or completely suspend the indexing provision for the top two brackets. As evidence, previous changes in tax law introduced measures to phase out personal exemptions and up to 3 percent of itemized deductions above certain income levels but only through 1997. The 1993 tax law extends the phaseout provisions indefinitely.

It is important *not* to equate graduated rates with *progressivity*. A tax system is progressive when it takes an increasing share of a taxpayer's income as that person's income rises or, as we can now say, if the average tax rate rises with income. To illustrate, consider three families with incomes of $10,000, $20,000, and $30,000. Suppose the three families paid taxes of $500, $2,500, and $4,500, respectively. The first family thus pays 5 percent of its income in taxes, the second, 10 percent, and the third, 15 percent. Such payments would satisfy the definition of progressivity because families with larger incomes paid a higher share of their income in taxes than those with smaller incomes. But the tax rate is not graduated in this example—the marginal tax rate is 20 percent for all three families.

It is not necessary for a progressive tax system to have rising marginal rates. In chapter 3 we design a progressive system with one flat rate. The key is to provide each taxpayer with a personal allowance and to tax all income above that allowance at the one rate. The allowance constitutes a *threshold* of taxation: taxes are imposed on income above the threshold and exempted below the threshold. In fact, the current system, with its five graduated rates, may be regressive because it gives high-bracket taxpayers numerous opportunities for legal deductions that reduce their average rates below those of middle- or lower-middle-income families that cannot utilize them. One gift of art, for example, can completely wipe out all tax liabilities for a millionaire in any given year, a provision fought for and won by the art museums of America. The elite institutions—universities, art museums, dance troupes—that house vocal supporters of graduated tax rates remain the strongest supporters of unrestricted deductions for the rich who make gifts of art or appreciated stock *to them*. For the inhabitants of these institutions, fairness is no match for self-interest!

Any income tax requires a precise definition of income to know what is being taxed. Take gross domestic product (GDP), which is the most comprehensive measure of the annual value of goods and services produced by a nation. The *tax base* against which any structure of tax rates is applied is that portion of GDP that remains after all allowable deductions and exemptions have been removed. Those items that have been removed may take the forms of *exemptions* (usually an allowance for each member of a taxpaying household), *deductions* (special provisions in the law for mortgage interest, charitable contributions, the standard deduction for those with few itemized deductions, and so on), *exclusions* (moving expenses, retirement contributions), and *credits* (sums that can be credited against tax liabilities). Collectively, these four categories are known as *loopholes*, devices that allow taxpayers to reduce their taxes. They are also called *tax preference items* or *tax expenditures*, the equivalent of the taxes the government does not collect on those social or economic activities for which it may seek to influence behavior or is responding to interest group pressure; it is as if the government were paying taxpayers to conduct those activities.

The effect of loopholes is to *narrow the tax base*, which means that there is less income to tax. As documented in chapter 1, the federal government counted 50 tax expenditure items in 1967 that cost the IRS an estimated $37 billion in uncollected taxes. By 1981, the number of tax expenditures had grown to 104, with an estimated loss of $229 billion, a total that more than doubled to over $500 billion in foregone revenues in 1986. By 1989 the figure had fallen to about $400 billion, but by 1993 it again surpassed $500 billion. The effect of all these loopholes, demanded and obtained by special-interest groups, is that the tax base is in the neighborhood of half the GDP.

Chapter 1 described the harmful effects of *tax shelters*—investments designed to generate deductions to offset income rather than investments to produce goods and services that consumers want. Aggressive shelters attempt to provide deductions larger than the amount of money invested in them. Home ownership, the most common tax shelter, permits taxpayers to deduct mortgage interest and property taxes; these deductions encourage people to buy, not rent. Taxpayers with low marginal rates have smaller incentives to buy homes as tax shelters because they can claim only 15.0 cents in tax benefits from every dollar of mortgage interest, unlike those in the top bracket, who can claim 39.6 cents. In the current tax code, the richer you are, the larger the benefit, a curious feature of a structure of tax rates designed to make the rich pay their fair share.

Tax shelters are used to *avoid* taxes. *Tax avoidance*, which is perfectly legal, is simply taking advantage of opportunities created in law to give preference to certain kinds of expenditures or investments. The problem with tax avoidance (see chapter 1) is that higher tax rates prompt investors to be more concerned with the tax advantages of investing than with its economic benefits, which costs the economy billions of dollars in lost or misdirected output.

*Tax evasion*, a polite word for cheating, also rises in tandem with increases in marginal tax rates. *The underground economy*, in which people barter (exchange goods and services for other goods and services with no cash changing hands) or pay unreported cash for goods and services, is less efficient than the legal economy: barter is less likely to place goods and services in the hands of those most likely to value them, and illegal organizations cannot gain efficient scale and must spend resources avoiding detection. Moreover, as the underground economy grows, it reduces the tax base, thereby shifting the burden of taxes to those who fully report their income.

A technical term relating to the issues of fairness and fair share is the *distribution of the tax burden*, or *incidence* of taxation, which focuses on the tax burden, or the share of income paid in taxes, by different income groups. Most discussions of alternative tax proposals focus on how different categories of taxpayers—typically identified in deciles or quintiles as poor, low income, middle class, upper middle class, and rich—would gain or lose under rival plans.

Finally, a new tax system can raise additional revenue, maintain the same level of revenue as the current system, or reduce receipts. A *revenue-neutral* reform is one that leaves revenue unchanged. Some proponents of tax reform not only want to simplify the system and lower marginal rates but also want to shrink the size of government by lowering revenues. Other proponents of tax reform strive to raise revenues to balance the budget at current levels of spending. Our flat tax, presented in chapter 3, is a revenue-neutral replacement for the current federal individual and corporate income taxes. A revenue-neutral flat tax allows us to talk about the benefits of tax reform without becoming embroiled in such issues as the size of government (it's probably too intrusive in the economy), the budget deficit (it's probably not good), or the Social Security system (whose tax is earmarked to specific retirement benefits). These are all valid issues but are not the subject of this book.

## TYPES OF TAXES—A LEXICON

The U.S. government gets almost all its revenue from income taxes and Social Security taxes, with a very small portion from miscellaneous excise taxes, duties, fees, and charges. The states and localities, which are outside the scope of this book, rely heavily on sales and property taxes in addition to state and local income taxes. Less familiar is the terminology of consumption taxes, value-added taxes (VAT), excise taxes, wealth taxes, corporate taxes, and a myriad of other special levies. To understand the intricacies of the tax system and take part in public discussion on reforming the federal income tax, it is necessary to examine the major categories of federal taxation.

In fiscal year 1993, the federal government collected more than $1.1 trillion from the following sources: individual income tax (45 percent), social insurance taxes (38 percent), corporate income tax (9 percent), and excise taxes (4 percent), with the balance from estate and gift taxes, customs duties, and other miscellaneous items. (The exact percentages vary slightly from year to year; for example, corporate taxes vary with profitability.)

Sticking with 1993 for the moment, any proposal to replace the individual income tax would have to generate slightly more than $500 billion; any package that scrapped both the individual and corporate taxes would have to yield more than $600 billion. The plan set forth in chapter 3 is constructed to replace both individual and corporate taxes; it does not eliminate or replace social insurance, excises, customs, and other federal receipts. It is possible, of course, to do so, with a simple change in the tax rate. But the issue of the Social Security system is so large that, in our opinion, it requires separate treatment. It can happily coexist, however, with our simple flat tax.

### *Individual Income Tax*

Although nearly everyone comes into contact with the federal income tax, it is nonetheless useful to describe its main features. Basically, taxpayers add up their income from all taxable sources, subtract certain allowable deductions and exemptions for themselves, spouses, and dependents, and then apply a table of taxes or schedule of tax rates to the balance. The two main concepts that convert income into taxes are *adjusted gross income* and *taxable income*. Adjusted gross income is a close approximation in the tax law to the economic or ordinary notion of total income, excluding moving expenses, retirement plan contributions, and a few special deductions. The tax code exempts some forms of income as taxable for a variety of social, economic, or political reasons: interest on state and municipal bonds, welfare payments, food stamps, fringe benefits, and other transfer payments.

To arrive at taxable income, the law permits a wide variety of deductions to be subtracted from adjusted gross income. Among the most popular are home mortgage interest, charitable contributions, some state and local government taxes, excessive medical expenses, casualty losses, and unreimbursed business expenses. Or one can take a standard deduction in place of an itemized list. Taxpayers are also allowed one or more personal exemptions, depending on family size. The combination of personal exemptions and deductions constitutes the threshold of taxable income. High thresholds increase progressivity.

According to the national income accounts, total personal income in 1992 was about $5 trillion. In its spring 1994 *Statistics of Income Bulletin*, the IRS released a preliminary analysis of individual income tax returns for 1992 (which excludes corporate returns). Total adjusted gross income was $3.64 trillion (about 73 percent of personal income). Taxable income was $2.4 trillion (slightly less than half of personal income), and total individual income taxes were $476 billion (about 9.5 percent of personal income). The base of taxable income is not quite half the total amount of personal income received by individuals, a ratio that has remained steady for more than a decade.

Which items contributed most to the shrinking tax base for individual income tax? Total itemized deductions were $487 billion; the three largest were home mortgage interest, $194 billion, state and local taxes, $159 billion, and charitable contributions, $63 billion. The value of standard deductions was $368 billion. Total deductions were $843 billion. Personal exemptions contributed another $525 billion.

IRS data reveal some interesting patterns. In 1992, taxpayers reported $29 billion rental net income but $29 billion rental net losses, exactly canceling each other out. More alarming is farming, which generated $10.5 billion net income and $12.2 billion net losses. The IRS would come out ahead if farming were exempted from taxation.

For readers interested in the main sources of adjusted gross income, salaries and wages provided 77 percent; taxable interest, 4 percent; business (excluding corporations) net income, 4 percent; capital gains, 3 percent; partnership and S Corporation net income, just over 2 percent; dividends, 2 percent; and Social Security benefits, less than 1 percent. Other items include pensions, unemployment compensation, and estates or trusts. These numbers mean that the bulk of all individual income taxes comes from wages and salaries, reflecting that three-quarters of the gross domestic product is paid to labor.

With the passage of the 1993 tax increases, a series of five rates, from 15.0 percent on the lowest bracket to 39.6 percent on the highest bracket, are applied to taxable income. The rate schedule is different for single people, married people filing separate returns, married couples filing joint returns, and heads of households. For a married couple filing jointly in 1993, the standard deduction was $6,200 and each personal exemption was $3,250. A family of four thus received $15,600 in tax benefits, meaning that it paid fifteen cents in tax on its first dollar of adjusted gross income exceeding $15,600, or taxable income is adjusted gross income minus $15,600.

Pages and pages of tax tables simplify computing tax up to a taxable income of $100,000. Others have to use the tax rate schedules. Schedule Y-1, for married filing jointly, charges 15 percent on taxable income (amount on Form 1040, line 37) up to $36,900; thereafter, 28 percent up to $89,150; 31 percent up to $140,000; 36 percent up to $250,000; and, 39.6 percent over $250,000. However, it's not that simple.

The income tax provides for phaseouts of personal exemptions and a portion of itemized deductions for upper-income taxpayers. Personal exemptions are phased out over adjusted gross incomes of $108,450 to $230,950 for single individuals and $162,700 to $285,000 for married couples filing jointly. Three percent of the value of itemized deductions is gradually lost on adjusted gross incomes above $108,450 for all filers, without an upper limit. These phaseouts effectively raise the top marginal rates for persons caught in these ranges.

### *Corporate Income Tax*

Since 1981, the corporate income tax has generated, on average, about a fifth as much revenue as the individual income tax. But, unlike the individual income tax, it is hard to determine who pays the corporate tax.

It is important to distinguish between the *mechanics* of the corporate income tax and the *incidence* of it, that is, who really pays it. The first point is straightforward. Each year, every corporation files a corporate income tax return. The corporate tax is a tax on business, with deductions confined to expenses incurred doing business. To arrive at its business net income, a firm subtracts depreciation of capital, wages, pension contributions, goods and services purchased, interest paid, and a raft of special provisions too complicated to discuss here from gross receipts. The tax is extremely complicated; depreciation schedules that vary by item and a variety of methods can be used to calculate allowable depreciation. The rate structure applied to net income is mildly graduated, beginning at 15 percent of the first $50,000 of taxable income, rising to 25 percent on the next $25,000, and reaching a standard rate of 34 percent on income over $75,000. (A blip in the code applies a 39 percent rate to taxable income between $100,000 and $335,000, above which the 34 percent rate again takes hold.) The 1993 tax increase imposed a 35 percent rate on income over $10 million, 38 percent between $15—18.3 million, reverting to 35 percent over $18.3 million. Over half of corporate taxable income is subject to the top rate.

But one should not think of the corporate income tax as a tax on some anonymous entity. Rather, it is a tax on the individuals who, taken together, own a corporation. In this sense, the corporation is simply a collection device by which the IRS taxes the income of the owners of the business. To say that corporations do not pay their fair share in taxes can only mean that owners of corporations should pay higher taxes on income earned by corporate business entities.

So why do we have corporations if they serve largely to make the job of the IRS easier? The reason is that the corporation is a legal entity that provides special privileges and benefits to its owners (limited liability of shareholders, perpetual life, marketability of shares, growth through retention of earnings, and so forth). It is more suitable for conducting certain kinds of business than are sole proprietorships or partnerships.

Although it appears that the corporate income tax is collected from the owners of the business, economists disagree on whether its true incidence lies with stockholders, owners of capital through depressed rates of return, consumers through higher prices, workers in the form of lower wages, or some combination of these groups. A good illustration of this issue is the 1990 tax increase that imposed a 10 percent luxury tax on yachts. Although the measure increased the sales tax, not the corporate income tax, the principle is the same. The tax was repealed in 1993. Potential boat buyers, unwilling to pay the additional luxury tax, postponed new purchases of yachts. By raising the price of yachts, the tax reduced demand, a predictable result following the law of demand, the most basic principle of elementary economics. Fewer sales forced layoffs and lower wages. The 10 percent luxury tax on yachts was borne largely by laid-off yacht workers. Unemployed yacht builders were not impressed with the attempt to make the rich pay more.

### *The Problem of Double Taxation*

An important feature of the corporate income tax is that, in conjunction with the individual income tax, it causes *double taxation*. Corporations pay dividends to shareholders *after* they pay taxes on business profits (with unknown incidence) at a 35 percent rate. Individuals, in addition to reporting wages and salaries, must declare dividends on their tax returns and pay taxes at rates up to 39.6 percent. Top-bracket taxpayers pay 39.6 percent on the 65 percent of corporate profits they receive in the form of dividends, assuming all business income is paid out in the form of dividends. (The incidence of tax on dividends is reported in IRS summaries of adjusted gross income from individual tax returns.) The combined tax on business income for an individual in the 39.6 percent bracket comes to 60.7 percent. Rates at this level impose heavy disincentives on entrepreneurial activities.

The problem of double taxation has generated numerous proposals to integrate corporate and individual income taxes. For example, companies might deduct dividends in computing corporate taxes. Or, more simply, dividends could be excluded from individuals' tax returns. Numerous countries around the world follow one of these two practices.

The corporate income tax in the United States has the peculiar property of imposing heavy tax rates and generating little revenue. Some economists maintain that the effective rate of taxation of corporations is low and thus we need not be concerned with any adverse effects of its statutory 35 percent rate or the purported effects of double taxation. Other economists maintain that the corporate tax is a major obstacle to growth, capital formation, and efficiency. We will not try to settle the issue. Rather, we will stress the shortcomings of the corporate tax in extracting revenue from business income and the adverse effects of its high tax rates.

### *Who Pays the Income Tax?*

The income tax consists of payments to the IRS from individuals and corporations. It's easy to quantify payments from individuals, based on wages, dividends, interest, and a variety of other sources and activities, and subject them to analysis on the basis of age, sex, race, income category, region, and so forth. We cannot, unfortunately, do the same for corporate tax payments. Any serious attempt to determine tax burdens by income categories must take a stab at allocating that part of corporate income to individuals not paid out in dividends and corporate tax payments. Those attempts require making unverifiable assumptions about the individuals who own corporations and thus pay the corporate taxes.

Why does this matter? Because critics of our flat tax often misleadingly compare the flat tax to a windfall for the rich. Other critics compare the tax on wages in the flat-tax plan with the tax reported on Form 1040, which includes a variety of nonwage income and a raft of special deductions. A proper comparison must include all types of income—business income, interest, dividends, wages, and so forth—and assign total income to individuals in income categories to see how those categories of individuals fare under Hall-Rabushka versus under current law. This is not an easy exercise for academics or politicians. It sounds complicated, but it is a crucial aspect of the debate on fairness and fair shares. We will return to this point after we set forth the details of our plan. For now we just want to emphasize that any fair comparison of two alternative tax systems by income category must include corporate income taxes as well as individual taxes.

### *Consumption Taxes*

An increasing number of economists and politicians are proposing that federal income taxes be reconstituted as consumption taxes. As the name suggests, a consumption tax is a tax on spending rather than income. Consumption taxes are growing in popularity because, by exempting investment or savings from taxation, they would encourage saving and stimulate capital formation. Put another way, the underlying concept of consumption taxes is that individuals would be taxed on what they take out of the economy (when they spend money to consume), not on what they produce (reflected in working and saving).

Consumption taxes take many forms. In one form, a family would pay a *cash-flow expenditure tax* on the basis of its total income minus saving. The forms for computing individual income tax would contain lines to report deposits into various forms of savings instruments (a deduction) and money withdrawn from savings instruments or borrowed funds used for spending (an addition). The consumer would pay the tax directly.

Another form of consumption tax is the *value-added tax*, or VAT, which is levied on goods and services at each stage of production through the retail level; it is collected from the seller. Some percentage rate is levied on the difference between a firm's sales and its purchases, and this sum is incorporated into the price of the object (and, commensurately, the consumer price level). It is widely used in Europe.

Yet another form is the *sales tax*, which is levied on the sales of goods and services and is also collected from the consumer by the seller. Sales taxes are in use in virtually every state in the union and are regarded as the preserve of state and local governments in the United States.

The plan we set forth in chapter 3 is a tax on consumption that differs from the cash-flow expenditure tax, the European-style VAT, or a national sales tax. Rather, it is a comprehensive income tax (the base is GDP) with a 100 percent immediate write-off of all business investment at the level of the business enterprise. It is a consumption tax because it removes all investment spending from the tax base.

The justification for consumption taxes rests on their built-in incentives to save and invest. By exempting investment from taxation, consumption taxes encourage investment and discourage spending. (Over time, each act of investment traces back to an act of saving; thus exempting investment from the tax base amounts to exempting saving.) Chapter 4 presents some estimates of the impact that a full-fledged, flat-rate consumption tax would have on growth.

## TAX RATES, TAX BURDENS, AND FAIR SHARES

After explaining our flat-tax proposal in chapter 3, in chapter 4 we subject it to every reasonable test of fairness and examine how different categories of taxpayers would fare as against the current code. But there exists a body of evidence from U.S. tax history that is pertinent to this chapter's discussion of taxes and fairness. Three episodes of major changes in tax legislation in the 1920s, 1960s, and 1980s suggest that cutting tax rates causes the rich to pay a higher share of the tax burden. In other words, the most effective way to increase progressivity and collect more taxes from the rich is to lower, not raise, marginal rates of taxation.

Table 2.1 Effects of Mellon Tax Cuts

| *Income Category* | *Tax Revenues Collected (in millions of 1929 constant dollars)* | | *Percent Change* | *Percentage of Tax Revenues Collected from Each Group* | |
|---|---|---|---|---|---|
| | *1921* | *1926* | | *1921* | *1926* |
| Less than $10,000 | $155 | $33 | −79% | 21% | 5% |
| $10,000 to $25,000 | 122 | 70 | −43 | 18 | 10 |
| $25,000 to $50,000 | 108 | 109 | +1 | 16 | 15 |
| $50,000 to $100,000 | 111 | 137 | +23 | 16 | 19 |
| Over $100,000 | 194 | 362 | +86 | 29 | 51 |

*Andrew Mellon and the 1920s*

Recall that the first income tax of 1913 imposed rates that ranged from 1 to 7 percent; wartime needs for revenue increased the tax rate structure almost overnight, to a range of 6 to 77 percent. When peace returned, the wartime structure of tax rates came under the ax of Secretary of the Treasury Andrew Mellon, who cut the top rate to 25 percent.

Professors James Gwartney and Richard Stroup have analyzed tax receipts by income categories before and after the Mellon reductions. After the reductions, the highest income category paid substantially more in absolute tax dollars and nearly doubled its share of total federal revenues. The lowest income category paid almost 80 percent less in absolute dollars, and its share of the total burden fell from 23 to 5 percent (see table 2.1).

To repeat, cutting the top rate from 77 percent to 25 percent produced a more progressive tax system.

How can this be? How can a massive windfall to the rich cause them to pay more in federal income taxes? Why do lower rates increase progressivity? One big reason is that formerly high-bracket taxpayers shifted assets from tax-free bonds into productive outlets. Even though the rate reductions were greatest for higher-income brackets, the 1920s cuts shifted the tax burden to that area. The tax base proved highly responsive to changes in the incentive structure during the Mellon years.

This is not a book about the pros and cons of tax-free municipal bonds or hundreds of other specific loopholes. There are plenty of highly paid professional lobbyists in Washington, D.C., who will defend each specific loophole, no matter how bizarre. The important point here is that high rates shrink the tax base by encouraging individuals to seek tax-free income. Low rates increase the tax base by rewarding individuals who earn higher taxable incomes. A broad-based, low-rate tax system is the best route to progressivity.

### *John F. Kennedy and the 1960s*

Republican appointee Andrew Mellon's 1920s rate cut was not a unique episode in U.S. tax history. President John F. Kennedy, a Democrat, took up the same cudgel to cut marginal tax rates across the board in his term of office. Proposed in 1963 and signed into law in March 1964, Kennedy's legislation reduced all brackets, from a

Table 2.2 The Effects of 1964 Tax Cuts on Upper-Income Taxpayers

| | *Taxpayers Earning \$50,000–\$100,000* | *Taxpayers Earning \$100,000–\$500,000* | *Taxpayers Earning over \$500,000* |
|---|---|---|---|
| Tax paid, old law | \$3.622 billion | \$2.405 billion | \$701 million |
| Tax paid, new law | \$3.693 billion | \$2.780 billion | \$1.020 billion |

range of 20 to 91 percent to 14 to 70 percent. In dollar terms, about 70 percent of the estimated total reduction of \$5.5 billion would go to taxpayers making less than \$10,000, who made up 84 percent of all taxpayers and who bore 48 percent of the income tax burden. Although the largest *dollar amount* went to taxpayers of modest means, the largest *percentage cut* applied to those with taxable incomes over \$500,000.

Using income data reported by the IRS, Lawrence B. Lindsey compared taxes paid by high-income taxpayers before and after the 1964 rate reductions. In 1965, the first year for which the new rates applied, high-income taxpayers declared more taxable income and paid more in taxes than they would have paid under the old law. The trend was especially pronounced in the highest bracket (see table 2.2).

Lindsey offers three reasons why lower rates increased the share of taxes paid by the rich. One, taxpayers in the highest brackets shifted money from consumption or tax-sheltered investments into more productive, taxable investments; tax avoidance declined. Two, taxpayers became more honest as evasion became less rewarding; tax evasion declined. Three, some taxpayers, rewarded by higher after-tax returns, worked harder; incentives improved.

### *Ronald Reagan and the 1980s*

The 1980s provide the best evidence that lower tax rates increase the fairness of the tax system. Between 1981 and 1986, marginal tax rates were reduced across the board, although the full rate reduction in the 1981 Economic Recovery Tax Act did not take effect until January 1, 1984. The Tax Reform Act of 1986 further reduced the top rate of 50 percent to 28 percent. How did the rich respond? The share of total individual income taxes paid by the top 1 percent (by adjusted gross income category) rose from 17.9 percent in 1981 to 25.6 percent in 1990 (see table 2.3). The share paid by the top 5 percent rose from 35.4 percent to 44 percent and by the top 10 percent from 48.2 percent to 55.7 percent. The bottom 50 percent reduced its contribution from 7.4 percent in 1981 to 5.7 percent in 1990.

Why did the cuts in marginal rates increase the tax burden on the rich? As before, when tax rates fall, upper-income households shift assets out of instruments that generate tax-exempt income, or from schemes that are designed to shelter income, into taxable economic activity. In 1986, federal tax expenditures, items that represent revenue lost from loopholes, amounted to $500

Table 2.3 Share of Total Federal Individual Income Tax Burdenby Adjusted Gross Income Percentile

| *Tax Year* | *Top 1 Percentile* | *Top 5 Percentile* | *Top 10 Percentile* | *Top 25 Percentile* | *Top 50 Percentile* |
|---|---|---|---|---|---|
| 1980 | 19.3% | 37.9% | 49.5% | 73.1% | 92.9% |
| 1981 | 17.9 | 35.4 | 48.2 | 72.4 | 92.6 |
| 1982 | 19.3 | 35.4 | 48.8 | 72.6 | 92.7 |
| 1983 | 20.7 | 37.7 | 50.1 | 73.3 | 92.9 |
| 1984 | 21.8 | 38.6 | 51.1 | 73.8 | 92.7 |
| 1985 | 22.3 | 39.3 | 51.9 | 74.3 | 92.9 |
| 1986 | 25.8 | 42.7 | 54.9 | 76.0 | 93.5 |
| 1987 | 24.8 | 43.3 | 55.5 | 76.9 | 93.9 |
| 1988 | 27.6 | 45.8 | 57.3 | 77.8 | 94.3 |
| 1989 | 25.2 | 43.9 | 55.8 | 77.2 | 94.2 |
| 1990 | 25.6 | 44.0 | 55.7 | 77.2 | 94.3 |
| 1991 | 24.7 | 43.5 | 55.4 | 77.3 | 94.5 |

*Source:* Internal Revenue Service, Statistics of Income Division, unpublished data.

billion. By 1990, the figure had fallen to $400 billion. More than $100 billion of activity was brought into the tax net, largely by individuals in the former high brackets. Lower rates also curbed tax evasion.

The 1990 budget accord raised the top personal tax rate from 28 percent to 31 percent. This marginal tax rate increase was part of President George Bush's $500 billion deficit reduction package, negotiated with the leadership of Congress. For married filing jointly, the 31 percent rate applied to taxable income over $82,150 (equivalent to adjusted gross income over $100,000);

this bracket constitutes the top 3.3 percent of the income distribution.

The IRS statistics for 1991, the first taxable year following the 1990 tax rate increase, reveal that the superrich, the top 1 percent of income distribution, and the ordinary rich, the top 5 percent, both paid smaller shares of total income taxes in 1991 than in 1990. The new, higher tax rate in the 1990 law reduced the progressivity of the system, making it less fair. We expect that IRS statistics for 1994 and beyond will show that less fairness, not more, was the most visible consequence of the 1993 tax increase legislation. Political rhetoric is no match for evidence when it comes to real tax fairness.

### *Tax Rates and Economic Behavior*

Although it seems obvious that tax rate increases affect economic behavior, this point is denied by the fair-share proponents of higher tax rates on the rich and is not fully incorporated in the economic models of the Treasury, the Joint Committee on Taxation, or the Congressional Budget Office, which accounts for the "static" revenue gains and losses when they calculate the revenue impact of changes in tax rates. To dispute that higher tax rates discourage economic activity is to repudiate the one genuine law in economics—the law of demand—which stipulates that prices and quantities are inversely related. Consumers understand the effect of changes in price. When prices fall, they buy more of an item; when prices rise, they buy less.

*Higher tax rates discourage economic activity.* Higher tax rates reduce the demand to work, save, and invest by reducing after-tax rates of return. Lower tax rates increase the demand to work, save, and invest by increasing after-tax rates of return. Evidence for the adverse effect of higher tax rates is seen by comparing the government's projections of new revenues attached to tax increase legislation with the actual revenues.

For example, consider the Tax Reform Act of 1986, which raised the maximum capital gains tax rate from 20 percent to 28 percent. (In chapter 3 we discuss the right way to tax capital gains.) Capital gains realizations fell sharply, from $350 billion in 1986 to an annual range of $100—150 billion during 1987—1991. Treasury and Congressional Budget Office (CBO) predictions of capital gains realizations for 1987—1991 were far higher, by several hundred billion dollars, than actual reported gains. In January 1990, for example, the CBO projected that capital gains in 1991 would total $269 billion; the actual figure turned out to be only $108 billion. As a result, revenues from capital gains fell sharply. The loss in anticipated capital gains revenues amounted to about half a percent of GDP. The fall in realized gains was more dramatic among the middle three-fifths of taxpayers than among the top 20 percent because taxpayers with incomes as low as $22,100 saw their effective capital gains tax rate increase from 14 percent to 28 percent, while those taxpayers in the top bracket experienced a somewhat smaller fractional rise, from 20 percent to 28 percent. Half a percent of GDP in anticipated capital gains taxes that failed to materialize amounts to about $30 billion. The reason for the gross overestimate of capital gains realizations is that the CBO did not take into account the fact that taxpayers, facing sharply higher taxes on capital gains, significantly reduced their sales of assets at all income levels.

So why do supporters of higher tax rates cling to a price-free model of human behavior? They point to something known as the target income hypothesis, which posits that people work and invest to attain a target level of after-tax income. In this view, higher tax rates will encourage people to work harder and save more. If this proposition were remotely true, the country should consider returning to the 91 percent top marginal tax rate of the 1950s to get the most effort and savings from the most productive segment of the population. A hidden implication in this argument is that the government should impose higher tax rates on poverty-level and lower-middle-income households, which will force them to work harder to keep from slipping further into poverty.

In the midst of mythology, Congress discovered one verity—the price effect of taxes matters. As previously described, both houses of Congress agreed to repeal the 10 percent luxury tax on boats, jewelry, furs, and airplanes that wreaked havoc in those sectors. The reason is that this tax, by raising prices, reduced demand, lowered sales, put people out of work, and lost revenues.

### BIPARTISAN SUPPORT FOR THE FLAT TAX

Almost from its modern inception, the flat tax enjoyed bipartisan support. Our involvement began with an article we wrote for the *Wall Street Journal* on December 10, 1981, in which we first proposed our flat-rate tax. The public, media, and politicians latched onto the flat tax as a vehicle for radically simplifying and reforming the federal income tax, making it a widely discussed issue for more than a decade. Members of Congress have introduced numerous flat-tax proposals since 1982; our proposal has been introduced in almost every Congress since then.

The flat tax was not a partisan idea in origin or spirit. Senator Dennis DeConcini of Arizona, a Democrat, introduced one of the first bills (S. 2147) on March 1, 1982, after extensive consultation with us—his bill, in effect, was our plan. Representative Leon Panetta of California, also a Democrat, introduced a similar bill on April 5, 1982. Republicans too, including Representative Phil Crane of Illinois, introduced a different form of the flat tax.

Senator Steve Symms of Idaho, a Republican, joined Senator DeConcini in reintroducing the Hall-Rabushka flat tax in 1983 and again in 1985. In 1983, members of both parties rushed in alternative plans; the most publicized were those of Democrats Bill Bradley and Richard Gephardt and Republicans Bob Kasten and Jack Kemp.

Why did the flat tax enjoy bipartisan support? Liberals strongly believe in a progressive tax system, which for them means that rich people should pay a higher share of their income in taxes than other people, and have relied on the graduated rate structure to achieve this goal. Congress, however, has inserted hundreds of loopholes into the tax code that allowed some very rich people to pay little or nothing in taxes. Liberal supporters of the flat tax, correctly observing that the progressive rates in the tax code were steeply at odds with reality, also feared that evasion and avoidance could reduce the flow of revenues to Washington, D.C., jeopardizing spending programs they considered valuable.

On the right, conservatives, who believe strongly in a free market economy, argue that high marginal tax rates harm incentives to work, save, and invest. High rates, they say, penalize success, discourage risk taking, and impose a levy on some forms of income at confiscatory levels. A flat rate avoids penalizing success, ends bracket creep once and for all, removes the penalty on marriage, and taxes all returns to effort and savings at the same low rate.

In the middle, millions of taxpayers in the American mainstream, exasperated by the unfathomable complexity and high costs of compliance and offended by an upsurge in tax cheating, find the flat tax to be an attractive alternative. They especially like the idea that a tax return could fit on a postcard, taking a few minutes to complete, with everyone bound by the same rules.

In universities and think tanks, the dozens of scholars who have studied the flat tax generally agree that the current graduated-rate tax code distorts the flow of resources in the economy, with losses to economic welfare in the hundreds of billions of dollars. They acknowledge that adopting a flat tax would improve economic efficiency and, over time, generate higher revenues than the current system. Indeed, the preamble to several flat-tax proposals offered by moderate Democrats in the 1980s began with the premise that high tax rates damage investment and weaken the performance of our economy.

The Tax Reform Act of 1986, which reduced the top rate to 28 percent, took the steam out of the flat-tax movement, for it completed a process of rate reductions in the 1980s that brought the top rate down from 70 percent to 28 percent, certainly closer to our 19 percent rate. The 1986 act also truncated the tax code from more than a dozen brackets in 1980 to just two brackets, 15 and 28 percent. Two brackets with a relatively low top rate came close to accomplishing one goal of tax reform: eliminating the disincentive costs of high rates. However, it left unresolved the issues of complexity and high compliance costs.

### *Reviving the Flat Tax*

The flat tax sprang back to life from an unlikely source, former California Governor Jerry Brown. As a candidate for the Democratic Party's presidential nomination in 1992, Brown endorsed the flat tax for three reasons: (1) to eliminate the power of special interests to buy favors from the tax-writing committees of Congress by closing almost every loophole; (2) to simplify the system so that everyone could understand their tax obligations and easily file their returns; and (3) to improve economic performance by dramatically slashing tax rates. These reasons blend fairness with efficiency. Few would contend that Jerry Brown wanted to give a tax break to the rich.

At the same time, Republican Bruce Herschensohn, candidate for the U.S. Senate from California, made the flat tax a centerpiece of his campaign. Herschensohn, on the far right of the political spectrum, ran on the flat tax for three reasons: (1) to improve incentives and increase growth; (2) to simplify the tax code; and (3) to reduce the costs of compliance. Brown and Herschensohn, had they been victorious, would have made an odd couple.

Brown and Herschensohn differed on the specifics. Brown proposed a version developed by Arthur Laffer, a combination personal income tax and cash-flow expenditure business tax, both assessed at a 13 percent rate, which also incorporated Social Security taxes. Herschensohn ran on our plan. As a presidential candidate who in late March 1992 was Clinton's principal remaining opponent, Brown's version of the flat tax came under intense media scrutiny.

### *The Media and the Flat Tax*

The dominant media were not kind to Brown. The *New York Times* editorial page said, "Tilted"; *Business Week* said, "'Jerry's Tax': Wrong Answer, Right Questions"; *U.S. News & World Report* labeled it "Brown's new fad," saying, "It's not by any means as simple—or quite as fair—as it sounds"; and *Fortune* said it was "half-baked."

But these same commentators gave Hall-Rabushka rave reviews. Perhaps the strongest endorsement was printed as the lead editorial in the March 27, 1992, edition of the *New York Times*.

> Taking Jerry Brown seriously means taking his flat tax proposal seriously. Needlessly, he's made that hard to do. By being careless, the former California Governor has bent a good idea out of shape. He could fix it, but until he does, Bill Clinton is right to attack the plan as a budget-buster and a dagger aimed at poor families.
>
> Mr. Brown's basic idea—creating a simplified code that encourages saving—is exactly right. But he ignores all-important details. The tragedy is that his cavalier attitude has armed his critics to denounce the one truly creative and important idea to emerge from the Presidential campaign.
>
> The present tax code is riddled with wasteful contradictions and complexity. For example, profit from corporate investment is taxed twice—when earned by the corporation and again when distributed to shareholders. That powerfully discourages savings and investment—the exact opposite of what the economy needs to grow.
>
> The remedy is, in a word, integration, meshing personal and corporate codes so that the brunt of taxes fall on consumption, not saving. Tax reform should also simplify the code, making loopholes harder for Congress to disguise, and enact. And for reasons of elemental decency, tax reform shouldn't come at the expense of the poor.
>
> *Remarkably, there is a reform that achieves all*

> *these objectives. 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* [italics added].

The editorial went on to explain how Hall-Rabushka, in contrast to Brown, accomplished complete integration, simplification, progressivity, and revenue neutrality.

The day before, the *Wall Street Journal* acknowledged that it was "favorably inclined toward the flat tax. Economists Robert Hall and Alvin Rabushka of Stanford have popularized the concept on this page."

On May 4, 1992, *Fortune* stated that "Flat is Beautiful."

> A well-designed flatter tax system would merely tax all income at a single low rate and could easily be made progressive. The one designed by Hoover Institution economists Robert E. Hall and Alvin Rabushka, for instance, would tax individual and corporate income at 19%—not coincidentally, about the total burden of the median family income. But it would pass over the poor and maintain progressivity by including generous personal exemptions.
>
> What would make those lower rates sit up and work, of course, is that virtually all loopholes and deductions would disappear. The economic benefits are twofold and powerful: The flat tax would take nearly all the complexity out of the code, and it would put an end to most unproductive taxophobic behavior. Those were the goals of the tax reform movement of the early 1980s, and were partly achieved in 1986. Why not finish the job?

Peter Passell wrote in the *New York Times* of April 1, 1992, that Brown's consumption tax, a European-style VAT, or new gasoline taxes were inferior alternatives to "the clever direct consumption taxes devised in the mid-1980s by Robert Hall and Alvin Rabushka of the Hoover Institution at Stanford University." *Forbes* called the previous edition of our book, *The Flat Tax*, the bible of the flat-tax movement.