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## CHAPTER IV. INCOME TAX BASE BROADENING AND RATE REDUCTION

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### INTRODUCTION

If tax preferences were eliminated, income tax rates could be reduced without changing the yield of the tax. This approach is called broadening the tax base and reducing tax rates. This chapter evaluates large-scale base broadening--repeal of all or nearly all tax deductions, credits, exclusions, and exemptions--coupled with substantial marginal tax rate reduction. Under a truly comprehensive income tax, all personal deductions would be disallowed, including, among others, those for charitable contributions, medical expenses, state and local taxes, and casualty losses.<sup>1</sup> Interest on state and local bonds would be taxed, as would transfer payments, disability payments, workers' compensation, and fringe benefits. Real capital gains would be taxed in full, and most tax credits would be eliminated, including, for example, those for political contributions and home insulation. Costs of earning income would continue to be deductible, however, to ensure that the tax is on true net income rather than on gross receipts.

In addition to structuring a comprehensive income tax, several proposals call for flat-rate income taxes rather than graduated taxes. In these cases, the rate reduction accompanying base broadening would impose only one flat tax rate, so that all taxpayers would pay the same marginal rate on increments to income. Because most proposals for flat-rate taxes preserve a personal exemption, average tax rates would rise with income, however, so that the taxes would not be strictly proportional.

For example, suppose a flat-rate tax of 20 percent applied to all income above \$3,000. As shown in Table 6, the marginal tax rate would be

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<sup>1</sup> See U.S. Department of the Treasury, Blueprints for Basic Tax Reform (January 17, 1977), for a good discussion of both the ideal and practically feasible tax treatments of each individual base broadener. Many individual base broadeners are discussed also in Joseph Pechman, ed., Comprehensive Income Taxation (Washington, D.C.: The Brookings Institution, 1977); and Special Committee on Simplification, Section of Taxation, American Bar Association, "Evaluation of the Proposed Model Comprehensive Income Tax," Tax Lawyer (1979), pp. 563-686.

TABLE 6. AVERAGE AND MARGINAL TAX RATES FOR A FLAT-RATE TAX OF 20 PERCENT ON INCOME ABOVE \$3,000<sup>a</sup>

Income (In Dollars)	Average Tax Rate (In percents)	Marginal Tax Rate (In percents)
3,000	0.0	20.0
4,000	5.0	20.0
6,000	10.0	20.0
8,000	12.5	20.0
12,000	15.0	20.0
20,000	17.0	20.0
40,000	18.5	20.0
60,000	19.0	20.0
150,000	19.6	20.0
300,000	19.8	20.0
1,000,000	19.9	20.0
2,000,000	20.0	20.0

- a. This illustrative tax cannot be compared directly to the current tax because the two taxes do not yield the same revenue. The current tax is much more progressive than the tax in this example, with marginal rates from 11 to 50 percent.

20 percent for taxpayers of all incomes, but average tax rates would rise sharply for incomes just over the exempt amount of \$3,000 and then level off and approach 20 percent as income increased.

Other pending proposals for broadening the income tax base would reduce tax rates but preserve more progressivity by leaving in place a graduated marginal rate structure. They would collapse the current twelve tax brackets to only three or four, whereas a flat-rate tax would collapse them to one bracket.

Liberals and conservatives alike have long supported the idea of broadening the income tax base and reducing rates. Joseph Pechman suggested this approach about 30 years ago.<sup>2</sup> Milton Friedman endorsed a broad-based, flat-rate income tax as early as 1962.<sup>3</sup> William Simon, former Secretary of the Treasury, announced his support for the concept in a speech in December 1975.<sup>4</sup> In 1976, the Brookings Institution sponsored a conference to explore broadening the income tax base and reducing tax rates.<sup>5</sup> During the Ford Administration, the Treasury Department released a study of two major options for reform of the income tax: conversion to the taxation of consumption rather than income and institution of a broadly based income tax with only a few graduated tax rates.<sup>6</sup>

Proposals to broaden the income tax base and reduce tax rates have recently attracted wide support. Many bills have been introduced in the Congress, and the Senate Finance Committee held hearings to investigate

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<sup>2</sup> Joseph Pechman, "The Individual Income Tax Base," Proceedings of the 48th Annual Conference on Taxation sponsored by the National Tax Association, 1955.

<sup>3</sup> Milton Friedman, Capitalism and Freedom (University of Chicago Press, 1962), p. 173.

<sup>4</sup> Text of William Simon's December 3, 1975 speech at the Tax Foundation's national conference is reprinted in Daily Tax Report, Bureau of National Affairs, (12-4-75), pp. J-1 - J-3. Simon has more recently elaborated on his views in William Simon, Reforming the Income Tax System (Washington, D.C.: American Enterprise Institute, 1981).

<sup>5</sup> Papers presented at the conference appear in Joseph Pechman, ed., Comprehensive Income Taxation, (The Brookings Institution, 1977).

<sup>6</sup> U.S. Department of the Treasury, Blueprints for Basic Tax Reform (January 17, 1977).

the idea in September 1982.<sup>7</sup> President Reagan called the flat-rate tax "very tempting."<sup>8</sup> The Washington Post dubbed it "this year's phenomenon."<sup>9</sup>

In spite of such wide-ranging support and praise of base broadening and rate reduction on the part of many academics, much skepticism exists on a practical level.<sup>10</sup> Every special deduction, exemption, exclusion, and

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<sup>7</sup> Members of Congress who have introduced bills in this Congress to reduce rates and broaden the tax base or to study the concept include: Senators DeConcini (S. 557), Quayle (S. 1040), and Bradley (S. 1421); and Representatives Hansen of Idaho (H.R. 170), P. Crane (H.R. 542), Paul (H.R. 1664 and H.R. 2137), Drier (H.R. 1770), Panetta (H.R. 2520), Hance (H.R. 2564), and Gephardt (H.R. 3271).

<sup>8</sup> President Reagan called the flat-rate tax "very tempting" and "worth looking into." (New York Times, July 7, 1982, p. 1). Treasury Secretary Regan said, "a straight, across-the-board tax with no deductions may be the fairest tax of all." (New York Times, May 25, 1982, p. D6). OMB Director Stockman said, "I don't want to minimize the difficulty, but I would not be surprised if it (the flat-rate tax) was part of next year's budget." (Washington Post, June 22, 1982, p. A8). The flat-rate tax was not, however, submitted as part of the fiscal year 1984 budget.

<sup>9</sup> Washington Post, July 4, 1982, p. F1. The Washington Post endorsed a flat rate of taxation on all income above an arbitrary threshold of perhaps \$10,000 per year. (Washington Post, April 15, 1982, p. A24). In June 1982, the Washington Post again endorsed "a flat low-rate tax," but in the same editorial said, "A well-off person is certainly able to share more of his last dollars with the government than a poor person, and a decent tax system will take account of that fact," and went on to support a negative income tax as the best way to make the tax progressive. (Washington Post, June 3, 1982, p. A19.) A year later the Washington Post spoke favorably of the Bradley-Gephardt bill that proposes a progressive, broad-based income tax (as described in Chapter VII). (Washington Post, June 9, 1983, p. A18.) The New York Times backed a broad-based income tax with graduated tax rates. (New York Times, June 6, 1982.)

<sup>10</sup> William Fellner argued that not much would be gained by base broadening and that it would be nearly impossible to accomplish. (William Fellner, Problems to Keep in Mind When It Comes to Tax Reform (American Enterprise Institute, 1977).) Barber Conable, Jr.,

tax credit has a well-formed constituency, and many institutions, industries, and individuals feel dependent on these provisions for their continued financial well-being.<sup>11</sup> While most Americans favor a comprehensive income tax in theory, for instance, they do not approve eliminating the deductions necessary to make such a tax possible.<sup>12</sup>

The arguments for and against broadening the tax base are separable from the arguments for and against graduated and flat tax rates and are, therefore, discussed separately in this chapter. The chapter first reviews the merits of reducing tax rates generally and the pros and cons of a flat-rate tax versus a graduated-rate tax and then the merits of broadening the income tax base. It concludes with some generalizations that apply to all proposals (flat-rate and graduated-rate) to broaden the tax base, covering the problems that would remain, the difficulty of the transition to the new tax, and the likely distributions of hypothetical taxes by income group.

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ranking Republican on the Committee on Ways and Means, recently said, "You begin making exceptions to the exceptions, and pretty soon you're right back where you started." (Newsweek, July 19, 1982, p. 51). When asked what the chances are that a flat-tax proposal will be enacted, Milton Friedman responded, "Zero." (Fortune, July 26, 1982, p. 34.) John Nolan, a former Treasury Department official, said, "It's fun to talk about it (the flat-rate tax), but it would be impossible to implement." (Wall Street Journal, July 8, 1982, p. 1.)

- 11 See, for example, Thomas J. Reese, The Politics of Taxation (Westport, Conn.: Quorum Books, 1980), pp. 105-106.
- 12 In a Harris poll conducted in August 1982, 62 percent of the public backed a flat-rate tax with few deductions, but when asked about individual deductions, the same people overwhelmingly opposed their repeal. For instance, 80 percent favored retaining the deduction for medical expenses, 71 percent the deduction for home mortgage interest, 38 percent the credit for political contributions, and 34 percent the deduction for oil and gas drilling costs. (Business Week September 6, 1982, p. 15.) In a 1980 poll, 90 percent of the public responded that all of the interest paid on home mortgages should be deductible, and 69 percent that the costs of home insulation should be deductible. (Paul Harstad, "Interpreting Americans' Attitudes Toward Taxes," Tax Notes, November 9, 1981, p. 1091.)

## MARGINAL RATE REDUCTION

### Efficiency

Reducing tax rates substantially would have beneficial effects on economic efficiency, whether through a single, flat rate or a set of graduated rates. Lower marginal tax rates would probably induce additional work and saving, although no one knows by how much. Graduated income tax rates exact a cost in lost economic efficiency, since those in higher brackets work and save less. The extent of the efficiency loss is uncertain, however, as is the level of overall taxation and of rate progressivity at which the loss becomes serious.

Throughout this section, the theoretical arguments for and against graduated tax rates and the beneficial effects of lower marginal rates are discussed and quantified when possible. Broad-based, graduated-rate taxes can be designed to reduce marginal tax rates for most taxpayers. Most flat-rate tax proposals, however, would increase marginal tax rates by several percentage points for many low- and middle-income taxpayers, while they would decrease marginal tax rates substantially (from as high as 50 percent currently to around 20 percent) for high-income taxpayers. Therefore, in considering the overall effects of a flat-rate tax, the beneficial effects of reducing marginal tax rates for some taxpayers must be weighed against the effects of increasing them for others.

Labor Supply. Higher tax rates make work less attractive because more and more leisure must be given up to earn each additional dollar in take-home pay. On the other hand, higher taxes increase the amount of work needed to attain any given desired level of income. These two effects work in opposite directions, making it impossible to predict on theoretical grounds which will prevail.<sup>13</sup>

Although it has been known for some time that progressive taxes discourage married women from working outside the home, until recently,

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<sup>13</sup> When marginal rate reduction is coupled with base broadening that preserves the total yield of the tax, individual taxpayers may incur tax cuts or increases, which complicate this analysis. The net effect of the rate reduction and base broadening would be to increase the work effort of those taxpayers whose tax burdens rose or stayed the same (since the rate reduction and loss in after-tax income would both work to increase work effort), but the net effect on the work effort of those whose taxes fell is indeterminate (since the increase in after-tax income may reduce work effort, while the rate reduction would increase it).

most evidence suggested that the tax system had little influence over the work decisions of prime-aged men.<sup>14</sup> A 1981 study contradicts these results and indicates that men would choose to work significantly more if the progressive tax were eliminated in favor of a broad-based, flat-rate tax, and that such a change would significantly improve the well-being of the labor force.<sup>15</sup> The new study compared the 1975 income tax (with marginal tax rates ranging from 14 to 50 percent on labor income) with prototype flat-rate taxes designed to raise roughly the same amount of revenue. Moving to a flat-rate tax of 14.6 percent with no exemption would increase married men's desired hours of work by about 10 percent, while a flat-rate tax of 20.7 percent with an exemption of \$4,000 would increase desired hours of work by about 5 percent.<sup>16</sup> Unfortunately, the effects of a broad-based, graduated-rate income tax in increasing labor supply and improving well-being were not studied, so it is impossible to break down the beneficial effects of the broad-based, flat-rate tax into those resulting from the single tax rate and those from the rate reduction made possible through base broadening.<sup>17</sup>

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- <sup>14</sup> See, for instance, Richard Goode, The Individual Income Tax (The Brookings Institution, 1976), pp. 52-56; and Arthur Okun, Equality and Efficiency: The Big Tradeoff (The Brookings Institution, 1975), pp. 96-97). The tax system was believed not to influence the number of hours that men spend in the workforce, because most men have little choice but to work a forty-hour week. However, other work decisions that men make (like age of retirement, intensity of work effort, and level of schooling and other training) might be more sensitive to tax rates. (Harvey S. Rosen, "What is Labor Supply and Do Taxes Affect It?" American Economic Review (May 1980), pp. 171-176.)
- <sup>15</sup> Jerry Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., How Taxes Affect Economic Behavior (The Brookings Institution, 1981), pp. 27-83. Goods and leisure are assumed to provide well-being according to a mathematical formula.
- <sup>16</sup> *Ibid.*, pp. 63-64. Hausman also compares the "deadweight welfare losses" of the various taxes. (Deadweight loss is the amount of money that would have to be given a taxpayer along with a rebate of his taxes in order to make him consider himself as well off as if there were no tax.) Deadweight loss was about 29 percent of tax collected under the 1975 income tax but would drop to 14.5 percent of tax under a flat-rate tax of 20.7 percent with a \$4,000 exemption and to 7 percent of tax under a flat-rate tax of 14.6 percent with no exemption.
- <sup>17</sup> The study determined, however, that the progressive 1975 income tax had a much greater effect in discouraging labor supply among high-

These results are preliminary, in that they have not been substantiated by other studies and are based on a model that does not account for all of the market adjustments, such as changes in wage rates, that would certainly follow from such major changes in the tax code. Moreover, although the results indicate large increases in desired hours of work, work schedules might not be flexible enough or the demand for certain skills strong enough, particularly over the near term, for such large increases to occur in practice.

In general, at lower tax rates, people would be more apt to seek employment remunerated in money and to pay the taxes that they owe on their income.<sup>18</sup> Tax-motivated barter of goods and services would lessen,

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income workers than among other taxpayers. Men who earned \$10 an hour, for instance, desired to work about 12.8 percent less in 1975 than they would have in the absence of an income tax, while those who earned \$6 an hour desired to work about 8.5 percent less, and those who earned \$3 an hour desired to work about 4.5 percent less. Moreover, the 1975 tax imposed a substantially greater deadweight welfare loss on high-wage taxpayers than on others. In addition to the amount paid in tax, those in the highest wage fifth suffered a deadweight welfare loss of about \$1,000 per year from the 1975 tax, compared to about \$360 for those in the middle fifth and \$80 for those in the lowest fifth.

Under the flat-rate taxes considered in the study, the effective marginal tax rates of the lowest-income taxpayers actually fell, those of middle-income taxpayers remained the same or rose by several percentage points, and those of the highest-income taxpayers dropped to 15-21 percent from rates as high as 50 percent. The welfare of all income groups increased, with the biggest increases occurring for those with the highest incomes. (Jerry Hausman, "Labor Supply," pp. 61-64; and "Income and Payroll Tax Policy and Labor Supply" in Lawrence Meyer, ed., The Supply-Side Effects of Economic Policy (May 1981), p. 192.)

<sup>18</sup> At lower tax rates, the odds are changed in the "tax lottery." The payoff from successful tax evasion--tax saved--is lower. Unless the probability of being caught or the penalty imposed on those who are caught is also reduced, people will evade less tax, although no one knows how much less.

for instance. In addition, people would be more likely to spend their time on activities in which they have an economic comparative advantage.<sup>19</sup>

At low tax rates, workers would also demand more cash and fewer fringe benefits, and employers would spend somewhat less on deductible business expenses for company cars, travel, and entertainment that may serve partly as tax-free income for employees.<sup>20</sup> The marked rise in fringe benefits as a percent of payroll (from 18.7 percent of payroll in 1951 to 37.1 percent in 1980) may have been partly caused by the increases in marginal tax rates faced by many employees during that period.<sup>21</sup> A recent study suggested that a cut in marginal tax rates of 10 percent would decrease the percentage of compensation made up of fringe benefits by 2.2 percent.<sup>22</sup> (Taxing all fringe benefits would diminish their attractiveness and use even more.)

Saving and Investment. It is impossible to predict theoretically whether personal saving would increase or decrease if marginal tax rates were reduced. On the one hand, all taxpayers might be inclined to save more, because each dollar saved would earn more future consumption than

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- 19 A drop in marginal tax rates makes labor more mobile. In order for a move to a higher-paying job to be worthwhile, the additional after-tax income of the higher-paying job has to exceed the cost of the move. A reduction in marginal tax rate increases the pay differential and so can make worthwhile a move that otherwise would not pay. It thereby increases the mobility of the labor force.
- 20 Based on historical data and a model of firm behavior, one study predicted that a reduction in the top marginal tax rate from 70 to 50 percent like that enacted in 1981 would cause proprietors to reduce spending on entertainment by about 5 percent, on travel by about 2 percent, and on gifts by about 7 percent. (Charles Clotfelter, Business Perks and Tax-Induced Distortions: The Case of Travel and Entertainment (Duke University, March 1982), p. 18a.)
- 21 Some of the increases in fringe benefits have been mandated by law. Legally required fringe benefits--FICA taxes and contributions to unemployment and workers' compensation--made up 3.5 percent of payroll in 1951 and 8.9 percent in 1980. These and the statistics in the text are from U.S. Chamber of Commerce, Employee Benefits Historical Data 1951-1979 (1981), p. 11, and Employee Benefits (1980), p. 8.
- 22 James Long and Frank Scott, "The Income Tax and Nonwage Compensation," Review of Economics and Statistics (May 1982), p. 215.

before the tax cut. On the other hand, taxpayers might be inclined to save less, since they would need to save less in order to meet any particular desired level of future consumption.<sup>23</sup> Although the empirical work needed to resolve this theoretical ambiguity is highly controversial, the consensus today is that a reduction in marginal tax rates induces only a modest increase in personal saving, if any.<sup>24</sup> According to the study that found the largest positive saving response, a 25 percent cut in marginal tax rates (slightly more than the 23 percent cut enacted in the 1981 Economic Recovery Tax Act) would be expected to raise the saving rate from about 3.9 percent of GNP annually in 1976-1980 to between 4.1 and 4.2 percent annually.<sup>25</sup>

High marginal tax rates magnify the income tax's influence over investment decisions. Even if high marginal tax rates did not lead to a decline in overall national saving, they might cause a reallocation of saving away from heavily taxed investments into less heavily taxed or tax-free investments. The higher the marginal tax rate, the more it pays for taxpayers to spend time and money to seek out tax-sheltered investments. In addition to the wasted financial and legal resources, national output suffers because investment dollars do not flow to their most productive use.<sup>26</sup> Moreover, the higher the marginal tax rate, the more the tax

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<sup>23</sup> Analysis of the effects of marginal rate reduction coupled with base broadening is more complicated. Elimination of tax preferences for saving would increase the marginal tax rate on some forms of saving. Moreover, those taxpayers whose tax burdens increased might save more in an attempt to recoup the loss in after-tax income.

<sup>24</sup> Two recent studies that explored the responsiveness of saving to the after-tax interest rate are Michael Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy (April 1978), Pt. 2, pp. S3-S27; and E. Philip Howrey and Saul Hymans, "The Measurement and Determination of Loanable-Funds Saving," in Joseph Pechman, ed., What Should Be Taxed: Income or Expenditure? (The Brookings Institution, 1980), pp. 1-48.

<sup>25</sup> Herbert Stein and Murray Foss, "Taxes and Saving," The AEI Economist (July 1981), p. 6. This article also provides a good, nontechnical summary of the evidence concerning the link between marginal tax rates and saving.

<sup>26</sup> In an effort to save taxes and earn the highest after-tax return, investors in the highest tax brackets invest in the most lightly taxed assets. This drives up before-tax returns on heavily taxed assets, making those assets attractive for tax-exempt and low-bracket inves-

deductibility of interest encourages borrowing for consumer loans and home mortgages.

The aggregate amount of individual saving is probably somewhat less under a progressive tax than a proportional tax of equal yield, because progressive taxes fall more heavily on high-income people, whose saving rates are on average relatively high.<sup>27</sup> For each dollar of tax paid, the amount that would have been saved had it not been taxed is greater for high-income than for low-income taxpayers. The net resultant reduction in national saving is probably not very large, however, and reduced national savings occurring as a result of a progressive tax can, in theory, be recouped through federal budget surpluses.<sup>28</sup>

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tors. Pretax rates of return on tax-exempt and partially taxed assets are thus driven down below what they would be were there no tax, and pretax rates of return on fully taxed assets are driven above what they would otherwise be. The concomitant overinvestment in tax-sheltered assets and underinvestment in other assets results in a loss in national output. (See Harvey Galper and Eric Toder, Transfer Elements in the Taxation of Income from Capital (Advisory Commission on Intergovernmental Relations and Department of Treasury, 1982); and Martin J. Bailey, "Progressivity and Investment Yields under U.S. Income Taxation," Journal of Political Economy (November/December 1974), pp. 1157-1175.)

27 Unfortunately, not much is known about the relationship between income and personal saving rates. The intuitive notion that savings rates increase with income was substantiated in the 1972-1973 Consumer Expenditure Survey. (U.S. Department of Labor, Consumer Expenditure Survey: Integrated Diary and Interview Survey Data, 1972-1973, Bulletin 1992 (1978), pp. 34-35.) Some part of the greater savings of higher-income people may be due to the high saving rates that one would expect of people whose incomes are uncharacteristically high only for a year or two. (See, for instance, Alan Blinder, "Distribution Effects and the Aggregate Consumption Function," Journal of Political Economy (June 1975), pp. 447-475.)

28 Goode estimated the cost in terms of decreased national saving of the progressive tax in effect in 1960-1961. Compared to the 25 percent of tax revenue that would have come from private saving under a proportional tax, the progressive income tax in place in that year drew 30 percent of tax revenue from private saving. (Goode, The Individual Income Tax, p. 66.)

Progressive taxation is popularly believed to discourage investment in risky undertakings. Because a progressive tax lessens the expected return more for risky than for riskless investments, it makes risky investments relatively less attractive.<sup>29</sup> At the same time, however, the tax reduces incomes, motivating some taxpayers to undertake additional risk in an effort to recoup the loss. For some, the first effect dominates so that a progressive tax leads them to decrease the riskiness of their portfolios, while for others the second effect dominates with the opposite result. Because a proportional tax with full loss offsets would not affect the relative attractiveness of risky versus risk-free investments, it would not produce the first effect mentioned above. Imposition of a proportional tax, therefore, would produce only the second effect and cause all taxpayers to increase the riskiness of their portfolios in an attempt to recoup the income lost through taxation.<sup>30</sup> If only partial or no loss offsets were allowed, however, the effect of a proportional tax on the amount of risk taking would also be ambiguous.

Effects on the Entire Economy. A recent study compared the overall efficiency of a progressive income tax with marginal rates ranging from 23 to 43 percent with that of a proportional tax of equal yield. Its simplified model of the economy predicted that a switch from the progressive to proportional tax would have beneficial effects equivalent to an increase of about 6 percent of lifetime resources.<sup>31</sup> In other words, in order to make

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- <sup>29</sup> The loss from an unsuccessful investment reduces income which, under a progressive income tax, produces tax savings at a lower tax rate than the rate imposed on the gain from a successful investment.
- <sup>30</sup> Evsey Domar and Richard Musgrave, "Proportional Income Taxation and Risk Taking," Quarterly Journal of Economics (May 1944), p. 390.
- <sup>31</sup> This is larger than the gain of about 5 percent of lifetime resources of switching from a progressive income tax to a progressive consumption tax, but smaller than the gain of about 7 percent of switching from a progressive income tax to a proportional consumption tax. (Alan Auerbach, Laurence Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform," Harvard Institute of Economic Research, discussion paper #870 (December 1981), pp. 41-42.)

In this and other economic studies, welfare is measured by making assumptions about how much satisfaction an individual derives from different bundles of goods and leisure consumed over the course of his lifetime. All of the models require strong simplifying assumptions about tastes for such things as labor versus leisure and current consumption versus deferred consumption, about the amount of addi-

taxpayers as well off under the progressive income tax as under the proportional tax, the nation would have to increase its earning potential by 6 percent.

### Simplicity and Ease of Administration

In some respects, a flat-rate tax would be simpler and easier to administer than a graduated-rate tax. Reducing the progressivity of a graduated-rate tax would also simplify the tax, but by less than changing to a flat-rate tax.

Tax Manipulation. Under a flat-rate tax, less time and effort would be spent arranging to have income taxed at lower tax rates--by realizing the income in years when a taxpayer is in a lower tax bracket himself or moving it to family members in low tax brackets. For instance, less income would be deferred until retirement and fewer income-producing assets would be transferred to children. Since most flat-rate taxes under consideration would provide an exemption of the first several thousand dollars of income and would not tax those with net losses, however, a somewhat limited opportunity would remain for this kind of tax manipulation. In addition, because taxpayers always benefit from postponing tax payment, since they can earn interest on the money during the interim, they would still seek to defer some tax.

A broad-based tax with tax rates less steeply graduated than the current rates would also lessen incentives to manipulate taxes, although not by as much as a flat-rate tax. Moreover, since most taxpayers do not engage in this kind of tax manipulation, some authorities have downplayed the contribution of a single tax rate in reducing tax manipulation.<sup>32</sup>

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tional work and saving that will result from reductions in taxes on work and saving, about opportunities available for and returns to working and investment, and about initial endowments of talents and wealth.

<sup>32</sup> For instance, M. Bernard Aidinoff, Chairman of the American Bar Association's Section on Taxation, claims that most complexity is caused not by graduated tax rates but rather by the combination of high marginal tax rates and the many special provisions of the tax code that narrow the tax base. (Statement of M. Bernard Aidinoff, "Flat-Rate, Broad-Based Income Taxation," before the Senate Finance Committee (September 29, 1982) p.4.)

Income Averaging. Entertainers, athletes, recipients of capital gains, and other taxpayers whose incomes fluctuate widely can be penalized by income taxes with steeply graduated rates. Since their income is bunched in one or several years, it is taxed at higher rates than it would be if it were spread over a number of years. The current tax compensates imprecisely for this by allowing taxpayers to average their income and by taxing capital gains at preferential rates. Income averaging is complicated, however, and even with averaging, people whose income is bunched seek expensive means of deferring the income to have it taxed later at a lower rate. Under a flat-rate tax, the need for income averaging would not be compelling, since the bunching of income in one year would no longer have adverse tax consequences.<sup>33</sup> Eliminating income averaging would simplify the income tax for the 5.7 million taxpayers who elect the provision as well as for those who consider doing so but do not.<sup>34</sup>

Inflation Indexing. A flat-rate tax would do away with nearly all inflation-caused bracket creep. The personal exemption and other dollar-denominated provisions retained in the tax code would have to be adjusted periodically to avoid having their real values eroded by inflation, however, and the tax base would continue to be mismeasured during periods of inflation, unless it was explicitly indexed for inflation as described in Chapter V. The inflation-caused distortions of the taxation of interest income might be greatly reduced under a proportional income tax, however, as discussed also in Chapter V.

Marriage Neutrality. As discussed in Chapter III, graduated-rate income taxes that tax married couples as one unit cannot be marriage neutral. In other words, upon marriage the tax liability of a couple must either increase or decrease under such a system. In general, reductions in progressivity lessen marriage penalties and bonuses, and proportional taxes are marriage neutral. Even though a flat-rate tax would probably not be strictly proportional, it would greatly lessen marriage penalties and bo-

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<sup>33</sup> The need for income averaging is alleviated by any reduction in the steepness of marginal tax rates. Some sort of special tax treatment of capital gains, with the attendant complexity, might be preserved even under a flat-rate tax. The arguments advanced in favor of the special tax treatment of capital gains are set forth in Chapter V.

<sup>34</sup> The 5.7 million 1980 tax returns on which income averaging was used represent about 6 percent of the 93.9 million individual income tax returns filed that year. Internal Revenue Service, Statistics of Income -- 1980, "Individual Income Tax Returns," (U.S. Government Printing Office, 1982) Table 1.1, p. 36 and Table 3.1, p. 77.

nuses compared to current law, and allow the two-earner deduction enacted in 1981 to be repealed.<sup>35</sup>

Ease of Tax Collection. Under a flat-rate tax with no deductions, credits, or exclusions other than a personal exemption, most tax could be readily collected at the source of the income.<sup>36</sup> Employers could withhold accurately taxes on wages and salaries. Employers could also more easily withhold taxes on fringe benefits, which would not have to be allocated to particular employees. (Valuing fringe benefits would remain a problem, however.) Tax on interest and dividends could more accurately be withheld by the financial institutions and companies paying them. All the tax due by most taxpayers would thus be paid on their behalf by employers and financial institutions, and taxpayers would need only to file simple forms annually with the Internal Revenue Service for refund of their personal exemption amounts. Low-income workers might face hardship waiting until year-end for their refunds, however. Alleviating the problem by exempting them from withholding would introduce the same sort of complexity as the provisions for exempting those of low income from the withholding of interest and dividend income enacted in 1982.

### Equity

Both a flat-rate tax with exemptions and a graduated-rate tax are progressive, in the sense that average rates of tax increase with income, but a graduated-rate tax is more progressive than a flat-rate tax with equal personal exemptions and of equal yield.<sup>37</sup> For centuries, philosophers and economists have tried to establish by logic and analysis whether a progressive or proportional tax is fairer. Unfortunately, as discussed below, although in theory criteria can be set forth for assessing the fairness of a tax, it is impossible to evaluate how well different taxes

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<sup>35</sup> A flat-rate tax is marriage-neutral if the standard deduction for a married couple is twice that for singles. (For a mathematical proof, see Michael Lovell, "On Taxing Marriage," National Tax Journal (December 1982), pp. 507-510.)

<sup>36</sup> Dan Soule and Clyde Bates, "A Progressive Income Tax With a Uniform Tax Rate," Nebraska Journal of Economics and Business (Spring 1976), pp. 19-32.

<sup>37</sup> A flat-rate tax is most progressive for incomes about equal to the exempt amount and very nearly proportional for incomes far above the exempt amount, as shown by the example in the introduction to this chapter.

measure up to these standards without knowing more than is humanly possible about the preferences of individual taxpayers. As a result, the decision as to which tax--graduated or flat-rate--is fairer must necessarily be subjective, based on whether and by how much one thinks the government ought to redistribute income in order to lessen economic inequality. As Henry Simons said:

The case for drastic progression in taxation must be rested on the case against inequality--on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.<sup>38</sup>

In what is probably the most exhaustive modern treatment of progressivity, Blum and Kalven evaluate each of the arguments advanced in favor of progressive taxation and reject them all, except the argument that progressive taxation can be used to lessen economic inequality and redistribute income. Their major arguments are summarized in Appendix A. They conclude that the case for a progressive income tax is "an uneasy one."<sup>39</sup> Blum's and Kalven's work has been criticized because the authors come out in favor of a flat-rate tax by default after rejecting progressivity, rather than by making a positive case for a flat-rate tax. As Tobin said:

I do not see any obvious presumption in favor of proportional taxation. One could as well say that the burden of proof is on those who would depart from a quadratic schedule, or from the Revenue Act of 1975 . . . . I fail to see how the issue of progressivity is essentially different from the issue of equality.<sup>40</sup>

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<sup>38</sup> Henry Simons, Personal Income Taxation (University of Chicago Press, 1938, Midway Reprint, 1980), pp. 18-19.

<sup>39</sup> Walter Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation (University of Chicago Press, 1953).

<sup>40</sup> James Tobin, "Considerations Regarding Taxation and Inequality," in Colin Campbell, ed. Income Redistribution (Washington, D.C.: American Enterprise Institute, 1977), p. 128.

Boris Bittker agreed: ". . . In short, the case for every tax base and every rate schedule is 'uneasy,' since interpersonal comparisons cannot be avoided."<sup>41</sup> (Author's emphasis.)

Although economic theory cannot determine absolutely or objectively whether proportional or progressive income taxation is superior, this issue can be decided by a democratic government whose role is to resolve the inherently conflicting preferences of its citizens with respect to a whole range of issues. The people's elected representatives can thus decide on the appropriate degree of progressivity depending on their subjective evaluations. In the same way, they can decide on the appropriate degree to which government spending should redistribute income.

The public's assessment of the fairness of progressive taxation is not immutable. In a 1981 poll, for instance, 58 percent of the public declared that progressive income taxes are fair and equitable, whereas only 47 percent gave that response in 1982.<sup>42</sup>

Regressivity of Other Taxes. Progressivity in the individual income tax can be defended as a way to counteract the regressivity of other taxes, such as the Social Security tax, even if a proportional rather than progressive overall tax system is desired. Although the individual income tax is currently progressive, the regressivity of most other federal, state, and local taxes balances this out, leaving the entire system of U.S. taxes only slightly progressive.<sup>43</sup> Since much government spending is redistributive in

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<sup>41</sup> Charles Galvin and Boris Bittker, The Income Tax: How Progressive Should It Be? (American Enterprise Institute, 1969), p. 37.

<sup>42</sup> In 1982, 45 percent of the public felt that progressive taxes are not fair and equitable, compared to 38 percent who gave that response in 1981. (Testimony of Louis Harris before the Senate Finance Committee (September 29, 1982), p. 7.)

<sup>43</sup> Under one particular index of progressivity in which a measure of +1 is achieved only by the most progressive tax (one in which those with the highest incomes pay all of the tax), a measure of 0 by a proportional tax and a measure of -1 by the most regressive tax, the individual income tax measured .19 in 1970, compared to .32 for the corporate income tax, -.15 for sales and excise taxes, and .07 for all taxes combined. (Daniel Suits, "Measurement of Tax Progressivity," American Economic Review (September 1977), p. 750.) Suits' estimates are based on assumptions about the incidences of taxes put forth in Joseph Pechman and Benjamin Okner, Who Bears the Tax Burden? (The Brookings Institution, 1974).

nature, government spending and taxing taken together are redistributive and would be even if the income tax were proportional.<sup>44</sup>

Exploitation of a Minority. Progressive income taxation has been criticized by some because it allows the majority to impose confiscatory taxes on and exploit those with very high incomes.<sup>45</sup> The potential for exploitation of a minority by the majority is a more general problem of democratic government, rather than of progressive taxation alone, however, and applies to government spending as well as taxing.<sup>46</sup> Moreover, the temptation to impose confiscatory taxes on the very wealthy may be tempered by the hope on the part of the average citizen that one day he will be wealthy himself.

### BROADENING THE INCOME TAX BASE

Whether base broadening is accompanied by reduction in the tax rates to a flat-rate or graduated-rate structure, some general conclusions hold true and are discussed below. Arguments for and against tax base broadening are broken down into those of simplicity, efficiency, and equity.

#### Simplicity

Eliminating most personal deductions and tax credits would greatly simplify the tax code and tax returns. Taxpayers would no longer be required to keep extensive records of charitable contributions and medical expenses, for example, if those deductions were eliminated. On the other hand, taxing other items not now taxed would introduce added complexity. Taxing transfer payments, like AFDC, the cash value of food stamps, and all unemployment compensation, would bring more taxpayers into the system, increasing the administrative burden. Taxing fringe benefits and accrued life insurance earnings might pose difficult valuation problems. Taxing capital gains in full might be opposed unless the gains were indexed for inflation, and indexation would introduce added complexity. In addition, if tax subsidies were replaced by new direct government spending,

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<sup>44</sup> Although the Social Security tax itself is regressive, for instance, Social Security taxes and benefits together are redistributive.

<sup>45</sup> See, for example, Bruce Bartlett, "The Economics of Progressive Taxation," Modern Age (Summer 1978), pp. 288-289.

<sup>46</sup> See Blum and Kalven, The Uneasy Case, p. 20; and Bittker, The Income Tax, p. 33.

the gains in tax simplification might be offset by the complexity of the new spending programs.

### Economic Efficiency

Failing to tax all income equally causes a misallocation of resources, since certain forms of saving and certain investments are given favorable treatment. The special tax provisions for owner-occupied housing, for instance, have resulted in overinvestment in housing relative to plant and equipment.<sup>47</sup> The tax exemption of interest on state and local bonds gives state and local governments an advantage compared to private firms in the cost of providing goods and services.<sup>48</sup> The ability of taxpayers simultaneously to invest in tax-free assets and to borrow and deduct in full all interest paid creates an opportunity for many high-bracket individuals to profit at the Treasury's expense, through borrowing and lending that creates no net change in the taxpayers' financial positions but does involve a waste of resources.<sup>49</sup> Moreover, since most fringe benefits are not taxed, the mix of compensation is tilted too heavily toward fringe benefits relative to cash. Since employer-provided medical and life insurance are untaxed, for instance, the nation might be consuming too much medical care and life insurance.

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<sup>47</sup> See, for example, Frank deLeeuw and Larry Ozanne, "Housing" in Henry Aaron and Joseph Pechman, eds., How Taxes Affect Economic Behavior (The Brookings Institution, 1981), pp. 283-326; and Congressional Budget Office, The Tax Treatment of Homeownership (1981), pp. 21-32.

<sup>48</sup> This has been a problem, particularly in the last decade, as municipal bonds have been issued in increasing quantities to finance traditionally private-purpose goods and services, such as housing, private hospitals, and buildings and equipment for private firms of all sorts. See Congressional Budget Office, Small Issue Industrial Revenue Bonds (April 1981); Tax-Exempt Bonds for Single-Family Housing (April 1979); and Tax Subsidies for Medical Care (January 1980).

<sup>49</sup> Although it is illegal to deduct interest on money borrowed to invest in tax-exempt bonds, this provision is hard to enforce since uses of borrowed funds are nearly impossible to trace. Since investment interest deductions are limited to \$10,000 more than investment income, the ability to deduct interest payments on borrowed funds invested in tax-free assets is also limited.