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A FEASIBLE APPROACH TO FLAT TAX REFORM¹

KAMBHAMPATI S. SASTRY² AND JEFFREY B. NUGENT³

ABSTRACT

Flat tax reforms have the distinct advantage of simplifying the tax structure and improving tax collection. However, the flat tax proposals have made little progress due mainly to the transitional problems associated with the type of 'value added' tax suggested for the purpose. Modifications proposed include incorporation of payroll taxes in the scope of tax reform, a flat rate of 10% for business tax on a widened tax base of all incomes generated, a flat tax rate of 20% on all incomes and a consolidated and refundable tax credit of \$2,000 per capita (at 1996 prices) in lieu of 'standard deduction', so that tax reforms achieve wider acceptance.

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² K S Sastry
Visiting Scholar,
Department of Economics,
University of Southern California,
E mail: ksastry@rcf.usc.edu

³ Jeffrey B. Nugent
Professor of Economics,
Department of Economics,
University of Southern California,
E mail: nugent@almaak.usc.edu

I. INTRODUCTION

Several suggestions have been made in recent years of how to simplify the structure of income tax and promote efficiency at the same time. A flat rate tax epitomizes this approach.

There is a general consensus among lawmakers and professional economists that a simplified income tax structure is highly desirable since it would facilitate compliance, reduce enforcement costs and thereby reduce the tax burden on the honest tax payer. If a simplified structure could be built around low rates of tax, so much the better since it would encourage voluntary compliance. (Rates can also be brought down by reducing the spending obligations of government, but that is a separate debate.)

If the tax structure could be simplified with a low and flat rate, it would be even better. This is because a tax levied at a uniform percentage on all incomes and at all income levels would leave work incentives largely unaffected between either work and leisure or full time work in the formal sector and part time work in the informal sector. Thus, tax payers would no longer have the incentive to switch their earnings or other income from a period when they are subject to a higher rate of tax to a period when a lower rate would apply.

If a simplified tax structure with a low and flat rate could also promote saving, leading to accelerated growth of the economy, it would be even more desirable. Yet, with so many possible objectives of tax reform, there can arise conflicts among objectives. For example, if the attempt to promote saving complicates the tax structure or leads to higher tax rates, it would conflict with the objectives of simplification and tax reduction.

Congressional hearings on the subject of tax reform would seem to indicate the primacy of the simplification objective, followed by that of tax reduction, but consistent with the objective of vertical equity whereby taxpayers with higher incomes pay higher effective rates of tax than taxpayers with lower incomes (Congress, 1995a, 1995b, 1995c).

The present tax structure is widely acknowledged to be both inefficient and inequitable. The various flat tax proposals presently under consideration are deemed to raise efficiency but they are also expected to increase inequity. The latter cost is important given the considerable increase in income inequality which has occurred in the U.S. since 1980s (Bureau of Census, 1996). In the following, we delineate an approach that can achieve the efficiency-improving goals of simplification and rate reduction but also greater equity. All too often economists close their eyes to the possibility that, instead of tradeoffs between efficiency and equity, both goals can be achieved simultaneously.

II. THE REFORM PROPOSALS

The concept of flat tax owes its origin to Alvin Rabushka and Robert E. Hall of the Hoover Institution, Stanford University. The concept received wide recognition and has since taken different forms. The various legislative proposals on the subject have been adequately described and analyzed in several publications. For reasons of space and relevance to our own proposal, we shall consider only the proposal suggested by Richard Armev (1997), Majority leader in the House of Representatives of the Congress, and the proposal made by Senators Sam Nunn and Pete Domenici, known as 'unlimited saving allowance' (USA) proposal, although the latter is not for a flat tax as such. (See JCT, 1995 for a full description of the two proposals).

The Armev proposal

The Armev proposal seeks (1) to replace the present individual income tax and the corporation income tax with a new individual income tax and a tax on business activities and (2) to repeal the estate and gift taxes.

The new individual income tax would be levied only on wage income while the new business tax would be levied on all capital income, payable by any person engaged in business activity 'whether such a person is an individual, partnership, corporation, or

In the individual income tax, all exclusions and deductions from taxable income and all tax credits available under current law would be replaced by a 'basic standard deduction' of \$22,000 in the case of a joint return or a surviving spouse, \$14,000 in the case of a head of household and \$11,000 in the case of an individual and married individual filing separately. For each dependent, an 'additional standard deduction' of \$5,000 would be allowed. Determination of the individual's filing status as well as the definition of dependent would be the same as under the present law. The deductions would be at the 1996 price level, deductions for future years being indexed to the consumer price index for all-urban consumers published by the Department of Labor.

The proposal prescribes a 20% flat rate for the individual income tax. However, with the provision of a 'standard deduction', incomes up to a certain level would not be taxable. The *effective* tax rates are thus graduated, comencing from zero. All pension benefits would be taxable as they accrue to the employees. Fringe benefits provided by employers to the employees in forms other than wages or retirement benefits would be taxable at the hands of the employers. Some such fringe benefits are presently not taxable at either end.

Under the business tax, gross income from sales *less* 'business inputs', wages and retirement contributions (the latter captured under the individual income tax) is taxable. Business inputs include the cost of all purchases including capital equipment. For the business tax also, the same tax rate of 20% is prescribed. While the Armev proposal calls for a reduction in the individual and business tax rates to 17% by the year 1999, according to a Treasury official (Toder, 1995), the proposal would require a rate of approximately 24% to raise the same revenues as the current corporation and individual taxes it would replace.

The USA proposal

In the USA proposal, all net saving (including bank accounts and other forms of saving) would be deducted in full from the taxable income; correspondingly all dissaving, that is, reduction in saving accumulated in previous years, would be taxed at rates applicable in the year of dissaving. Family allowances and itemized deductions analogous to provisions in the current law would continue; in addition, pay-roll taxes paid are deducted from the tax payable. The graduated tax rates would range from 8% to 40% of taxable income. Individuals who own businesses would be required to file two returns, one as an individual and one as a business.

Businesses would be subject to a 11% tax on the 'value added', that is, wages, fringe benefits, interest, and profits, with a tax credit for payroll taxes paid by the employers. All capital investments would be 'expensed' in the year of purchase. Receipts from export sales would be excluded from taxable income of the businesses, while imports would be subject to tax at the same rate of 11%. There would be no change in estate duty and gift taxes.

Promotion of saving

The common objective of both the tax reform proposals is to encourage saving by transforming the tax structure from one based on taxing income to one based on taxing consumption, that is, income *less* saving. However, the specific form of the tax, namely, the value added tax (VAT) gives rise to both (a) a bias against human capital and (b) difficult transitional problems. The Armev proposal has no other specific feature to encourage household saving.

There has been a perceptible fall in the savings rate in the country over the last fifteen years. Average gross saving fell from 18.6% of the GDP in the years 1981-85 to 15.1% in the years 1991-95. At first, this was as much due to increased budget deficits as due to a fall in household saving. More recently, however, with reductions in the budget deficits, the more serious decline has been in household saving as a proportion of disposable income. The latter decline seems to have been the natural result of rising wealth in the form of appreciation of both land and financial assets. The downward trend in the U.S. pattern of lower household saving, moreover, has been similar to that of other OECD countries (OECD,1994).

The cause of the fall in the savings rate has been the subject matter of extensive research and discussion by economists. Other than the wealth effects, the survey by Browning and Lusardi (1996) found little empirical evidence to support any of the several explanations offered. The decline in the savings rate is particularly baffling since the share of income of the top 5% households, who are often assumed to have a greater propensity to save than others, has increased from 16.3% to 20.0% during the same period that household saving rates have fallen.

Since the fall in the savings rate is due to decline in the proportion of household saving in after-tax disposable income, current tax law cannot be said to have led to fall in saving. It is worth noting that, under a tax structure with graduated tax rates (as with virtually all tax incentives), tax incentives for saving are regressive in nature. For example, Hubbard and Skinner (1996) reported that, in the year 1985, 18 per cent of tax payers (in the age group 55-64) with incomes below \$20,000 were contributing to IRAs, while 70 per cent with incomes above \$40,000 were contributing. The response to a tax-favored savings instrument such as IRAs could well be different were a flat rate of tax to be introduced; since in this case it could no longer be used to achieve a lower effective tax rate.

Current tax law allows contributions to Individual Retirement Accounts, Keogh plans, and Section 401(k) plans and others to be deducted from taxable income at the time of contribution. These are taxed, along with interest, when the amounts are withdrawn. The USA proposal would remove all limits on such saving allowances to households. However, to remain revenue neutral this would require an increase in tax rates. The Arney flat tax proposal does not incorporate any new initiative to promote household saving. Instead, it adopts the pragmatic approach of continuing the present treatment of retirement savings under the individual income tax while doing away with all other specific tax concessions.

For the business tax, both proposals advocate the introduction of a VAT kind of tax to encourage investment and thereby saving. The VAT has been introduced in all OECD countries except Australia and the U.S. (OECD, 1995). However, no country has replaced its income tax by a VAT. Wherever introduced, the VAT replaced only the cumbersome sales and excise taxes, not individual and corporate income taxes.

Various types of VAT can be chosen. In the 'credit invoice' type of VAT adopted by the European countries, only the VAT element of the cost of capital purchases is set off against the VAT payable on sales. (This type of VAT is mandatory for countries wishing to join the European Union because it facilitates border tax adjustments). Under the 'subtraction' type of VAT advocated in the U.S. tax reform proposals, however, the full cost of purchases (that is, the supply price plus the tax) would be deducted from the total value of sales (that is, the sale price plus the tax). As a result, investments in capital assets would be fully expensed at the time of purchase. Such a means of expensing capital assets would introduce a bias in investment in favor of physical assets relative to human capital. Yet, one should consider that very significant and, perhaps, rising contributors to long-term growth in the U.S. economy are investment in education, R&D, and consequent technological progress. Samuelson and Nordhaus (1995) draw attention to the fact that, of the long term growth of 3.2% per annum in the GNP, over the years 1948 to 1990, only 1.8% per annum could be attributed to growth in physical capital (1.2%) and labor (0.6%). The remainder (1.4%), called 'total factor productivity growth', was attributed to economies of scale, education, advances in technology etc.,. It would be a pity if modifications in the tax structure were to reverse this trend.

Further, it is the expensing feature which has proved to be the stumbling block in tax reform. Even businesses which would stand to benefit from it are lukewarm due to transitional problems posed. In particular, the full expensing of new investments would have a backlash effect on investments to date imposing a sudden loss on the owners of existing capital. Consequently, prices of shares in corporations with heavy existing capital assets might plummet in the stock markets. These transitional problems and their possible remedies have been studied extensively (see, for example, Seidman, 1997) but there seems to be no prospect of a consensus in favor of any one transitional arrangement or remedy.

This is, however, no reason why reform of the present tax structure, which is both inefficient and inequitable, should not proceed on the basis of other positive features of the proposals, modified to the extent suggested by us, without prejudice to the introduction of VAT at a later stage.

Simplification

The Armev flat tax proposal achieves considerable simplification of the tax structure and this is important considering that, because of the complexities of the present tax structure, the compliance costs incurred by the taxpayers are as much as \$200 billion per annum (Hall, 1995). Indeed, the clinching argument in favor of a flat rate of income tax is its administrative simplicity and the resulting savings to the taxpayers arising from reduced compliance costs.

If everyone were to pay the tax, the burden on the honest taxpayer would be less. A flat rate of tax offers great scope for monitoring the withholding of tax and for containing tax evasion. According to IRS sources quoted in JCT (1993, p 107), “ as many as 10 million taxpayers, with a total tax liability of nearly \$120 billion, may not be filing tax returns”. If all those making payments by way of wages, interest, dividends and transfers were given a uniform rate for withholding, as would be the case under a flat rate of tax, less income would go unreported.

Widening of tax base

It is quite easy to see how the various currently prevailing tax concessions which benefit specific groups shrink the tax base and increase the tax rates for all. For example, the aggregate personal income accruing to all individuals in 1993 (the latest year for which IRS statistics are available) was \$5,480 billion. However, after deducting the ‘tax exempt’ incomes, the total ‘adjusted gross income’ (AGI) of those who filed the tax returns was only \$3,714 billion. Furthermore, after deducting the ‘exemptions’ and ‘standard deduction’ or ‘itemized deductions’ from the AGI, taxes were actually levied on even a smaller base of \$2,454 billion. Tax rates are high because of the narrow tax base. If tax were to be collected on the full tax base of \$5,480 billion, the *average* tax rate could be brought down to 9.3%. The principal vehicle for reform and rate reduction is thus a broadening of the tax base.

While one can be cynical about the feasibility of removing all the tax breaks in the face of pressures from interested groups, it is fair to say that lobbies in their favor initially come about and are then sustained precisely because of the high tax rates. When nominal rates are high, it is natural to look for ways of bringing down the effective tax rates. For example, in 1993 less than 9% of the tax returns with gross income below \$50,000 (with a marginal tax rate of 15%) claimed the deduction for mortgage interest, while 77% of the tax returns with gross income above \$100,000 (with marginal rates of 31% or higher) claimed the deduction.

If nominal rates themselves are brought down, tax payers would not mind paying a small price for a simpler system with a lower tax rate on a wider tax base, especially if it should happen to be the universal base. Moreover, the acid test is whether taxpayers in various income groups would be asked to pay higher taxes after the tax reform. If no one would have to, there would be less resistance and lobbies would become weaker. The challenge lies in formulating a reform proposal which would not adversely affect any income group.

The Arme y flat tax proposal does not suggest outright removal of the tax concessions. Instead, to avoid tax-induced distortions in the functioning of the economy, on the one hand, and interference with the freedom of taxpayers, on the other, all such concessions would be subsumed under a consolidated 'standard deduction'. This is an extension of the principle adopted in the current tax structure wherein one can opt for a 'standard deduction' in lieu of 'itemized deductions'. The USA proposal, on the other hand, would maintain the existing tax deductions for mortgage interest, contributions to charitable bodies, and state and local taxes paid, with the result that the tax base would not be widened.

Lowering of tax rates

It is by widening the tax base that the Armev flat tax proposal brings down the highest marginal tax rate for individual income tax from 39.6% to 20% and that for the business tax from 35% to 20%. The substantial reduction in the marginal tax rates is very significant from the point of view of economic efficiency. Marginal tax rates directly impact on the marginal costs on the basis of which both individuals and businesses make their supply and demand decisions in the relevant markets. It is generally believed that the distorting effect of taxes increases with the square of marginal tax rates (Boskin, 1996).

In the USA proposal, the marginal rate would be reduced to 11% in the case of the business tax, thereby producing another illustration of how the widening of tax base helps in lowering the tax rate. In the case of the individual income tax, however, the USA proposal would leave the highest marginal tax rate virtually unchanged.

Eliminating distortions in the use of capital

The Armev proposal succeeds in eliminating the distortions created by the present tax structure in the use of capital in the economy. The USA proposal succeeds in eliminating these distortions only partially since the tax concessions on housing would continue.

In an insightful contribution, Gravelle (1994) estimates the efficiency cost of the present corporation tax to be 1.36% of GNP, while the revenue collected is 1.38% of GNP. Thus, the efficiency loss due to various distortions in the economy could be as much as 95% of revenue collected from the tax.

One kind of distortion arising from the discriminatory tax rates is that between corporate investments and non-corporate investments. Fullerton and Karayannis (1993) have shown that, after the 1986 tax reforms, the overall effective tax rate on capital in the corporate sector is twice the rate in the non-corporate sector which, in turn, is twice the rate for owner-occupied housing. There are also discriminatory tax rates (1) between different sectors and industries through varying investment incentives, and, (2) between different types of capital assets through differentiated rates of allowed depreciation which have little or no relation to differences in their economic depreciation rates. These distortions together account for an estimated efficiency loss of 65% of the revenue collected.

A second kind of distortion arises from the differentiated treatment in taxation between equity capital and debt capital since the latter is a deductible expense for the corporation. This creates a bias in favor of borrowed capital. This distortion is estimated to cost about 12% of the revenue collected. A third kind of distortion is due to the differences in tax rates between retained profits and distributed profits, accounting for an estimated efficiency loss of 14% of revenue collected. Finally, since capital gains which arise mainly due to retained profits are taxed only on their actual realization, another 4% of the revenue collected is lost.

The business tax part of the flat tax proposal would justifiably eliminate all these distortions. In particular, double taxation of dividends would be avoided. With respect to the investment, the proposal would ensure neutrality between equity and debt capital within the corporate sector as well as between the corporate and non-corporate sectors. On the dividend policy of corporations, the proposal would bring about neutrality between paying dividends and retaining profits (at least as long as the tax rate would remain unchanged over the years).

III. SUGGESTED MODIFICATIONS

Despite all the positive features of the flat tax proposals characterized above, there is room for improvement in certain important respects.

Treating the individual as the unit of taxation

Both the Arney and the USA proposals take the household as the unit of taxation. Because of the exemptions and the graduated effective tax rates, if husbands and wives were taxed separately, they would get the benefit of lower effective tax rates than would be the case if their incomes were pooled. The justification given for the pooling of incomes is that, when both husband and wife earn, their taxpaying capacity is higher.

The issue becomes irrelevant when a single tax rate is applicable to all incomes. Tax law can thus be simplified further if the individual is made the unit of taxation. The individual is the proper focus of fairness in any social institution. The individual focus should also extend as between adults and children.

Current tax law provides for the same amount of 'exemption' from taxable income for the spouse and other dependents. Abandoning the simplification approach in this respect, the Arney flat tax proposal suggests that differential amounts of 'standard deduction' should apply to dependents including children. The flat tax proposal in this regard is particularly inexplicable when the 'standard deduction' is sought to replace tax credits for child care and dependents as well.

Providing a 'standard deduction' for children that is on par with that for adults should encourage efficiency in investment in human capital in the long run. Poverty and malnourishment in the early years of life irretrievably retard human development. But, as Solow (1994) observes, "Americans have allowed child poverty levels to remain astonishingly high .. higher than for children in nations who are our competitors .. and far higher than one would think a rich and ethical society would tolerate." Twenty two per cent of the total number of children in the population were poor in 1993, up from 18% in 1980. And, the younger the children were, the poorer they were, e.g., while 22% of all children were poor, 26% of those under six were poor.

A per capita basis for the 'standard deduction' would simplify the tax structure. For example, for a household with two dependents, instead of a basic standard deduction of \$22,000 and additional standard deduction of \$5,000 for each dependent, a per capita deduction of \$8,000 can bypass the issues of living arrangements of the family as well as the mode of filing the tax returns.

Universal tax

A further means of simplification would be to make the individual income tax universal. The income tax system covered 90% of the population of 259.3 million in the year 1993. A total of 114.6 million tax returns were filed with the IRS on behalf of 232.9 million persons (being the total number for whom 'exemptions' were claimed in the returns). It will help simplify the tax structure and help monitor tax compliance if all incomes were taxed and the coverage made 100%.

The benefit from introducing a flat rate of tax would be frittered away if income up to a certain limit would be exempted from tax since, with such an exemption, monitoring the withholding of the tax at the source would be undermined. Indeed, a universal withholding system is a hallmark of an efficient flat rate tax system. With the help of social security numbers for individuals and employer identification numbers for business entities, it would then be easy for the IRS to trace all the income flows so that no income would be left out of the tax net. The IRS would need to audit only ‘by exception’, that is, only where discrepancies arise in the data on income flows. Further, if tax payers who have no income other than income on which tax has already been withheld were exempted from filing tax returns, paper work could be reduced substantially.

Ensuring progressivity of the effective tax structure without graduated tax rates

The estimated effective tax rates under the current federal taxes are as shown in Table 1. The introduction of a flat rate of tax for the individual income tax, which is the most progressive of all taxes, but without including payroll taxes, which are regressive, would compound the problem of vertical equity between taxpayers of high and low incomes.

If the current tax structure could serve as a guide, there is overwhelming consensus on the need for an individual income tax imparting a degree of progressivity to the tax structure. This progressivity could be retained even with a flat rate of tax if payroll taxes were also included in the reform. This need has been recognized in the USA proposal and constitutes one of its more perceptive features.

As noted above, progressivity of the tax structure is important in view of the widespread evidence of growing inequality in the U.S. According to Quadrini *et al* (1997), the bottom 40% of households account for only 1% of total wealth, the top 20% account for 80% and the top 1% no less than 30% of the total wealth. As for incomes, households in the top 5% have steadily garnered a proportionately larger share of income over the last two decades at the expense of each of the other groups, their share going up from 15.8% in 1980 to 21.0% of the total income by 1993. During the same period, the share of bottom 20% declined from 4.3% to 3.6% (Bureau of Census, 1996).

It is thus important to incorporate payroll taxes in the reform proposal. From the point of view of tax administration, the simplest procedure for accomplishing this is to adopt the procedure incorporated in the USA proposal wherein credit would be given to the employees under the individual income tax for the payroll taxes paid by them and, likewise, credit would be given to the employers under the business tax for the payroll taxes and contributions made by them.

The USA proposal goes further than merely incorporating the payroll taxes in that it would continue the graduated rate structure of the individual income tax. Such an approach might be desirable if there were no alternative to graduated rate structure for achieving the purpose of taxing the higher income groups at proportionately higher *effective* tax rates. Moreover, Seidman (1997 pp 36, 39) has shown that the current graduated rate structure has succeeded in reducing the income share of the top 1% households only marginally from 12.8% (before taxes) to 12.2% (after taxes).

Krugman (1994) has shown that only the top 1% households with income of \$330,000 (at 1993 price level) had benefited very considerably during the period 1977-89 (and probably beyond that). As a result, there would seem to be little reason why the remaining 99% households should be denied the benefit of a simplified tax structure of a flat tax, provided progressivity in the *effective* tax rates can be ensured.

Other means of reducing the skewness at the top of the income distribution without resorting to graduated income tax rates would include (1) curtailment of public policies, including tax policies, that encourage investment in real estate, (2) taxing wealth and taxing wealth transfers more heavily, (3) policies designed to raise the income of the poorest without jeopardizing the fiscal balance. Such measures would ensure level playing field for all in a free market system. In any event, while the progressivity of the tax structure is important, a graduated rate structure is not the most effective way of achieving it.

Replacing standard deduction with a tax credit

While both the Arney and the USA reform proposals attempt to preserve the progressivity of the income tax structure by exempting incomes up to a certain limit by providing a 'standard deduction', a tax credit mechanism would be a better alternative. A tax credit is a deduction from the tax payable, not a deduction from taxable income. It can be fixed as a uniform amount for all incomes while conferring a proportionately higher benefit on smaller incomes. With a tax credit mechanism, it would not be necessary to shrink the tax base.

Also, in the case of a flat rate tax, it would not matter whether a tax concession is given above or below the line. For instance, with a flat rate tax of 20%, a tax credit of \$2,200 would be the same as a 'standard deduction' of \$11,000 (provided for an individual in the Armev proposal).

Thus, to preserve the progressivity of the tax structure with a flat rate of tax, a fairly large tax credit, say, \$2,000 per capita should be provided in lieu of the 'standard deduction'. If such a tax credit were to be made refundable for individuals with lower incomes, it would be possible to introduce a genuinely flat rate of tax for all incomes *including those of the poor*. The tax base for such a comprehensive individual income tax would be the 'personal income' received by all individuals. In 1996, the aggregate personal income was estimated at \$6,448.5 billion. (SA, 1997, p 452).

A tax credit mechanism is presently used, among others, for the Earned Income Tax Credit (EITC) applicable to low income workers with dependent children. Since entitlement to EITC is not contingent on the tax becoming payable, it is refundable. It is contingent, however, on earning some income.

In 1996, a taxpayer with two or more qualifying children was entitled to a maximum EITC credit of \$3,556 if his or her earned income as defined for the purpose of this concession was between \$8,850 and \$11,650. The refundable credit gradually declined for incomes above \$11,650, becoming zero for income of \$28,495 and above. This is understandable. What is ironic, however, is that the tax credit became lower than \$3,556 for earned income below \$8,850 becoming only \$410 when the income was \$1,000. Such anomalies are bound to arise when policies on tax and welfare systems are formulated separately.

A consolidated and refundable tax credit providing an income supplement irrespective of the employment status would provide the necessary cushion against uncertainties in the labor market but without destroying the work ethic since income can be earned without forgoing the benefit of the income transfer through the tax credit. At the same time, with a universal tax based on a flat rate, everyone would face the same marginal rate of income tax.

According to the Bureau of Labor Statistics (1995), there were 11.6 million people in the labor force but below the poverty line in 1993. Of these, 6 million were 'usual full time workers'. As many as 3.9 million of these workers were in labor force for 27 weeks or more. However, they all remained poor as 70% of them experienced low earnings in their jobs; others experienced unemployment or involuntary part-time employment or both. No one should be very concerned for able-bodied persons who are not willing to work. But, society has an obligation to see that those who work hard enough do not remain poor.

The problem of low income wage earners is not likely to be addressed on the expenditure side of the budget since dissatisfaction with state intervention is even greater on the expenditure side. There is certainly no consensus in favor of enlarging the role of state in the field of welfare. Rather, the consensus is clearly in favor of a less intrusive state, both on the tax side and on the expenditure side.

EITC is acknowledged to have had a positive impact on low income earners, especially single mothers covered by the AFDC program. For example, a study by Scholz (1996) predicted that the 1993 expansion of EITC (with its full impact felt in 1996) would lead to increased participation of those who were not working earlier. Such participation would more than offset the reduction in working hours by those who were already in the labor market.

Another study by Martini (1997) concluded that with an expanded EITC the number of AFDC mothers working full-time would not increase but the number of part-time workers would go up by 124%, from 11.4% to 25.4% of the total number of such mothers. Correspondingly, there would be a significant drop in the number of participants in AFDC itself. A more recent study by Liebman (1998) has also concluded that EITC increased labor force participation among single women with children, and offset a significant share of recent increases in income inequality.

We, therefore, recommend that, instead of abolishing EITC along with all other tax breaks as suggested in the The Arme y flat tax proposal, it should be converted into a 'basic' tax credit at all income levels.

The amount of the basic credit could be fixed at \$2,000 per capita at 1996 price level. For a household of three persons below the poverty line, this would provide an income of \$6,000 per annum compared to the maximum EITC of \$3,556. Even then, it would constitute only 48% of the estimated poverty line of \$12,517 for such a household in 1996.

A universal income supplement through such a tax credit would confer on each and every citizen a basic economic power. This would enable every citizen to become a player in the free market system. It would also serve as an incentive to participate in the political process more meaningfully. Economic growth would be fostered, democratic processes strengthened and human dignity preserved.

Saying that such a ‘basic income / flat tax’ structure would be an improvement over the Hall-Rabushka plan (and, hence, also the Armev proposal), Atkinson (1995) says that “ it should definitely be on the agenda for possible discussion, and there are certainly circumstances in which it would be, in my judgement, the best way to develop a tax and social security system in the European Union.”

With such a ‘basic’ tax credit, public assistance programs in the form of Food Stamps, Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) could be curtailed. According to the Budget documents (1998, Historical Table 11.3), federal government outlay in 1996 on these programs was \$65.0 billion.

The same tax credit mechanism should be used for providing tax incentives for saving or other purposes considered essential. Although there is no agreement among the economists on whether tax incentives result in additional household saving, a reasonable case can be made out in favor of a tax incentive for retirement savings like contributions to the IRAs as they would add to the social security of the individual in old age (Hubbard and Skinner, 1996).

The maximum deduction from total income admissible in 1996 on account of saving in IRAs was \$2,000 per individual. With a flat tax of 20%, this would translate into a tax credit of \$400. Twenty per cent of retirement savings by individuals in the age group 18-64 could be given as a tax credit subject to a ceiling of \$400. This would be in addition to the 'basic' tax credit and would be non-refundable.

Widening the base for the business tax

The 'value added' by all business entities in the economy is the widest possible base for any business tax. Both reform proposals reviewed above are based on the concept of taxing this value added. It is a sound and efficiency promoting principle in that it seeks to tax income from all sources at the same rate. However, in the case of Armev flat tax proposal, the problem arises in splitting the tax into two, one payable by the individuals on wage income and the other payable by the business entities on capital income.

This gives rise to a perception problem on the part of tax payers that capital income would not be taxed at all. Even if this apprehension were incorrect, cognitive theory of psychology tells us that it would not be easy to convince wage earners that such a system would be fair to them (McCaffery, 1994).

While there could be some dispute on how much of the existing corporation tax (to be replaced by the broader business tax) is actually borne by capital and how much by others, there is no denying that part of it is borne by workers and consumers. Since, under the Armev proposal, their wage income would be taxed under individual income tax but also they have to bear part of the burden of the business tax they would be subject to double jeopardy.

Horizontal equity would require that taxpayers with the same level of income should pay the same amount of tax. The Armev flat tax proposal does not ensure this, as the illustration of two businesses generating the same aggregate value added in Table 2 shows. The table also illustrates that under the individual income tax two four-member households with the same income do not bear the same tax burden.

The conflict with the principle of horizontal equity in both cases could be avoided by keeping the two taxes separate, as now, but enlarging the base for the business tax to include all incomes generated by the business, instead of just profit. Such a business tax would tax value added on the income side of 'social accounts'. It would be a tax on the business in the wider connotation of its role - not simply a tax on a narrowly defined business income.

The tax base for such an enlarged business tax was \$5,025 billion in the year 1996 (as estimated from SA,1997, p 453). This excludes the compensation of government employees, employees in private households, non-profit hospitals and educational institutions, religious, charitable, and welfare organizations, and all other non-profit bodies. This compensation would not be taxable under the business tax but would continue to be subject to payroll taxes and contributions by the employees as well as the employers.

Setting revenue-neutral, efficiency-enhancing, low tax rates

The criterion of revenue neutrality would require that the aggregate revenue collection from the federal income taxes should remain at the same level as now. In 1996, revenue from these taxes totalled \$809.0 billion, net of outlay portion of the EITC, as may be seen from Table 3. The tax base for the restructured individual income tax, which is the aggregate personal income of all individuals, would be \$6,448.5 billion while that for the business tax would be \$5,025.0 billion.

The tax structure for the individual income tax we propose is that all taxpayers pay tax at a gross tax rate of 20 % of their total income. At the same time, each one gets a refundable 'basic' tax credit of \$2,000. In addition, each can claim a separate tax credit for retirement savings not exceeding \$400.

Estimated amounts required for the tax credits would be \$596.1 billion. Gross revenue with a tax rate of 20% for the individual income tax would be \$1,289.7 billion. After deducting the tax credits and the credit for payroll taxes of the employees, the net revenue would be \$453.2 billion, as shown in Table 3. A 10% tax rate for the business tax, net of the payroll taxes and contributions by businesses, would similarly yield \$297.5 billion. Total revenue of \$750.7 billion. would fall short of the required revenue of \$809.0 billion by \$58.3 billion. However, this could be made up by saving under welfare programs with an outlay of \$65.0 billion, as mentioned earlier.

Thus, tax rates of 20% for the individual income tax and 10% for the business tax should be revenue-neutral. The combined rate of 30% for the individual income tax and the business tax would compare favorably with the estimated rates, on revenue neutral basis, in the Arney flat tax proposal (if account is taken of the payroll taxes).

A tax rate of 20% for the individual income tax would be less than the 15% income tax on total income and 7.65% payroll taxes on the wage component of income currently paid by about 70% of the taxpayers in the lower income groups. As such, together with the consolidated tax credit, it should satisfy the criterion that no group should be adversely affected by the tax reform. It is relevant to note that this criterion is not satisfied in the other tax reform proposals being considered (Slemrod and Bakija, 1996).

IV. CONCLUSION

The modifications suggested to the Armev flat tax proposal, grafting in part some of the features of the USA proposal, include (1) continuing the present arrangement of separate taxes on individual incomes and on business, but widening the base for the business tax to include all incomes generated (value added), (2) giving credit under both the taxes for the payroll taxes paid, and (3) substituting a tax credit for the 'standard deduction' under the individual income tax.

In restructuring the business tax as suggested, a giant step would have been taken towards the introduction of a consumption tax should the thorny transitional problems associated with it be satisfactorily addressed at a later stage. The issue of expensing the capital investments at the time of purchase would also become less important with a low tax rate that we have suggested. Meanwhile, the elimination of distortions in the use of capital and the reduction in the marginal tax rate for the business tax to 10% would enhance the prospects for economic growth.

The modified tax structure proposed would ensure both horizontal and vertical equity. It would conform to the principle of working within the framework of a free market system of economic management with minimal interference. It would reinforce both equity and efficiency and is thus a 'win-win' proposal.

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Table 1
Effective Federal Tax Rates by Income Group, 1993

<i>POPULATION QUINTILE</i>	<i>INDIVIDUAL INCOME TAX</i>	<i>PAYROLL TAXES</i>	<i>CORPORATION INCOME TAX</i>	<i>ALL TAXES (INCL. OTHERS)</i>
Bottom 20%	-3.2%	7.6%	1.1%	8.4%
Next 20%	2.8%	9.5%	1.6%	15.5%
Next 20%	6.2%	10.1%	1.8%	19.5%
Next 20%	8.7%	10.5%	2.0%	22.3%
Top 20%	15.5%	7.7%	2.8%	26.6%
Top 1%	21.9%	2.1%	4.1%	28.4%
All income groups	10.9%	8.9%	2.3%	23.2%

Source: derived from Richard Kasten *et al* (1994)

Table 2

Incidence of the Armev flat tax and the modified proposal (an illustration)

The following illustrates that two businesses generating the same aggregate value added would pay different amounts as tax under the flat tax proposals:-

	<u>Business X</u>	<u>Business Y</u>
Wages	\$70 million	\$60 million
Interest	\$10 million	\$10 million
Profit	\$20 million	\$30 million
Total value added (income side of social accounts)	<u>\$100 million</u>	<u>\$100 million</u>
Payroll taxes (7%)*	\$4.9 million	\$4.2 million
Tax on interest (20%)	\$2.0 million	\$2.0 million
Tax on profit (20%)	\$4.0 million	\$6.0 million
<i>Total tax</i>	<i>\$10.9 million</i>	<i>\$12.2 million</i>

* approximate overall rate assumed to avoid complexity in the illustration

With 10% business tax as proposed by us, both businesses would pay the same tax of \$10 million.

Similarly, under the individual income tax, taxpayers with the same income would pay different amounts as tax under the flat tax proposal, as may be seen from the following illustration for two four-member households:-

	<u>Household A</u>	<u>Household B</u>
Wage income	\$100,000	\$80,000
Capital income	0	\$20,000
Total income	<u>\$100,000</u>	<u>\$100,000</u>
Standard deduction under the flat tax proposal		\$32,000
		\$32,000
Taxable income	\$68,000	\$48,000
Income tax payable(20%)	\$13,600	\$9,600

	Payroll taxes (approx.)	\$5,410
\$5,120	<i>Total tax</i>	<i>\$19,010</i>
		<i>\$14,720</i>

With 20% tax on total income and a 'basic' tax credit of \$2,000, both households would pay the same tax of \$12,000.

Table 3
Estimated Tax Collections for the year 1996

<u>Estimated collections under current tax law</u>	<u>\$</u> <u>billion.</u>
Individual Income Tax	656.4
Corporation Income Tax	171.8
<i>Less Earned Income Tax Credit (outlay portion)</i>	19.2
<u>Total</u>	<u>809.0</u>
Payroll Taxes payable by employees	240.4
Payroll Taxes and Unemployment Contribution by employers	269.0
(of which, taxes and contributions by businesses)	(205.0)
<u>Estimated collections in the revised tax structure</u>	
Individual Income Tax @ 20% (tax base: \$6,448.5 billion)	1,289.7
<i>Less Payroll Taxes</i>	240.4
<i>Less Basic Tax Credit @ \$2,000 per capita</i>	531.2
<i>Less Tax Credit for Saving @ \$400 per capita</i>	64.9
<u>Net revenue from Individual Tax</u>	<u>453.2</u>
Business Tax @ 10% (tax base: \$5,025.0 billion)	502.5
<i>Less Payroll Taxes</i>	205.0
<u>Net revenue from Business Tax</u>	<u>297.5</u>
<u>Total Revenue</u>	<u>750.7</u>
Gap in revenue to be filled by curtailing welfare programs	58.3

Notes:

1. Estimated tax collections for 1996 under current tax laws are from Table 516, Statistical Abstract (SA), 1997, p 333.
2. Payroll taxes and contributions from businesses in 1996 are estimated *pro rata*.
3. Tax base for the Individual Income tax is estimated from Table 698 (SA, 1997 p 452).
4. Basic Tax Credit worked out for the total population of 265.6 million and the Tax Credit for Saving in respect of 162.3 million persons in the age group 18-64.
5. Tax base for the Business Tax estimated from Table 701 (SA, 1997 p 453)

6. Net revenue from the proposed Individual Income Tax and the Business Tax are not strictly comparable with revenues under the current Individual Income Tax and Corporation Tax respectively since tax on unincorporated businesses is currently accounted for under Individual Income Tax.