

**THE IMPACT OF THE FLAT TAX
ON CALIFORNIA**

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THE IMPACT OF THE FLAT TAX ON CALIFORNIA

VOLUME I

A SURVEY OF THE ISSUES

I. Introduction

Congress is currently considering a number of proposals for overhauling the federal tax system. Among the most prominent of these proposals is the *Freedom and Fairness Restoration Act of 1995* (HR 2060), sponsored by House Majority Leader Richard Arney.¹ The Arney proposal is closely modeled on the tax system described in **The Flat Tax**, by economists Robert Hall and Alvin Rabushka of the Hoover Institution. Unlike our current federal income tax system, the flat tax would tax national consumption rather than national income. Such a dramatic redesign of federal tax policy would cause changes in tax burdens and economic incentives throughout the economy. In response to a request from the members of the Franchise Tax Board,² this report analyzes the impact that the adoption of the flat tax by the federal government would have on Californians and on various sectors of the California economy. This report is divided into two volumes. The first volume presents an overview of the Arney proposal and surveys a variety of issues related to the flat tax. The second volume presents simulations of the effects of the flat tax on California taxpayers.

The flat tax has generated interest from both politicians and taxpayers for two primary reasons. First, it is perceived to be simpler than our current tax system. Second, it is considered to be more efficient than our current tax system. Clay Chandler, of the *Washington Post*, expresses the typical case for the flat tax when he writes that, "The flat tax's proponents say it would wipe out loopholes and vastly simplify the average American's tax filing procedure, perhaps enabling families and businesses to file a return no larger than a postcard. Advocates also say it would spur investment and economic growth."³ The efficiency gains are seen as arising from two primary features of the flat tax. The first feature is that the flat tax does not tax the return on savings and investment. The current system does tax the return on savings, although it does provide exemptions -- e.g., IRA provisions, exemptions from employer and employee taxation of pension contributions, and differential tax rates for capital gains -- for very particular types of savings. The second feature is that the flat tax eliminates the high tax rates for high-income taxpayers.

The Arney proposal is a flat tax because all income, whether earned by businesses or as individual wages, is taxed at a common rate. (The significant exception to this fact is that individual taxpayers are allowed a standard personal exemption, as well as exemptions for any dependents.) There is only one rate, and that one rate is much lower than the top marginal rates

¹ The actual proposal -- H.R. 2060, Title I -- is presented in Appendix I.

² See Chairwoman Connell's comments on page 32 of the minutes to the Franchise Tax Board meeting, August 3, 1995.

³ Clay Chandler, "Flat Tax Proposals Take Center Stage," *Washington Post*, September 3, 1995, Sec. A, p. 1.

under the current system. These are significant features of the flat tax. The flat tax, however, would do much more than simply reduce the number of tax brackets. In fact, a flat tax rate could be imposed on taxable income as currently defined within the current federal corporate income tax and the federal personal income tax. The feature that makes the Armev flat tax such a significant reform is that the flat tax would fundamentally alter the tax base.

Under the current tax system, the calculations of taxable income for corporations and for individuals are not integrated. Under the Armev plan, however, all income is taxed once and only once (again, ignoring the complications of the personal and dependent exemptions on the individual flat tax) at the same rate. Income, as understood by economists, is produced in an economy when factors (labor, capital, land) are rewarded for providing services that go toward the production of some valuable good or service. The Armev proposal taxes the return to capital and land at the business level, and the return to labor at the individual wage-earner level. If capital is provided -- whether in the form of equity or a loan -- for a productive enterprise, the return on that capital will have already been taxed at the business level and will not need to be taxed at the level of the individual owner of the capital. Therefore, income from sources such as interest, dividends, and capital gains are not taxed. As a result, the flat tax is equivalent economically to a consumption tax, such as a value-added or a retail sales tax. The third significant feature of the flat tax is that it eliminates a wide variety of exemptions, deductions, and credits which currently reduce the tax rate on or remove entirely many items from the tax base. The justifications for, and implications of, these changes in the tax base are explored in Chapters II and III below.

The flat tax has two components: the individual wage tax and the business tax. The individual wage tax is equal to compensation less allowances multiplied by the tax rate. Compensation is simply the sum of all wages, salaries, and pensions received during the year. Allowances consist of a standard exemption plus an additional exemption for each dependent. No other deductions are allowed.

The business tax is equal to gross revenue from sales less costs multiplied by the tax rate. Costs include: purchases of goods, services, and materials; wages, salaries, and contributions to pension plans; and purchases of capital equipment, structures, and land. Note that each of these deductible cost items is taxed either at the individual level or as the receipts of another business. Therefore, all income is taxed, but only once. The tax rate is the same for both individual and business taxes.

As Alan Feld notes, “For the general public, the most salient attraction of the flat tax lies in its promise of simplicity.”⁴ Tax returns, both individual and business, will fit on postcard size forms (presented in Appendix II). Even under this seemingly straightforward proposal, however, a number of issues will still need to be resolved before the new tax system can be fully implemented. Indeed, Richard Joseph argues that, “the very simplicity of the Arme y flat tax is likely to create complex problems of construction.”⁵ In its current form, however, the Arme y proposal provides little or no guidance on a variety of details necessary for the administration of an actual tax system. For details not addressed in the current Arme y proposal, this report will assume, wherever reasonable, that features of our current tax system will be retained. This is an important point; it should be kept in mind that the implications presented below and the simulations presented in Volume II may be very sensitive to many of the as yet unresolved details.

In Chapter II, the primary conceptual arguments that have been offered by supporters and opponents of a flat tax are presented. Chapter III discusses several potential impacts of a flat tax on California’s economy and state government. In Volume II, results of the department’s simulation of the impact of a federal flat tax as distributed across California individual and business taxpayers are presented.

⁴ Alan L. Feld, “Living with the Flat Tax,” *National Tax Journal*, forthcoming December, 1995.

⁵ Richard J. Joseph, “The ‘Consumption’ and ‘Flat’ Taxes Revisited,” *Tax Notes*, October 9, 1995, pp. 211-222, p.212.

II. Arguments For and Against the Flat Tax

This chapter presents a summary of the main arguments that have been advanced by policy analysts, economists, and politicians in support of and in opposition to the adoption of a federal flat tax. Since much of the analysis that can be applied to the flat tax has actually been concerned with the general category of consumption taxes, this chapter begins with a conceptual overview of consumption taxes and of how the flat tax relates to other consumption taxes.

II.A: An Overview of Consumption Taxes

A consumption tax is a tax which is levied only on income spent on goods and services; income saved is exempt from taxes. The consumption tax can be levied in many different ways. Methods currently being discussed in Congress include:

- a comprehensive national retail sales tax
- Value-Added Tax (VAT) -- of which there are several types
- a consumed-income tax.

This section will describe the different types of consumption taxes. The next section will compare consumption taxes to our current income tax system.

A retail sales tax is imposed on final sales of goods and services to consumers, but not on business purchases of intermediates. This type of tax is currently being used by many state and local governments. While, in theory, the tax could be imposed on all final sales, in practice, many goods and most services are exempted. These exemptions cause distortions in economic decisionmaking between the consumption of exempted and nonexempted goods, greatly reducing the efficiency of the economy. In addition, most actual sales taxes also are levied on some intermediate business purchases. This leads to excess taxation on goods containing intermediates that have already been taxed and still are subject to full tax upon final sale. These "cascading" taxes distort prices and reduce the efficiency of the economy.

A Value-Added Tax is a sales tax levied on the difference between a firm's gross sales and its purchases of inputs from other firms. Note that the final retail price of a product is equal to the sum of the incremental increases in price (or value added) at each stage of production. This means that, even though the tax is collected in little bits along the way, rather than all at once at the end, the VAT is economically equivalent to the retail sales tax.

There are several different methods by which the value added at each stage of production can be measured. The method currently being used by most countries that have a VAT, including all of the European Community countries, is the invoice or credit method. Under the credit method, a firm's tax liability is determined by allowing the firm to subtract Value-Added Tax paid on purchases from the tax due on its sales.⁶ The second method for calculating value-added tax is the subtraction method. In this method, a firm's tax base is its sales minus its purchases from other firms. The Arme y proposal is essentially a subtraction-method VAT.⁷ The credit and subtraction method VATs have the same economic effect, as long as there are no exclusions from the tax base and everything is taxed at the same rate.⁸ The third method for calculating a VAT is the addition method. In this method, a firm is taxed on the sum of its components of value added -- wages, rent, interest, and net profit.

A consumed-income tax retains the administrative structure of the income tax, but allows individuals to subtract their net savings from taxable income.⁹ The USA (unlimited savings account) plan of Senators Pete Domenici and Sam Nunn is the most prominent example of such a plan. The consumed income tax is similar to our current federal individual income tax system, with an allowance for unlimited IRA deductions. That is, taxpayers are taxed only on that part of their income that they do not save. In addition, they are taxed on all distributions of principal or earnings from existing savings. Since all income must be earned or spent, subtracting net savings from income must yield an individual's purchases. Therefore, this proposal, too, is equivalent to the sales tax on all purchases.

While all of these consumption-based taxes are economically equivalent, in the sense that they each tax national consumption (at least, in their most pure forms), there are differences in the way each plan would be administered. In fact, while the subtraction- and addition-method VATs and the consumed-income tax could all be administered under the existing tax

⁶*Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 3, Value-Added Tax*, Department of the Treasury, November, 1984, p. 8.

⁷The Arme y flat tax is imposed in two parts: one on individuals and the other on businesses. The business component is identical to the VAT, except that wages are subtracted from taxable income. These same wages, however, are taxed on the individual side. The sum of the business and individual taxes, therefore, equal a tax on value added. Because the tax on the wage component of value-added is separated out, however, this structure enables the granting of personal exemptions to enhance progressivity without the distortions in relative prices associated with exemptions in a standard sales or value-added system.

⁸ Edith Brashares and Laura Kalambokidis, "Assessing the Equivalence of Different forms of Consumption Tax," mimeo presented at the National Tax Association Conference, October 10, 1995, p. 3.

⁹ See, for example, Charles E. McLure Jr. and George R. Zodrow, "A Hybrid Approach to the Direct Taxation of Consumption," National Tax Association Conference and forthcoming in *Handbook of Tax Reform* Michael J. Boskin, ed., p. 2.

administration infrastructure, the invoice-credit VAT and the retail sales tax would likely require either a complete redesign or a replacement of the IRS. Additionally, each tax scheme could, potentially, have a different impact upon the economy, if there are differences in the way the burden of the tax is distributed among consumers, workers, owners of capital, and foreigners.¹⁰ Finally, because they have different administrative structures, these taxes differ in the ease with which they can be modified from their pure forms (e.g., a subtraction method VAT, like the Armev proposal, would lend itself to the allowance of personal exemptions to improve progressivity, while such an exemption would be very difficult to administer under a retail sales tax).

Among the reasons most commonly given for switching to a consumption tax are that it will increase savings and investment, increase economic efficiency, improve the trade balance, and reduce the complexity of the tax system. The disadvantage claimed most frequently by opponents of consumption taxes is that they are not fair, in the sense that they will be less progressive than the current federal corporation and individual tax systems.

The remainder of this chapter presents a summary of the issues that have been raised by economists and others involved in the consumption-tax debate. The sections that follow discuss the impact of a consumption tax on:

- savings and investment
- economic efficiency
- international competitiveness
- tax complexity

Chapter III presents a discussion of tax progressivity.

Before proceeding to the discussion of these four issues, it needs to be noted that there is an important distinction between differences that are related to the comparison of a consumption tax with a pure income tax and those that are related to the comparison of a consumption tax with our current federal tax system -- which is anything but pure. Within the current tax system, the first type of difference can either not be resolved at all, or can be resolved only by moving further away from a pure income tax system. For example, a pure income tax imposes a tax on the return from savings, while a consumption tax does not. That difference

¹⁰ For a more thorough discussion of incidence assumptions in flat tax modeling, see Robert Cline and Paul Wilson, "Consumption Tax Incidence: A State Perspective," paper presented at the 1995 National Tax Association Symposium, October 10, 1995.

could be resolved, to some extent, by allowing greatly expanded IRAs, but that would move the income tax further from its pure form.¹¹

The second type of difference could be resolved within the current tax system. For example, some economists argue that the allowance of a deduction for mortgage interest is inefficient because it causes a bias in investment towards housing and away from productive capital goods. Since the consumption tax does not allow any interest deductions, all types of investment would be treated equally. The bias in the current system towards investment in housing could be eliminated by disallowing the mortgage interest deduction. Therefore, the distinction, in this case, is not between a pure consumption tax and a pure income tax, but between a pure consumption and our current income tax systems. Any of the differences between tax systems discussed below, particularly those related to the difference between a pure consumption tax and our current income tax systems, may be diminished to the extent that the legislation that enacts a consumption tax deviates from a pure consumption tax.

Of the issues to be discussed below, only the issues of savings and investment and, to a limited degree, the issue of tax complexity are related to the difference between pure income and pure consumption taxes.¹² The other issues could be addressed within the context of an income tax system. Nonetheless, they represent important differences between our current tax system and its proposed replacements.

¹¹ Of course, if IRAs are expanded to the extent that the tax system allows for any amount of savings for all taxpayers, the tax system will cease being an income tax and will become a consumption tax (consumed-income tax).

¹² The issue of complexity is said to be partly an issue arising in the comparison between a pure income tax and a pure consumption tax, because certain items that lead to complexity under a pure income tax -- for example, the taxation of capital income -- would not be an issue under a consumption tax (since capital income would not be taxed). For the most part, however, any simplicity gains brought about by a consumption tax can be attributed to the difference between the current, impure, income tax, and a pure consumption tax.

II.B: Savings and Investment

The reason most frequently put forth in favor of replacing the income tax with a consumption tax is that this change could encourage domestic saving and capital formation and promote economic growth. The rate of savings in the United States is low relative to other industrialized countries and has been declining (see Chart 1 and Table 1). One factor that may be contributing to the savings decline is that our current income tax system provides incentives for people to consume their income rather than to save it. This is because money saved is taxed twice -- once when it is earned and again when the proceeds of investment are realized.

It is widely believed that tax reform would work towards correcting this problem.¹³ As Eric Toder, Deputy Assistant Secretary for Tax Policy of the US Treasury, explains, "Two effects from substituting a consumption tax for the income tax could boost total private saving. Economic theory suggests that if the after-tax rate of return on savings goes up, individuals would increase saving to consume more in the future since the 'price' of future consumption in terms of foregone current consumption is lower ... In addition, some people are 'savers,' while others consume essentially all their income. Shifting the overall burden of taxes from saver to consumer households can increase aggregate private saving."¹⁴

However, there are several reasons to suspect that the actual change in savings rates will be smaller than the more optimistic consumption tax supporters predict. First, while the reasoning presented above suggests that an increase in the after-tax rate of return on savings would increase savings, economic theory is actually ambiguous on this point. A reduction of the tax rate on saving can theoretically lead to either an increase or a decrease in the level of savings.¹⁵ In the real world, as Toder explains, "Most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small."¹⁶ Rudolph Penner,

¹³ This is not to say that changing the tax code would eliminate all of the forces in our economy which discourage savings. Several additional factors, such as demographic changes and the expansion of government social programs, would still be working to reduce savings rates. Nonetheless, changing the incentives in the tax code would be a step in the right direction.

¹⁴ Statement of Eric Toder before the Senate Budget Committee, February 22, 1995, p. 9.

¹⁵ This ambiguity arises because theory recognizes two effects that work in opposite directions. The first effect is the income effect. The removal of the tax on savings increases the reward (the amount of after-tax interest) to saving. This should encourage people to save more. On the other hand, there is the substitution effect. Since the return to saving is higher, the taxpayer can save less than before, but still enjoy the same level of consumption in the future. After surveying studies which attempt to estimate the relative importance of these two counteracting effects, the Joint Committee on Taxation concludes that "empirical investigation of the responsiveness of personal saving to the taxation of investment earnings provides no conclusive results." JCT, p. 68.

¹⁶ Toder, p. 9.

table 1 here

chart 1 here

former director of the Congressional Budget Office, points out, "(E)conomists are generally skeptical about the use of tax policy to increase private saving and investment. After all, the decline in the saving rate continued in the 1980s in the face of increased saving and investment incentives early in the period and lower marginal rates later."¹⁷ Furthermore, several aspects of the current tax system do tend to increase the return on savings. The existence of special savings plans, such as IRAs and 401(k)s, as well as the tax preferences provided for the employer-provision of pensions, mitigate the discrimination against savings in the current system and reduce the gains from converting to a consumption tax. As Toder observes, "While a pure consumption tax would encourage private saving more than a pure income tax, the effect on saving of substituting a consumption tax for our existing income tax is less clear. Our current income tax includes powerful incentives for employees to receive part of their compensation in the form of retirement savings plan contributions, and for employers to provide such plans for all their employees -- including low-income employees who would not be likely to respond to direct tax incentives. The incentive to establish retirement plans would be much weaker under a consumption tax."¹⁸ If employers choose to scale back existing retirement programs, this could offset increases in savings elsewhere in the economy. Finally, Toder warns that "if tax policy changes also increase the Federal budget deficit, there may be no net increase in national saving."¹⁹

Nonetheless, some economists do argue that a switch to consumption taxes could significantly raise the national savings rate. For example, Lawrence Kotlikoff, in testimony provided before the Congressional Ways and Means Committee, concluded that the switch to a consumption tax would, in fact, lead to an increase in the level of savings. He observes that the decline in the savings rate is strongly associated with the rise in transfer programs for the elderly (such as Social Security and Medicare). Kotlikoff then goes on to argue that "the fact that the government's past and ongoing intergenerational redistribution appears to be the chief culprit for the decline in U.S. saving is worth bearing in mind in considering switching from income to consumption taxation. Such a switch would partially offset this process of taking from the young and unborn and giving to the old. It would do so by placing a somewhat higher tax burden on [those who are elderly at the time the tax is implemented] and a somewhat lower tax burden on younger and future generations. In switching tax structures (and thus redistributing from the elderly with high propensities to consume to the young and unborn with low or zero propensities to consume), the government can engineer a reduction in aggregate consumption and a concomitant rise in national saving. This redistributive or 'income' effect is the key reason that

¹⁷ Rudolph G. Penner, "Is a Radical Tax Reform in our Future?" *NTA Forum* 21, Spring, 1995, pp. 1-6, p. 4.

¹⁸ Toder, p. 9.

¹⁹ "

consumption taxation raises national saving.”²⁰ Note, however, that one implication of this line of reasoning is that any transition rules which ease the impact on holders of preconsumption tax wealth will reduce the benefits to the economy of the switch to the consumption tax. Diane Rogers confirms this view, writing, “If existing wealth is given relief from taxation, the consumption tax degenerates into a wage-income tax. In turn, efficiency gains are reduced, because the lump-sum component of the tax base is lost.”²¹

Along with Alan Auerbach, Kotlikoff developed an analysis that employs a dynamic life cycle simulation model.²² In this analysis, the change to a federal consumption tax produces an immediate and dramatic increase in the economy’s saving rate from 2.6 percent to 9.0 percent. While the saving rate gradually declines after year 1, it remains above 6 percent through the tenth year of the transition. The long-run (year 150) value of the saving rate is 3.2 percent -- 23 percent larger than the year 0 value. The increased saving produces a concomitant increase in investment. As a result, the capital stock rises. Indeed, the switch in tax regimes leads eventually (by year 150) to a 34 percent increase in the per capita capital stock. Although the increases in the savings rate and capital stock would clearly be a step in the right direction, they only partially offset our current savings deficit. For example, even with a savings rate of 3.2 percent, our savings rate would still be less than the current savings rate in any of the other G-7 countries, and about one-half of what it was as recently as the 1970’s in the U.S. (see Chart 1 and Table 1). Rogers also reports simulations in which the savings rate increases by 20 percent following the switch to a flat rate consumption tax. She finds, however, that the results are extremely sensitive to assumptions in the model about individual preferences for saving money and for supplying labor. Alternative assumptions on the nature of these preferences reduce (and, in some cases, make negative) the calculated increase in savings.²³

²⁰ Lawrence J. Kotlikoff, “The Economic Argument for Consumption Taxation,” testimony before the Ways and Means Committee, June 6, 1995, p. 3.

²¹ Rogers, “Sorting Out the Efficiency Gains from a Consumption Tax,” National Tax Association’s 88th Annual Conference on Taxation, October 8, 1995. p. 2.

²² The results presented here are taken from Kotlikoff (1995), pp. 9-11, which cite Alan J. Auerbach and Laurence J. Kotlikoff, *Dynamic Fiscal Policy*, Cambridge, England: Cambridge University Press, 1987.

²³ Rogers, Table 4. In the scenario in which savings increase 20 percent, the elasticities of intertemporal substitution and of leisure-consumption substitution are both 0.5, “which are high relative to the econometric estimates surveyed in Randolph and Rogers (p. 5).”

II.C: Economic Efficiency

In addition to affecting the saving vs. consumption decision, the current tax system causes many other economic distortions. Of course, it should be kept in mind that, while some of these distortions are inadvertent, many others are created intentionally. Our current tax system contains many credits, deductions and other special rules (tax preferences) that purposely provide incentives for taxpayers to engage in certain activities. These incentives are intended to distort economic decisions. For example, a deduction is allowed for charitable contributions to encourage taxpayers to donate more money to charities.

The tax preferences currently in our income tax code generally fall into one of two categories. The first group, incentive tax preferences, are designed to encourage certain types of behavior that are thought to be socially beneficial. These preferences create positive distortions in the economy, in order to compensate for inadequacies of the free market. For example, many economists believe that, because they will be unable to control all of the rewards from their discoveries, firms in a free market will perform too little research and development; so the tax code offers a research and development credit to encourage technological advance. The second group of preferences, hardship preferences, are designed to promote tax equity. They provide needed relief to taxpayers who have suffered some hardship. The definition of hardship can be quite broad. An example in this category is the mortgage deduction that makes home ownership more affordable.

Tax preferences are often criticized for their distortionary impact on the economy. However, it must be remembered that tax preferences are, typically, put into the tax code intentionally to serve a particular purpose. Thus, even if such preferences can be argued to lead to a lower level of economic growth, they, presumably, are either encouraging socially beneficial behavior -- such as saving money or purchasing health insurance -- or they are making the current distribution of income more equitable.²⁴ Many of the benefits potentially created by tax preferences are not adequately accounted for in the Gross National Product. Thus, any decision as to whether a tax preference is inefficient must take into account the social benefits (even if not reflected in GNP) provided by the preference.

On the other hand, inadvertent distortions do not have any intended purpose and typically do not provide any social benefit. It is these distortions that can more freely be termed inefficient. Of the distortions to be discussed below, most would agree that the first four -- the bias against

²⁴ Equity is a normative concept. The term "more equitable," as used above, means simply that lawmakers voting for the tax policy in question believe that the resulting distribution of income is more equitable.

corporate investment, the bias against corporate dividends, the lock-in of accrued capital gains, and the bias against inventories -- are inadvertent distortions that are inefficient. The following two -- the preference for employee fringe benefits and the preference for home ownership -- are definitely intentional distortions.²⁵ There are many who would argue that such preferences are efficient, and many who would argue otherwise. This paper will not attempt to resolve these disputes. The final distortion, caused by the high marginal tax rates on high-income taxpayers, is both intentional and unintentional. While the high marginal tax rates are designed so that high-income taxpayers will shoulder a greater portion of the tax burden than that shouldered by lower-income taxpayers, it would be possible to design a tax system with a much larger base that taxes high-income taxpayers at a lower marginal rate but collects, on average, the same amount of tax.

Bias Against Corporate Investment

One of the most obvious biases is that noncorporate investment is favored over corporate investment. This problem arises because the current system taxes corporate income twice. First, a corporate income tax is paid when corporate income is realized, then personal income tax is paid on any distributed profits or realized capital gains. Earnings from noncorporate businesses, however, are taxed only once. The Armev proposal, as well as most of the other proposals for tax reform, integrates personal and business taxes. All income earned is taxed only once, so there is no discrimination against any particular method of earning income.²⁶ Double taxation of corporate capital under the current system causes resources that could otherwise be profitably employed in the corporate sector to be diverted to other uses.²⁷

²⁵ The list of intentional tax preferences that could be abolished by the adoption of a consumption tax is extremely long; including, among many others, preferences for timber, oil, and gas production, preferences for the purchases of capital equipment, and deductions for charitable contributions. This section addresses only two of the more significant preferences.

²⁶ There are modifications which could be made to address this issue within the current system. For example, shareholders could be allotted credits against their personal taxes equal to corporate taxes paid multiplied by the fraction of the corporation they own.

²⁷ Jorgenson suggests the magnitude of this problem by calculating the burden caused by different types of taxes under the current system. He estimates that, at the margin, "for every dollar of tax revenue transferred from capital income to labor income, the U.S. economy gains 64.1 cents in future growth opportunities." Dale W. Jorgenson, "The Economic Impact of Fundamental Tax Reform," testimony before the Ways and Means Committee June 6, 1995. p. 16.

Bias Against Divided Payouts

A closely related problem is that, because our income tax system taxes corporate earnings as soon as they are distributed, there is an incentive for corporations to avoid distributing their earnings. Retained earnings may be diverted to projects which are less efficient than the projects which would have been undertaken by the recipients of any distributed earnings. Since earnings which are distributed and then reinvested are not taxed under the consumption tax, this distortion of the capital market would disappear.

Bias Against Capital Gain Realization

Similarly, the switch to a consumption tax would remove the distortion from the “lock-in” effect, in which holders of assets with long-term capital gains fail to reoptimize their investment portfolios periodically because they would incur a tax penalty by doing so. Under a consumption tax, reinvested proceeds are not taxable, so there is no disincentive to realize gain and no distortion of investment patterns.

Bias Against Inventory

Under our current tax system, purchases of equipment may be depreciated, but inventories cannot. This introduces a bias to a firm’s decisions concerning their relative levels of investment in these two categories. By expensing both types of investment immediately, the flat tax eliminates this bias.

Preference for Employer-Provided Fringe Benefits

Switching to a pure form of a consumption tax would also remove the incentive for employers to provide fringe benefits to employees rather than direct wages. Our current system subsidizes a wide variety of employer-sponsored benefits, such as health plans, by allowing companies to deduct the costs associated with these plans, but not requiring employees to recognize income for the benefits received. Since employees clearly receive valuable goods and services through fringe benefit programs, the use of fringe benefits should be considered consumption and would be taxed under a pure consumption tax. By subsidizing fringe benefits, the current system creates a bias towards the over-allocation of compensation to such benefits by employers and distorts the consumption decisions of employees. A pure consumption tax would remove these distortions.

Preference for Home-Ownership

Perhaps the most controversial distortion caused by our income tax system, which would be removed by the flat tax, is the subsidy to owner-occupied housing. Our current tax code allows the deduction of mortgage interest payments from taxable income. A pure consumption tax taxes the purchase of a house just like the purchase of any other good. It would, therefore, no longer encourage people to purchase houses rather than other types of goods and services. The elimination of this distortion should improve the efficiency of the economy. (Disadvantages of this change will be discussed below.)

Bias Against Labor for High-Income Taxpayers

Many writers believe that the high marginal tax rates on labor in the upper income brackets of our current system cause many of the most productive workers in our society to choose to work less than they otherwise would. Since most consumption tax proposals aim to broaden the tax base in order to reduce marginal tax rates, the incentive to forgo productive work opportunities should be diminished. The Armev proposal calls for all wages to be taxed at a rate of 17 percent (20 percent during the transition phase). Thus, the labor decision distortion would be slightly greater for taxpayers currently in the 15 percent bracket, but it would be reduced for taxpayers currently in the 28 percent or higher brackets.

Impact of Distortions

Flat tax proponents expect that the removal of the distortions enumerated above will generate substantial economic growth. Kotlikoff reports simulations in which switching to consumption taxes results in a 34 percent increase in the capital stock and produces long-run increases in living standards of 10 - 20 percent. Dale Jorgenson, in a comparison of our pre-1986 tax system, our post-1986 tax system, and a consumption tax, estimates that the Tax Reform Act of 1986 created nearly one trillion dollars in new opportunities for economic growth, but that a consumption tax would have generated more than two trillion dollars in growth opportunities.²⁸ Jorgenson performs several different simulations in order to isolate the effects of different incentives in the tax code. He finds that the greatest opportunities for economic growth arise from equalizing the treatment of income from assets in the business and household sectors.²⁹ Other economists, however, predict that the magnitude of the response to improved

²⁸ Jorgenson, *op. cit.*

²⁹ He also discusses an alternative approach to treating capital employed by the household sector, which is conceptually very attractive, but almost certainly impractical. That approach

incentives will be much smaller. For example, “Randolph and Rogers conclude that the likelihood that the efficiency gain is greater than one percent of lifetime income is less than 10 percent.”³⁰

II.D: International Competitiveness

Another claim frequently made in favor of the consumption tax is that it would improve the United States’ trade deficit. The most common line of reasoning behind this claim does not, in fact, arise from any inherent differences between income and consumption taxes, but rather from the difference between origin and destination based taxes. Under the origin principle, taxes are levied on goods in countries where they are produced. Under the destination principle, taxes are levied on goods in the country in which they are consumed. Consumption taxes are not inherently destination based. Rather, they become destination based through the use of border adjustments -- such as refunds for value-added tax paid on intermediate goods used in exports and taxes levied on imports equal to those on similar goods produced domestically. Many countries, including all members of the European Community, have implemented border-adjusted value-added taxes.

Many business people believe that American businesses are at a disadvantage because, under the systems currently in place, goods exported from the United States must pay both U.S. income tax and foreign value-added tax, putting them at a disadvantage relative to foreign produced goods paying only the value-added tax. Meanwhile, foreign imports to the U.S. pay no tax, while domestic producers pay income tax, again giving the advantage to the foreign producer. Consumption tax proponents argue that replacing the U.S. income tax would level the playing field and enhance competitiveness. The Armeiy flat tax plan is not border-adjusted, however, so it is origin-based.

The view of most economists, furthermore, is that, even if we switch to a destination-based tax, any improvement in international competitiveness will be temporary. In the long run, prices and exchange rates will adjust to reestablish the original terms of trade. Harry L. Gutman, former Joint Committee on Taxation chief of staff, writes that “under the most commonly held incidence assumptions, a VAT, as compared to a corporate income tax, does not directly improve the U.S. balance of trade by raising the price of goods of foreign-owned firms. Moreover, even if the corporate income tax increases prices instead of reducing profits, under a system of flexible exchange rates, an offsetting adjustment in the exchange rate is likely to occur and eliminate any

would be to allow taxpayers to deduct the purchase of their house (and other durable goods) and then require them to include in income the implied rent for the use of their house each year.

³⁰ Rogers, p. 2, citing Randolph and Rogers, *National Tax Journal*, forthcoming.

disadvantage to exports from increased prices.”³¹ Similarly, Raboy concludes, “1) at equilibrium, both an origin and a destination-based VAT are neutral in their effects on the relative prices of traded goods; 2) switching from a pure origin-based VAT to a pure destination-based VAT would cause exports to increase in the short run and imports to decrease. At equilibrium, however, relative prices would return to the neutrality position that existed under free trade.”³²

II.E: Tax Complexity

While for most taxpayers -- for example, those with only wage income -- our current tax law is not complicated, for some it is quite complex. Indeed, the documentation and calculations required for compliance generate substantial costs. Arthur P. Hall II estimates the compliance cost of the federal income tax system at \$140 billion annually.³³ He argues that the primary source of complexity in systems which tax individuals and businesses is controversy over the timing or definition of taxable transactions. He then suggests that both the flat tax and the USA plan (see Section IIA) remove the complexities associated with timing issues by taxing on a cash flow rather than an accrued basis. The USA plan, as several commentators have noted, however, would increase complexity because of the need to track the value of several different categories of assets in order to determine net savings.³⁴ The flat tax, on the other hand, may prove to be less complex than our current system. Hall estimates that the simplest possible flat tax would reduce compliance costs 94 percent, to \$8.4 billion per year. He estimates that the Armev plan, in its current form, with monthly filing and no withholding, would entail about \$39 billion in annual compliance costs.

Other commentators are less optimistic. Leslie B. Samuels, Assistant Secretary for Tax Policy, observes that simplicity comes at the expense of other tax policy goals.³⁵ He argues that political pressures may lead to the reintroduction of complications, such as housing deductions, charitable contributions, and fringe benefits. Godshaw concurs, stating that “there is nothing particular to a consumption tax that makes it easier to eliminate preferences. In the end, it is likely that tax relief will remain for such items as research, charitable contributions, housing, life

³¹ Testimony before the Senate Budget Committee, February 22, 1995.

³² David G. Raboy, “The VAT and the Efficiency of International Trade,” testimony before the Ways and Means Committee, June 6, 1995.

³³ Testimony before the Ways and Means Committee, June 6, 1995.

³⁴ See, for example, Richard J. Joseph, “The ‘Consumption’ and ‘Flat’ Taxes Revisited,” *Tax Notes*, October 9, 1995, pp. 211-222, or Martin D. Ginsburg, “Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici’s Tax World.”

³⁵ Testimony before the Ways and Means Committee, June 7, 1995.

insurance, state and local bonds, and pensions.”³⁶ Each of these deviations from the pure consumption tax would generate regulations similar to the related provisions under current law.

The Armev plan would also place new burdens on some businesses. Generally Accepted Accounting Principles do not allow deductions at the time of input purchases; therefore, businesses must maintain two separate sets of books for accounting and tax purposes. This will increase compliance costs for those businesses that currently maintain only one set of books.

The biggest source of complexity under the flat tax will come from the need to distinguish business investment from personal consumption. Rules for the treatment of expenditures on goods which contain components of both investment and consumption (for example, cars used jointly for personal and business purposes) will undoubtedly need to be retained. In fact, the impact of these regulations will be magnified, since the value allowed as business will be expensed instead of depreciated. Furthermore, complex new rules for the recapture of business assets converted to personal use will be necessary. For example, Vernon Hoven suggests that, as the proposal currently is written, it may be possible for a taxpayer to purchase a condominium at Lake Tahoe and rent it out until all of the loss carryforwards from the business purchase have been used, then move into it and later sell it as a personal residence not subject to tax.³⁷ If such tax planning opportunities are not intended, regulations will be written to address them, restoring at least some complexity to the tax system in the processes.³⁸

Finally, Hoven suggests that the extreme simplicity of the flat tax's “postcard return” will increase the costs of tax law enforcement. He writes, “With less information on the tax return to perform computer and office audits, the IRS will need *more* field auditors to determine if business taxpayers are reporting all income or overstating expenses.”³⁹

³⁶ Gerald M. Godshaw, “Flat Taxes and Consumption Taxes: Are They Really so Simple?” June 5, 1995, p.12.

³⁷ Vernon Hoven, “Flat Tax as Seen by a Tax Preparer,” *Tax Notes*, August 7, 1995, pp. 747-55, p. 751.

³⁸ Several additional examples of tax planning opportunities under the current form of the Armev proposal that will undoubtedly generate new regulations can be found in Feld.

³⁹ Hoven, p. 749.

III. The Impacts of a Consumption Tax

This chapter presents a discussion of the impact of the adoption of a consumption tax on the U.S. economy. The subsections include discussions of:

- tax progressivity
- social policy through tax preferences
- differential sectoral impacts
- transition issues
- other miscellaneous issues

III.A: Tax Progressivity

While the case for consumption taxes stresses the removal of incentives to make inefficient economic decisions, thereby improving the overall performance of the economy, the case against a consumption tax recognizes that the conversion to the new regime will generate a large number of winners and losers among different classes of people and different sectors of the economy.

Perhaps the most frequently leveled criticism of consumption taxes is that they are regressive. Poor people have a higher propensity to consume than rich people. Therefore, a tax on all consumption, but on nothing else, produces a higher effective tax rate on poor people than on rich people. An analysis done by the Treasury Department found, for example, that replacing the current income tax system with a flat 14.5 percent tax (with no exemptions) would increase the total taxes paid by the lowest quintile of the population 134.1 percent, while reducing the taxes paid by 18.6 percent for the top quintile, and by 54.6 percent for the top one percent of the population.⁴⁰

Consumption tax supporters answer this complaint by arguing that the consumption tax is less regressive than generally believed and by adding mechanisms to their tax schemes to mitigate the problem. The argument that consumption taxes are less regressive than they appear is rooted in the view that the impact of the tax regime should be measured over a person's whole life, rather than on an annual basis. For example, college students and retirees are likely to have levels of consumption which are very high relative to their current income, but not when viewed

⁴⁰ See Table 1, Leslie B. Samuels, testimony before the Ways and Means Committee, June 7, 1995.

against their lifetime earnings. Of course, opponents point out that, for college students, this life-cycle interpretation only works if they can freely borrow money against their future earnings.

The flat tax also addresses the regressivity question by allowing a generous personal exemption and a deduction for each dependent. Adding the exemption increases the progressivity of the flat tax. Even with the exemption, however, the flat tax is not as progressive as our current system. Chart 2 compares the current system to a Treasury Department analysis of "a stylized flat tax similar to the Armey proposal. With standard deductions of \$24,700 (for joint returns) or \$12,350 (for single-filers) and a \$5,000 exemption for each dependent, the revenue-neutral rate for the flat tax rises to 22.9 percent. Under this version of the flat tax, the aggregate after-tax income for the group of families in the first through fourth income quintiles would still be lower than under current law (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). However, compared to the proposal without exemptions, the Armey-style proposal would cause a smaller reduction in aggregate after-tax income (between 1.0 and 2.2 percent of current law after-tax income) for the group of families in the first through fourth income quintiles. The percentage increase in after-tax income for the group of families in the highest income quintile, 1.6 percent, would also be smaller than the increase [for the flat tax with no deductions]. . . . The flat tax is progressive through the fourth income quintile, although the effective tax rate falls slightly from the fourth income quintile to the highest."⁴¹ An analysis performed by the Minnesota Department of Revenue reaches similar conclusions about the progressivity of the flat tax.⁴² Chart 3 presents their simulations of the effective federal tax rates for Minnesota residents under our current tax system, a pure flat tax, and a flat tax with personal exemptions.

III.B: Social Policy Through Tax Preferences

Our current tax code contains a wide variety of provisions (exemptions, deductions, and credits) whose intention is to alter taxpayer behavior in ways which legislators have decided are socially desirable. As mentioned in Chapter II, arguments can and have been made for and against almost any tax preference item. In a pure consumption tax system, all of these incentive programs would be discarded. While some of these programs could be reintroduced within the

⁴¹ Samuels, pp. 12-13.

⁴² Cline and Wilson, op. cit.

chart 2 here

chart 3 here

context of a consumption tax, doing so would seriously erode, and quite possibly overwhelm, the gains in simplicity and economic efficiency from the change in tax regimes.⁴³ While the list of tax preferences is very long and somewhat controversial, this chapter focuses on only four of the more significant preferences.⁴⁴

Fringe Benefits

Under our current system, many fringe benefits are deductible to businesses, but not taxable to employees. As noted above, this arrangement subsidizes consumption in the form of fringe benefits. There are at least three viewpoints regarding what will happen when the fringe benefits subsidy is removed. Some writers have suggested that the removal of the subsidy could result in a dramatic retrenchment of employer-sponsored programs, and that employees will bear the burden of the tax increase. This scenario is unlikely, because it suggests that total labor compensation will actually drop when a tax preference for providing a specific type of compensation is removed. The second view is that so many employees have come to expect fringe benefits that almost all employers will find that they have to continue offering generous fringe benefit packages in order to attract and retain quality employees, and business will absorb the associated costs. The final group expects there to be a scaling back of fringe benefit programs, coupled with a partially offsetting increase in wage levels. While the nominal value of the total compensation package received by employees will decline, they believe that the increased efficiency resulting from allowing employees to consume their compensation in any manner they see fit will largely reduce the impact on employee well-being.

Charitable Contributions

Another very popular element of our current tax code that would be eliminated under the Arney legislation is the deduction for charitable donations. Charities are fearful that this change will lead to a reduction in giving. Early attempts to model the decision to give to charity supported the belief that donations are sensitive to tax rates. Charles Clotfelter's summary of this work indicates that "typical estimates for the price elasticity are greater than one in absolute value, which implies that contributions would fall by more than 10% in response to an increase in the net price of giving of 10%."⁴⁵ More recent evidence suggests, however, that the drop in contributions

⁴³ Note that, even if these deductions were to be retained, any plan which reduces marginal tax rates for itemizers affects the value of the deductions and, in turn, the extent to which they influence taxpayer behavior.

⁴⁴ A list of Tax Preferences and their current estimated revenue cost, as tabulated by the Congressional Joint Committee on Taxation, is provided in Appendix 3.

⁴⁵ Charles T. Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in *Do Taxes Matter?* Joel Slemrod, ed., pp. 203-35, p. 208.

may not be so dramatic. Analyzing the reaction to the 1981 and 1986 tax reforms, which also raised the price of giving to charity, Clotfelter notes that, "Probably the most consistent message contained in articles reporting trends in charitable giving in recent years is that, despite charities' fears regarding the effects of tax reform, contributions have continued to increase year after year."⁴⁶ More recent modeling work by William Randolph indicates that early studies overestimated the permanent response of donations to price changes because they failed to account properly for year-to-year shifts in people's patterns of giving.⁴⁷ He estimates a price elasticity of only -0.49. This means that a tax change that increases the cost of donations by 10 percent would lead to about a 5 percent reduction in donations. Another interesting point raised by Clotfelter is that institutions, such as museums and institutions of higher education, that have traditionally relied more heavily on gifts from the wealthy, especially in the form of appreciated property, are likely to be hurt more by changes in the tax treatment of donations than institutions, such as religious organizations, that receive a higher proportion of their donations from lower income taxpayers.

Interest Earned on State and Local Government Bonds

Under our current system, interest earned on bonds issued by state and local governments is tax exempt, while interest earned on other bonds is taxable. This allows state and local governments to pay a below market interest rate on their bonds. Under a consumption tax, no interest on bonds is taxable, so state and local governments will lose this advantage. Since the tax benefit from the current treatment of these bonds is greatest for individuals in the highest income bracket, this change will be progressive at the individual level. State and local governments will be forced, however, to make higher interest payments on their bonds. Alternatively, some governments may opt to raise current taxes or forgo expenditures rather than issue new bonds. The potential drop in the volume of this bond market is difficult to predict. We can, however, estimate that the interest rates on these bonds will converge with the interest rate on bonds of similar quality in the general market. Currently, most municipal bonds are paying under 6 percent, while most commercial bonds are paying more than 8 percent. This means that state and local governments could see an increase of as much as 30 percent or more in the interest payments necessary for funds raised through bond issues. Of course, interest rates on government bonds will remain somewhat lower than rates on commercial bonds, if government issues are considered safer than commercial issues. The increase in costs also will be offset to the extent that interest rates in general drop after the introduction of the consumption tax. Some

⁴⁶ Clotfelter, p. 217.

⁴⁷ William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," OTA Paper 69, 1994.

reduction in interest rates is expected, but the magnitude of the drop is likely to be small relative to the current spread between exempt and taxable bonds.

It should be kept in mind that this cost increase will affect only bonds issued after the enactment of the new tax. Interest payments on bonds already sold will not change, and their real value may even drop if, as many expect, there is a round of inflation following the switch to the new tax regime. This would benefit all borrowers of preinflation funds, including state and local governments.

The exact amount by which each state or local government's interest payments increase will also depend on the issuer's credit rating. States may be able to help local governments maintain good credit ratings (and keep interest rates down) by guaranteeing the bonds in some way. Of course, a guarantee would lead to costs for the state if the local government defaulted. Another factor, which some observers worry may affect credit ratings, is the anticipated drop in property values following the introduction of a consumption tax. Such a drop could reduce the expected future revenue stream from property taxes, resulting in a lowering of some municipalities' credit ratings. This would force municipalities to offer even higher interest rates on their bonds.⁴⁸ (Note, however, that this effect may be less important in California, since, because of Proposition 13, many houses here could have their market value drop substantially without affecting their assessed value).

Home Ownership

Some of the most dramatic changes resulting from the adoption of a consumption tax will occur in the residential housing market. Pure consumption taxes, such as the Armey bill, remove the deduction for mortgage interest payments. The loss of the federal housing subsidy should lead to a reduction in the price of housing. To the extent that prices drop, current homeowners will be hit with a decrease in the value of their asset. A study by DRI/McGraw-Hill, sponsored by the National Association of Realtors, estimates that the long-run decline in the price of single-family housing could be 13 percent.⁴⁹ Recent purchasers with variable rate mortgages would be partially compensated by the expected drop in interest rates. For people looking to purchase a house, the effects of the consumption tax are mixed. The anticipated economywide reduction in interest rates will make housing more affordable. On the other hand, if the price of housing drops by less than the full value of the lost tax writeoff, housing will be less affordable. Of course, the

⁴⁸ Perry Israel, Assembly Revenue and Taxation Committee hearing.

⁴⁹ Roger E. Brinner, Mark Lasky, and David Wyss, "Residential Real Estate Impacts of Flat Tax Legislation," DRI Analysis Summary Prepared for the National Association of Realtors, May, 1995, p.15.

current tax benefit is only useful for taxpayers who itemize. For taxpayers who do not itemize, any drop in the price of housing increases affordability. Thus, the combination of changes in interest rates and prices is likely to be progressive -- lower income taxpayers will find housing more affordable, but higher income taxpayers will find it less affordable.

III.C: Impact Across Industries

Another area of concern is that switching to a consumption tax will have different effects on different sectors of the economy. The discussion above has enumerated a variety of changes in the tax base which would result from the adoption of the flat tax. The impact of these changes on any particular industry or sector of the economy will depend on the importance of that component of the tax base in the structure of that industry or sector. Volume II of this report presents the results of simulations of the effects of the flat tax on different sectors of the California economy. Others have already estimated intersectoral differences for the national economy. The results presented by Merrill, Wertz, and Shah are typical, and are summarized in this section.⁵⁰

Overall, Merrill, Wertz, and Shah report that, had the 17 percent flat tax been in effect from 1988-92, nonfinancial corporations would have paid 10 percent less than they did under the income tax, but that, if the rate were 23 percent, they would have paid 22 percent more than under the income tax. They find, however, that the impact of the flat tax on specific industries can vary substantially from this aggregated result (see Table 2).

Merrill, Wertz, and Shah note that "two factors appear to be particularly important in determining which industries would pay more or less tax under the flat tax: investment and net exports. Industries with large amounts of investment per dollar of gross receipts tend to pay less under the flat tax. Due to the deductibility of investments, the flat tax is beneficial to companies with high levels of investment. By contrast, under the flat tax, exporters would lose the benefit of the foreign tax credit and certain other provisions that reduce U.S. income tax on export income."⁵¹ It should be noted, however, that the advantage of expensing applies only to industries with large amounts of capital investment. Industries with valuable intangible assets actually tend to pay more under the flat tax in their calculations. These assets are often already

⁵⁰ Peter Merrill, Ken Wertz, and Shvetank Shah, "Corporate Tax Liability Under the USA and Flat Taxes," *Tax Notes*, August 7, 1995, pp. 741-45.

⁵¹ " p.744.

table 2 here

expensed under the current system, so firms producing intangibles gain little from the expensing provisions of the flat tax. In addition, the flat tax would eliminate the research and development credit, which currently provides tax benefits to many developers of intangibles.

At the sectoral level, Merrill, Wertz, and Shah find that, had the 17 percent flat tax been in place during these years, the Transportation, Communications and Utilities sector and the Trade sector would have been better off, but the Manufacturing and Service sectors would have paid more in taxes. The Transportation, Communications and Utilities sector gains under the flat tax, because it is a capital-intensive sector. The Manufacturing and Service sectors are hurt, they argue, because they are net-exporting sectors.

III.D: Transition Issues

Whatever the long-run impact of the adoption of a consumption tax would be, the transition from the current system to a new tax regime is going to raise a host of issues. Although a thorough analysis of transition issues is beyond the scope of this paper, this section will briefly describe several such issues.⁵² These transition issues include: how will the new tax system be administered; how will wealth existing at the time of the tax law change be treated; and what type of disruptions will occur in the economy during or immediately after the change.

Administration

Administrative transition issues should be relatively straightforward to resolve, but potentially will be costly. They include things like: the design of new forms and instructions; the development of new regulations and of transition rules; the implementation of new audit practices and procedures; the establishment of penalties appropriate to the new system; and taxpayer education about the new system.

Taxation of Consumption from Pre-Existing Wealth

Wealth already held at the time of the tax change was already taxed when it was initially earned. Taxing it again when it is consumed would result in double taxation. Whether pre-existing wealth will be subject to tax when it is consumed depends upon which consumption tax is adopted, and how the burden of the tax ultimately is distributed over consumers, labor, and

⁵² Which transitional issues end up being most significant will depend, to a great extent, on the details in the legislation adopting the consumption tax. As mentioned in the introduction to this paper, the details have not yet been developed.

capital. Under the Nunn-Domenici USA plan, consumption from wealth is explicitly taxed. Under the Armev flat tax proposal, however, consumption from wealth is taxed only to the extent that producers are able to pass along the tax on value-added to consumers.

If it is determined that, under whatever plan is being considered, pre-existing wealth would be subject to a second round of taxation, it is likely that transition rules would be adopted to lessen the taxation of pre-existing wealth. There are many different types of existing wealth which need to be considered when writing transition rules. The most obvious form of wealth is personal assets, such as bank accounts and houses. The Nunn-Domenici USA plan has already written rules for tracking indefinitely whether consumption is attributable to pre- or post-tax reform savings. These rules have been described by all who have read them as being extremely complex. Under the Armev plan, most of these types of assets will not be taxed directly, so transition rules may be less necessary. There will, however, be taxpayers who are hurt by changes in the prices of some categories of assets.

A second category of existing wealth is depreciable assets owned by businesses. If new purchases of equipment can be expensed, but old purchases cannot, existing businesses are put at a competitive disadvantage relative to new and expanding businesses. If all depreciation remaining at the time of transition is allowed to be expensed immediately, the tax base will be dramatically reduced. This would force a temporary increase in tax rates to ensure sufficient revenue and create all of the problems associated with higher tax rates.

A similar problem occurs with existing home mortgages. Complete eradication of all anticipated deductions for loans already issued would place a burden on these homeowners which may be too large to be politically feasible. If these deductions are phased out slowly, however, tax rates will need to be raised elsewhere during the transition period to maintain revenue. For businesses, this same concern will be raised with respect to a variety of accumulated credits, including net operating losses, alternative minimum tax credits, and research credits.

Treatment of Windfall Capital Gains

Another transition issue concerns the treatment of assets which experience windfall gains upon transition to a new regime. The removal of taxes on capital would lead to a reevaluation of many businesses and substantial increases in the value of their stocks and bonds. To maintain equity in the tax system, these windfall gains may require special treatment.

Macro and Micro Economic Disruptions

The final area of concern in transition is the possibility that the economy will be disrupted in the short run. One source of disruption will be from overly conservative business and financial planning due simply to uncertainty over the effects of the new system. Short run economic performance will also be hindered if there are any inefficiencies associated with the shifting of resources from sectors hurt by the tax changes to those which will benefit. If resources shift too slowly, they will not be employed where they would be most productive. If resources shift too quickly, there likely will be severe downturns in output and employment in the sectors experiencing retrenchment. For example, the DRI study sponsored by the National Association of Realtors estimates that housing starts will drop 22 percent in the first year after the implementation of the flat tax. This could generate a recession. This paper will not attempt to analyze the tradeoff between these short-run problems and the long-run benefits of tax reform.

III.E: Miscellaneous Issues

Besides the issues discussed in the previous four sections, there are several other concerns that do not fit neatly into any of the above categories. Those issues include: macroeconomic automatic stabilization, financial institutions, the ability of the government to protect domestic industries, and the taxation of governmental and nonprofit entities.

Macroeconomic Automatic Stabilization

The current tax system has an automatic macroeconomic stabilizing feature built into it. During an expansion, profits increase. As profits increase, taxes increase. The increase in taxes tends to act as a drag on the economy. Thus, an economic expansion creates a contractionary fiscal policy. An analogous but opposite story could be told about recessions. Under a consumption tax, business receipts will tend to grow in an economic expansion, just as happens under the current system. However, under a consumption tax, all investment is expensed. Investment levels are very sensitive to economic upturns and downturns. Thus, in an expansion, not only business receipts, but also business investment, will grow. Taxable income will not increase as much under the consumption tax as it would under the current system. In fact, if the growth in investment were large enough, taxable income could decrease during an expansion. The automatic stabilization feature of the current tax system would, thus, be diminished and potentially reversed under a consumption tax. On the other hand, since, as mentioned above,

taxable income will be less volatile under the consumption tax than under the current tax system, government revenue should be more stable.

Financial Institutions

Under a consumption tax, special rules will need to be written for many financial industries, the details of which are beyond the scope of this paper, but which will affect the complexity of the tax system and the tax burden on these industries. “The fundamental problem in measuring value added by financial intermediation,” as Peter Merrill and Harold Adrion explain, “is that charges frequently are ‘hidden’ in financial margins rather than stated separately. Consider, for example, interest payments under a bank loan. A portion of the interest charge represents the bank’s cost of funds and a portion represents compensation to the bank for originating and servicing the loan. Only the latter portion represents value added by the bank in this transaction. In this example there is no separately stated charge for the bank’s services; instead, the implicit service fee is buried in the interest rate.”⁵³ In its current form, the Armeý proposal does not contain any guidance on how this problem will be resolved. It says only that “in the case of the business activity of providing financial intermediation services, the taxable income from such activity shall be equal to the value of the intermediation services provided in such activity.”^{54,55}

Protecting Domestic Industry from Unfair Foreign Competition

Tax reform may affect the government’s ability to protect industries from certain types of foreign competition. There are several provisions in our current tax code, particularly in those sections dealing with agriculture and natural resources, such as timber, whose purpose is to match subsidies provided by foreign governments to the affected industries. A tax reform which eliminates all tax preferences would prevent the government from using this tool to maintain a level playing field in international trade.

⁵³ Peter R. Merrill and Harold Adrion, “Treatment of financial Services Under Consumption-Based Tax Systems,” *Tax Notes*, September 18, 1995, pp. 1496-1500, p. 1497.

⁵⁴ HR 2060, Sec. 102. See page 4 of Appendix I.

⁵⁵ To avoid facing this problem, many consumption tax proposals (and many consumption taxes already in place in other countries) opt not to tax financial services at all. Even with exemption, complex rules are still required for separating taxable and nontaxable activities. In addition, exemption may lead to distortions in the allocation of resources across sectors of the economy. Finally, exempting the financial sector would require raising tax rates elsewhere in order to maintain revenue neutrality. Although only 11 percent of GDP, this sector accounted for about 30 percent of corporate income tax receipts in 1992 (Merrill and Adrion, p. 1496).

Taxation of Governmental and Nonprofit Entities

Finally, one of the most interesting changes in the Armey proposal is the imposition of a tax on fringe benefits paid to employees of nonprofit and governmental organizations.⁵⁶ This change parallels the nondeductability of fringe benefits to businesses under the proposal and is considered necessary to prevent intersectoral distortions in the labor market. The tax payments on fringe benefits would, however, become a substantial cost for nonprofit and governmental organizations. The cost to the state and local governments is estimated and presented in Volume II.

⁵⁶ HR 2060, Sec. 102. See page 5 of Appendix I.

IV. Summary of Volume I

The flat tax fundamentally reforms our tax system in several ways. It reduces the number of tax brackets, lowers the top marginal tax rates, removes savings from the tax base, integrates the taxation of businesses and individuals, and eliminates a wide variety of tax preferences. Proponents anticipate that these changes will spur savings and investment, improve our balance of trade, and increase the growth rate of our economy. Additionally, they argue that the new tax system will be less complex. Opponents counter that many important sources of complexity will not be eliminated by the flat tax and that the economic benefits actually realized from the new policy likely will be much smaller than predicted. Furthermore, they point out that the transition to the new system will be disruptive and that the flat tax will be perceived by many people to be unfair.

Most taxpayers will see their taxes increased by some provisions of this legislation and decreased by other provisions. The net effect for any particular taxpayer will depend on all of that taxpayer's particular circumstances. This volume of this report has identified the most prominent channels through which the flat tax would impact taxpayers. Volume II presents projections of the net effect of the many proposed changes in the tax law on a variety of classes of taxpayers in California.

THE IMPACT OF THE FLAT TAX ON CALIFORNIA

VOLUME II

REVENUE AND DISTRIBUTIONAL ANALYSES

Volume I of this report surveyed a variety of issues associated with the flat tax and identified a number of types of individuals and industries that will be made either better or worse off if the federal government adopts the flat tax. This volume investigates the magnitude of

several of the changes that Californians will experience if the federal government adopts the flat tax. Chapter I examines the impact of the flat tax on different categories of California taxpayers. Chapter II considers the effects of the flat tax on governments in California. Chapter III examines the potential impacts of a federal flat tax on the California economy. Chapter IV presents a summary and conclusions.

I. Distributional Effects of the Flat Tax

This chapter presents the results of a microsimulation of the effect of the flat tax on California taxpayers. The first section describes the way in which the flat tax was modeled for this simulation. The second section reviews some of the important features of the flat tax and their expected impact on taxpayers. The final section presents the numerical results of the simulation.

I.A: Description of the Simulation

The simulation presented below uses the Franchise Tax Board's Personal Income Tax Sample and Bank and Corporation Tax Sample to calculate tax liability under the flat tax.⁵⁷ The calculation is made separately for each taxpayer in the sample, then extrapolated and aggregated into the tables presented below. The simulation is based on income actually reported by taxpayers in 1992. The data are adjusted for inflation and for general economic growth to provide projections for 1996. The tax amounts reported in the following tables are for tax payments to the federal government by California taxpayers.

The simulation assumes that the flat tax has been fully phased in. The simulation does not examine transition issues, such as whether taxpayers will be allowed to continue taking depreciation deductions on property not yet fully depreciated; instead, the calculations of tax paid

⁵⁷ The 1992 Personal Income Tax Sample is a stratified random sample of about 70,000 Personal Income Tax returns. The Sample includes over 350 data items from the California Form 540 and supporting schedules, as well as the federal Form 1040 and its supporting schedules. Weights are assigned to the individual records so that the weighted records provide an accurate statistical representation of the entire taxpaying population of California. The 1992 Bank and Corporation Tax Sample is a stratified random sample of more than 10,000 corporate tax returns. The sample includes all banks and corporations with state net income greater than \$5 million, all water's edge corporations and two percent of all other corporations. The sample contains roughly 240 variables from state and federal tax forms. Weights are assigned to the Sample records so that the weighted records provide an accurate statistical representation of the entire population of Bank and Corporation Tax payers.

under the flat tax assume that the flat tax has already been in place for many years, so that transition concerns have disappeared.

The first table presented below models the most current version of the flat tax legislation, HR 2060.⁵⁸ Subsequent tables simulate taxes paid under a somewhat modified version of the flat tax. Specifically, the simulation uses the same version of the flat tax that the Treasury Department analyzed in its study “A Preliminary Analysis of a Flat Rate Consumption Tax”. Treasury’s lead in simulation design is followed for two reasons. One is that it will enable us to make more meaningful comparisons between the results presented here and those of other studies that also use this methodology. The second is that the Treasury study produced the most reliable available estimate of a revenue-neutral tax rate for the flat tax. Conceptually, statements about the distributional impact of tax changes are more meaningful for proposals that are revenue-neutral since it is the stated intent of the flat tax proponents to propose a revenue-neutral tax reform package. Therefore, it is likely, that a package that either raises or lowers revenue will be adjusted toward revenue neutrality.

There are five differences between the flat tax modeled by the Treasury and HR 2060. The first is that, in the modified version, the standard personal exemption is \$24,700 for married couples and \$12,350 for singles, compared to \$21,400 for married and \$10,700 for singles in HR 2060. Second, HR 2060 specifies a 17 percent tax rate, but the Treasury calculates that a rate of 22.9 percent is needed to achieve revenue neutrality for the federal government.⁵⁹ In addition, the Treasury analysis does not consider three other components of HR 2060 -- the elimination of the Earned Income Tax Credit, the inclusion of Unemployment Insurance in taxable income, and the expensing of land and other tangible nondepreciable property.

Under current law, individuals include in taxable income all income derived from the ownership of noncorporate businesses and from S-corporations. Under the flat tax, each business must file taxes separately. This difference makes comparison of the two tax systems awkward. For example, individual taxes under the flat tax cannot be compared directly to personal income taxes under current law, because the individual portion of the flat tax is levied on a much smaller tax base. This paper will use the term “individual taxes” to refer only to taxes levied on wages and pensions and taxes on unearned income, such as interest and capital gains (noting that the tax rate on unearned income under the flat tax is zero). The term “business taxes” includes taxes on any entity that would be taxed as a business under the flat tax: including

⁵⁸ HR 2060, also called the “Freedom and Fairness Restoration Act of 1995,” was introduced by House Majority Leader Richard Armey on July 19, 1995. Title I of this bill, in which the flat tax is proposed, is presented in Appendix I.

⁵⁹ See Toder (1995).

both corporations, which are taxed separately under current law; and other businesses, such as sole proprietorships, farms, and partnerships, that are included in personal income taxes under current law. We will use the phrase “individual taxes including all pass-through entities” to refer to everything that currently is included in personal income taxes.

Under the flat tax, businesses owners have a strong incentive to pay themselves wages that are at least equal to the sum of their personal exemption and their dependent deductions. This is because business income is taxed without an exemption; whereas, individual taxpayers can use the personal exemption. Thus, business owners pay no tax on wages that they pay themselves, up to their exemption amount. If they fail to pay themselves wages, this income will be taxed. The designers of the flat tax recognize this.⁶⁰ In the simulations presented below, therefore, the appropriate amount of income is transferred from business income to wage income for all taxpayers with non-corporate or S-corporation business income who currently report wages less than the standard exemption.

In this simulation, no adjustments, other than those explicitly described, are made for possible changes in taxpayer behavior in response to the proposed changes in tax law or to changes in the general performance of the economy.

I.B: The Important Features of the Flat Tax

As described in Volume I, the flat tax contains several changes in tax law. The importance of each of these changes varies, however, from one taxpayer to the next. This section explores the relative importance of the major features of the flat tax for different classes of taxpayer.

To begin with, consider taxpayers who have only wage income and do not itemize their deductions. The effect of the flat tax is easiest to analyze for very low-income taxpayers. These taxpayers pay very little (if any) in taxes under either current law or the flat tax, so tax reform will have relatively little effect on them. Taxpayers with slightly higher earnings will benefit from the increase in the standard exemption and the dependent deduction. For example, the Smiths are married with two children, earn \$30,000 per year, and claim no itemized deductions.

⁶⁰ See e.g., Hall and Rabushka (1995), p. 68.

	<u>Current law</u> ⁶¹	<u>Flat Tax</u>
Income	\$30,000	\$30,000
Less: exemption	\$ 6,350	\$24,700
Less: deduction	\$ 9,800 (2,450 * 4 people)	\$10,000 (5000 * 2 children)
Equals: taxable income	\$13,850	\$ 0
Tax rate	15 %	22.9 %
Tax owed	\$ 2,077	\$ 0

Taxpayers such as the Smiths will have a substantial portion of their income shielded from taxation by the increased size of the personal deduction and the dependent exemption. Of course, if the flat tax includes a repeal of the earned income tax credit, this may cost many taxpayers more than what they gain from the increased exemption and deductions.

For taxpayers whose income exceeds their exemption and deductions, one of the most important features of the flat tax is the new tax rate. The tax rate on income currently being taxed at 15 percent will be increased. The point at which the cost of being taxed at 22.9 percent rather than 15 percent exactly offsets the savings from the increased exemption and deductions varies according to the taxpayer's filing status and number of dependents.⁶² The tax rate on income currently being taxed at 28 percent or more will also be 22.9 percent. This benefit will accrue only to taxpayers currently in the 28 percent tax bracket. For the highest-income taxpayers, this rate reduction will, in most cases, overwhelm any other effects of the flat tax. In sum, therefore, changes in the tax rate structure under the flat tax (as opposed to the changes in the tax base discussed below) seem likely to decrease taxes for low- and high-income taxpayers, but may increase taxes for middle-income taxpayers.

The above paragraphs assumed that taxpayers earn only wages and do not itemize their deductions. Since the flat tax removes all itemizable deductions, taxpayers who currently are itemizing will tend to face higher taxes under the flat tax. This change will affect more high-income taxpayers than low-income taxpayers, since more high-income taxpayers itemize. On the other hand, taxpayers with interest, dividend, and capital gains income -- also predominantly high-income taxpayers -- will benefit from the removal of these items from the tax base.

⁶¹ The IRS has not yet determined the actual amount of the standard exemptions and dependent deductions for 1996. All examples in this chapter use the 1994 levels for calculating current-law tax.

⁶² For example, comparing the exemption and deduction levels in the most recent version of HR 2060 to those in current law, the crossover point for single taxpayers is at an annual income of slightly above \$19,000; while, for a married taxpayer with no children, the crossover point occurs at an income of more than \$40,000. The \$5,000 deduction is so generous that almost all taxpayers with two or more dependents and no itemized deductions will see their taxes reduced by the flat tax.

For taxpayers with business activities, the effect of the flat tax will be a combination of the factors listed above, the effect of the flat tax on the tax liability of each business, and the fact that business losses will no longer be used to offset income generated elsewhere. The most important changes in business taxes under the flat tax (both corporate and pass-through) are the replacement of depreciation with expensing (which should, in the aggregate, decrease taxes), the elimination of the deductibility of interest payments and fringe benefits (which should increase taxes), and the exclusion of capital income -- capital gains and interest income -- from taxation (which should decrease taxes). On net, the impact of all of these changes will be an overall increase in business income. Although the impact on business income will vary by business, by industry, by entity type, and by entity size, increases in business income of more than 50 percent will not be uncommon.

The fact that losses from one business entity can no longer be used to offset income from other sources may lead to a substantial increase in taxes. For example, Maria's Diner had a profit of \$60,000 last year. Maria is a 50 percent partner in the ice cream shop next door. The ice cream shop lost \$80,000 last year. Under current law, Maria pays personal income tax on \$60,000, less one half of \$80,000, or \$20,000. Under the flat tax, the diner has to pay taxes on all \$60,000 of profit.⁶³ As will be seen in the next section, the removal of the business loss offsets will lead to a large increase in tax owed by some taxpayers.

The flat tax would also eliminate the Alternative Minimum Tax (AMT). Since, however, the taxpayers who pay the AMT currently are primarily those with large itemized deductions or business losses, the impact of repealing the AMT will not be significant.

⁶³ In these simulations, offsets across entity types (partnership vs. S-corps, for example) have been disallowed, but the data do not enable the removal of offsets across distinct businesses of the same type (such as one taxpayer belonging to three different partnerships). Nor, on the other hand, can the extent to which business owners will be able to combine their currently separate businesses after passage of the flat tax in order effectively to reestablish the offset be estimated.

I.C: The Tax Burden on California Taxpayers Under the Flat Tax

Under current law, California taxpayers are projected to incur \$81.7 billion in federal tax liabilities in 1996, of which \$4.3 billion would be returned to Californians in the form of earned income tax credits, leaving a net tax bill for Californians of \$77.4 billion. Under HR 2060, Californians would owe \$68.3 billion, a reduction of 11.8 percent. As can be seen in Table 1, this reduction can be broken down into a 34.4 percent decrease in taxes paid by individuals and a 79.8 percent increase in taxes paid by businesses.

As noted above, further distributional analysis of the current version of HR 2060 is impractical, since it is not known if the plan is revenue-neutral. By considering the Treasury's modified flat tax, which is estimated to be revenue-neutral, meaningful statements can be made about which groups of taxpayers will be made relatively better or worse off under the flat tax. Table 2 compares total tax under current law (this calculation differs from that presented in Table 1, because it does not include the earned income tax credit) to total tax under the modified flat tax described above. Table 2 also presents the federal tax liability of Californians by source of income. Under current law, California taxpayers are projected to incur \$81.7 billion in federal tax liabilities in 1996. Under the Treasury's version of the flat tax, they would owe \$87.1 billion, an increase of 6.6 percent.⁶⁴ The flat tax would increase the tax on business entities (including those taxed under current personal income tax law) by \$21.3 billion, or 139 percent, while the tax on individual earnings (excluding all business income) would drop by \$15.9 billion, or 24.0 percent. The tax impact of the current law treatment of Other Business income (primarily rental property and farms) is negative. Under the proposed law, in which negative income entities will have no tax impact, and positive income entities will be taxed on their income, these entities will pay more than \$5 billion in federal taxes. The loss of offsets is also an important contributor to the more than doubling of taxes on partnerships. The combination of the decreased tax on wage and capital income and the increased tax on pass-through entities produces very little net change in tax. The flat tax equivalent of current-law personal income taxes, decreases by \$0.8 billion, or 1.1 percent.

The overall incidence of the current income tax and of the flat tax for taxpayers in different income brackets is presented in Table 3. The average tax paid by taxpayers in each income group is presented in Table 4. For the calculations in these tables, corporate taxes are imputed to individuals in proportion to the individual's reported interest and dividend earnings

⁶⁴ There is, of course, no reason to expect that a tax reform that is neutral at the federal level will also be revenue-neutral for each state. A similar study by Cline and Wilson (1995) estimates a 7 percent increase in federal tax liability for Minnesota taxpayers.

table 1 here

table 2 here

table 3 here

table 4 here

and capital gains.^{65,66} The tax paid by Californians with negative adjusted gross income would increase by 360 percent under the flat tax. This occurs primarily because, under the flat tax, taxpayers may not offset wage income with business losses.

In the first income quintile (AGI of 0 to \$8,400), taxpayers pay very little tax under either system. Some taxpayers in this quintile do, however, have capital income and, therefore, pay corporate taxes indirectly. In addition, some taxpayers in the first quintile have business income losses. The tax paid by these taxpayers increases significantly under the flat tax. Much of this increase is due to the loss of offsets from the negative business entities. (The rest comes from increases in the tax on the positive income of other business entities owned by the same taxpayers and on indirect taxes on these taxpayer's capital income). As a result, the tax liability for taxpayers in the first quintile increases 96 percent; the total amount of tax, however, remains small.

In the second quintile (AGI \$8,400 - \$18,100), many taxpayers do have a significant tax liability under current law. For this group, the decrease in individual taxes resulting from increases in the personal exemption and the dependent deduction more than compensate for any increases in business taxes. Total liability in this quintile decreases 1.8 percent.^{67,68} For taxpayers in the third and fourth quintiles (AGI \$18,100 - \$32,500 and \$32,500 - \$56,000), the higher tax rate (22.9 percent under flat vs. 15 percent for most income under current law) and increases in business taxes lead to a net tax increase.

⁶⁵ Conceptually, it would be preferable to use accrued rather than realized capital gains for this calculation, but the relevant data do not exist.

⁶⁶ This analysis assumes that the burden of the corporate income tax falls on all owners of capital. In other words, the return on financial assets -- as reflected by interest income, dividend income and capital gains -- is reduced proportionally by the amount of income taxes paid by corporations. It is possible, however, that these taxes could instead be passed along to consumers in the form of higher prices or to labor in the form of reduced compensation. For a discussion of the implications of various incidence assumptions on the impact of flat taxes, see Cline and Wilson (1995).

⁶⁷ To see why the more generous standard exemption is particularly important for the second quintile of taxpayers, consider the tax bill for Sally, who earns \$15,000, files as a single taxpayer, and takes the standard deduction.

	<u>Current Law</u>	<u>Proposed Law</u>
Income	\$15,000	\$15,000
-- Exemption	\$ 3,800	\$12,350
-- Education	\$ 2,450	0
= Taxable income	\$ 8,750	\$ 2,650
Tax rate	15 %	22.9 %
Tax owed	\$1,312.5	\$ 606.85

⁶⁸ Under the most recent version of HR 2060, however, taxpayers in the first and second income quintile are hurt by the removal of the Earned Income Tax Credit. When the tax credit is included in the simulation, these taxpayers receive a net rebate from the federal government of \$1.25 billion under current law; but they would owe \$2.52 billion under the comparable version of the flat tax, a net increase of \$3.77 billion.

For the top quintile (AGI greater than \$56,000), the lower marginal tax rate under the flat tax almost exactly compensates for the elimination of deductions and the increase in business taxes (net tax increase of 1.7 percent). Within this quintile, however, the benefits are concentrated among the highest-income taxpayers. Although the top 10 percent of taxpayers (AGI greater than \$78,500) receive a 2.1 percent tax cut, the top one percent of taxpayers by income (over \$230,000) would have their total taxes reduced 15.7 percent by the flat tax, while taxpayers in the 2nd through 10th percentile would pay 12 percent more.

Table 5 compares, by income class, the combined tax on all activities (wage, capital and pass-through businesses) currently taxable as personal income (this is equivalent to Table 3 with the imputed corporate taxes removed). The importance of business loss offsets shows up even more dramatically in this table, as taxes for taxpayers with negative AGI increase more than 2,000 percent. In general, the results in Table 5 are qualitatively similar to those in Table 3.

Table 6 shows individual taxes paid by taxpayers, classified by AGI quintile, under current law and under the flat tax. Individual taxes include the tax paid on wages, pensions, interest, dividends, and capital gains, but excludes income from all business activities. Individual taxes decrease under the flat tax for all classes of taxpayer. Even the taxpayers with negative AGI pay less under the flat tax on their wages and capital income. The percentage drop in individual taxes is greatest for those in the first and second quintile; this is because of the expanded exemption and deductions. The largest absolute drop occurs for the highest-income taxpayers, as the lowered marginal rate on large incomes becomes more important.

Table 5 here

table 6 here

Tables 7, 8, 9, and 10 examine the relationship between the type of income a taxpayer receives and changes in the individual's tax liability under the adoption of the flat tax.⁶⁹ Tables 7, 8, and 10 only present results for those taxpayers with current-law AGI greater than zero. In Table 7, taxpayers are classified by wage income as a percentage of total income. Table 7 confirms the importance, suggested above, of using business losses to offset wage income. Taxpayers whose wages exceed their total income (predominantly taxpayers with some form of business losses) have their tax bill increase 79.1 percent. Taxpayers whose total income is exactly equal to wages would pay 21.2 percent less in taxes. These taxpayers tend to be low-income and, thus, they both benefit from the increased exemption levels and are not harmed by the loss of itemized deductions. All other categories of taxpayers in Table 7 experience a change of 5 percent or less in their total tax bill.

Table 8 classifies taxpayers by pass-through business income as a percentage of total income.⁷⁰ Tax liabilities are higher under the flat tax for taxpayers who derive large portions of their income from business activities. In fact, taxes decrease by 6.9 percent for taxpayers with no business income and by 11.0 percent for those with less than 20 percent of their AGI from business income. By contrast, taxes increase 43.5 percent for taxpayers who derive more than half their income from business and 77.2 percent for taxpayers with more than 90 percent of total income from business. In addition, taxpayers with net business losses would have a 16.6 percent increase in taxes.

Table 9 takes a closer look at those taxpayers who have some negative business income.⁷¹ Together, taxpayers reporting some negative business income would pay 19.4 percent more under the flat tax. Within this group, the lower the taxpayer's total income, the greater the percentage tax increase. The taxes of taxpayers with business losses who are in the lowest quintile of total income would more than triple under the flat tax. For taxpayers in the top one percent of total income, on the other hand, other attributes of the flat tax overwhelm the removal of the business loss offsets, leading to a net 12 percent decrease in taxes paid.

Table 10 compares taxpayers by the percentage of their total income that is capital income.⁷² Taxpayers for whom unearned income is more than 20 percent of total income would have their taxes go down under the flat tax. This is not surprising, since most forms of capital

⁶⁹ For Tables 7 - 11, corporate taxes are imputed to taxpayers by the method described above.

⁷⁰ This includes income from sole-proprietorships, partnerships, S-corporations, rental properties, farms, or any other non-C corporation business.

⁷¹ As with Table 8, negative business income includes negative income derived from sole-proprietorships, partnerships, S-corporations, rental properties, farms, or any other non-C corporation business.

⁷² This includes interest income, dividends, capital gains.

table 7 here

table 8 here

table 9 here

table 10 here

income -- such as interest, dividends, and capital gains -- are not directly taxable under the flat tax (of course earnings from corporate holdings are taxed indirectly). Taxpayers currently reporting net capital losses would lose this deduction. Their taxes would increase 33 percent.

Tables 11 and 12 consider two important taxpayer attributes not linked to sources of income -- homeownership and age. The loss of the deductibility of mortgage interest payments should be a major reason that Californians' share of federal taxes would increase under the flat tax. This is because the median price of residential homes in California in 1995 is projected to be \$173,000 for new homes and \$182,000 for existing homes. This is substantially above the national (projected) median of \$145,000 for new and \$115,100 for existing homes; 40 percent of all houses over \$350,000 are in California.⁷³ Californians, therefore, currently receive a benefit from the housing deduction disproportionate to their population and would be disproportionately burdened by its removal. Table 11 compares the impact of the flat tax on Californians who claim a home mortgage deduction to the impact on those who do not. Taxpayers who currently claim an itemized deduction for mortgage interest (which would be eliminated by the flat tax) would have a 14.4 percent increase in taxes under the flat tax, while those not claiming this deduction would pay 6.0 percent less under the flat tax.

Table 12 separates those taxpayers claiming an elderly exemption from those who do not claim one. In this simulation, Californians claiming this exemption would pay 7.0 percent less in taxes under the flat tax; while those not claiming it would pay 9.3 percent more. This is because many elderly taxpayers receive large amounts of dividend and interest income, which would no longer be taxable at the individual level under the proposed legislation, and because many elderly taxpayers are in the income ranges that benefit the most from the expanded personal exemption. In its treatment of the elderly, the flat tax differs from the other forms of a consumption tax that were reviewed in Volume I of this report. The other types of consumption taxes (retail sales tax, value-added tax, consumed income tax) all directly tax the elderly's accumulated savings when that savings is spent. Under the flat tax, by contrast, no tax is paid when consumption is financed from accumulated savings.

⁷³"Economic Impacts From Capping Deductible Mortgages at \$250,000: California," DRI Analysis Prepared for the California Association of Realtors, June, 1995, p4.

Table 11 here

table 12 here

Tables 13 and 14 examine corporate tax returns in greater detail. Table 13 shows that, although all industries face a tax increase, the effects of the flat tax vary across industries.⁷⁴ Among the industries that are hurt worst by the flat tax are services, trade (wholesale and retail), and construction and mining. Each of these industries has a low ratio of taxable income to gross receipts. If a company has a low ratio, a small change in deductions can lead to a large percentage change in taxable income. None of the three industries mentioned above has large deductions for interest or employee benefits (it is the loss of these deductions that drive the increase in taxable income under the flat tax).⁷⁵ However, because of the low taxable income ratios in these industries, the loss of those deductions has a much bigger impact on the taxable income for these industries than for other industries.

On the other side of the spectrum, the transportation, communications, and utility (TCU) industry is estimated to face a tax increase of 23 percent. This increase is more than 20 percentage points less than that estimated for any other industry. The TCU tends to have high levels of investment. Thus, TCU benefits greatly from the ability to expense, rather than depreciate, capital expenditures. Additionally, because this industry is capital-intensive, its spending on employee compensation and, thus, on employee benefits, is low relative to its total receipts. Thus, the TCU industry is not hurt as badly as other industries by the loss of the deduction for employee benefits.

The relationship between the flat tax and corporate size is examined in Table 14. Corporations with gross income of less than \$2 million will have their taxes more than tripled by the flat tax; whereas, corporations with gross income above \$2 million will experience only a 52.7 percent increase in taxes. The primary factor driving the large increase for the small corporations is the increase in tax rate. Currently, corporations face a corporate tax rate of 15 percent on taxable income below \$50,000, and of 25 percent for income between \$50,000 and \$100,000. Thus, while the switch from current law to a 22.9 percent flat tax means a decrease in the tax rate for most medium and large corporations, small corporation can face a tax rate increase. The data show that corporations with total receipts less than \$2 million will face a tax rate increase in the neighborhood of 40 percent, while the other size classes will face tax rate decreases. Additionally, small corporations tend to have lower taxable income margins. Thus, as discussed above, the loss of the interest and employee benefit deductions will have a greater percentage impact on small corporations than on large corporations.

⁷⁴ Unfortunately, the data do not enable us to perform industry level calculations for other organizational forms.

⁷⁵ The exception to this statement is the construction and mining industry, which has a relatively large deduction for employee benefits.

Table 13 here

table 14 here

Another group whose taxes will increase under the flat tax is organizations that are currently tax-exempt. The flat tax imposes a tax on the fringe benefits paid by these corporations, while current law does not. We estimate that tax-exempt organizations will owe \$1.4 billion under the flat tax.⁷⁶

⁷⁶ This calculation is based on data found in *California Nonprofit Organizations 1995*, University of San Francisco, Institute for Nonprofit Organization Management, 1995.

II. The Impact of the Flat Tax on Governments in California

State and local government in California will be affected by the flat tax in at least three important ways. The first, as noted in Volume I, is through changes in the market for government securities. The removal of the tax preference for government bond financing will cause an increase in the interest rate on currently tax-exempt bonds relative to other bonds. James McGinley and Robert White estimate that the ratio of the interest rate on long-term municipal bonds to the interest rate on U.S. Treasury bonds will increase from its historical range of between 75 and 85 percent to somewhere between 110 and 150 percent.⁷⁷ This ratio of interest rates will change in part because the interest rate on municipals is increasing and in part because the interest rates on other types of bonds are decreasing. Experts in the field disagree on the relative magnitude of the two components.⁷⁸ Based on discussions with the California Debt Advisory Commission, it is anticipated that state and local governments in California plan to issue between \$20 billion and \$25 billion of tax-exempt bonds in 1996. If the tax exemption for state and local government bonds is removed, and interest rates on these bonds rise, these governments will experience an increase in the cost of servicing new bond issues.

The exact cost increase will be determined by the size of the increase in interest rates. If, for example, the interest rate on municipal bonds increased by one-half percentage point, California state and local governments would experience a first-year debt-service cost increase in the neighborhood of \$100 million. Assuming the interest rate continued to be one-half percentage point above what it would have been under current law, the cost would grow dramatically over the next several years, as more and more of the existing stock of government debt is converted to debt with the higher interest rate.

The flat tax would require state and local governments to pay tax to the federal government on the fringe benefits that they provide for their employees. The annual cost of this

⁷⁷ James McGinley and Robert White, "Tax Reform and the Municipal Market: Phase One" October, 1995, Prudential Securities Incorporated. Interestingly, the ratio of municipal interest rates to the Treasury interest rates has recently risen over 90 percent on long-term issues. The interest rate on short-term municipal issues has remained close to that Treasuries, however. Many bond traders believe that this indicates that the market is incorporating the possibility of tax reform in the future into today's long-term interest rates.

⁷⁸ For example, Arthur M. Miller, "Tax Reform: The Proposals, the Reality, and Their Impact on Municipals," Goldman Sachs Municipal Market Research, May, 1995, argues that the actual interest rate paid by municipals will increase substantially. McGinley and White, on the other hand, believe the actual increase in rates will not be so dramatic.

provision could be approximately \$375 million for the State of California and \$2.2 billion for local governments within California.⁷⁹

The third complication arising from passage of a federal flat tax is that it would necessitate a redesign of California's income tax structure. Currently, California is generally in conformity with the federal income tax system, instructing taxpayers to use many calculations made for the federal government as starting points for computing their state taxes. If the federal government adopts a new system that no longer collects the same information, the current California tax system will not function. California could respond in one of two ways. The State could retain its current system. This would require establishing an administrative structure to perform all the functions, including information collection and enforcement, for which the State currently relies on the IRS. It would also require taxpayers to maintain all of the practices of the current tax system at the same time they implement the new federal tax system. Alternatively, California could reform its tax structure to once again adopt a policy of selective conformity with the new federal system. This would require an overhaul of the California tax code.

⁷⁹This calculation is based on data from *1994 California Statistical Abstract*, Table D-5, and *1994 Statistical Abstract of the United States*, Table 496, and assumes a 22.9 percent tax rate.

III. The Economic Impact of the Flat Tax on California

As discussed in Volume I of this paper, the adoption of a flat tax will have a potentially significant impact on the economy of the nation. The previous two chapters have presented estimates of the static impact of the adoption of a federal flat tax on California. In particular, under the flat tax scenario that was simulated, California taxpayers could end up paying an additional \$5.4 billion in federal taxes; state and local governments could end up paying approximately \$2.6 billion in federal taxes on employee fringe benefits; and nonprofit organizations operating in California would be required to pay approximately \$1.4 billion in federal taxes on employee fringe benefits. No attempt has been made, however, to measure the other impacts of the flat tax on the California economy. For example, it is relatively safe to predict that the adoption of a flat tax will tend to encourage savings, decrease interest rates, discourage the provision of fringe benefits, benefit those sectors of the economy with large capital outlays, and benefit those sectors of the economy that produce goods and services consumed by higher-income taxpayers. All of these impacts (and others for which there is less certainty regarding the magnitude or direction) will significantly affect the California economy.

An estimate of the long-run dynamic impact of a federal flat tax on the California economy would require a sophisticated macroeconomic model, such as a computable general equilibrium model. Such a model is not currently available. Even with such a model, it would be difficult to develop reliable estimates of the dynamic impacts of the flat tax. As such, it is beyond the scope of this paper to estimate these impacts.

To the extent the national economy is helped or hurt by the flat tax, the California economy will, to a greater or lesser extent, be helped or hurt. If the national economic pie becomes bigger, California's piece of the pie is likely to be larger. Thus, if the flat tax were to lead to an increase in savings and investment, the California economy would likely benefit. If the flat tax were to eliminate tax preferences that inefficiently distort economic decisionmaking, the California economy would benefit also. To the extent that beneficial tax distortions would be removed, the California economy would be hurt. This logic applies, in general, to any of the potential efficiencies discussed in Volume I.

Additionally, some of the impacts of the flat tax will tend to fall disproportionately on California. Even if the national economic pie does not change size, California's share may increase or decrease. For example, in Chapter I it was shown that very wealthy taxpayers will pay less under the flat tax. This would tend to benefit the California economy to the extent that California has a competitive advantage in the production of goods and services that are

consumed disproportionately by the wealthy. Some examples of these types of goods and services produced in California include high-technology goods, financial services, and recreation and entertainment. Also, if the adoption of a flat tax leads to an increase in imports or exports, California may benefit, at least relative to other states, due to its port industry.

There are many other avenues through which the flat tax might have a relatively beneficial or relatively detrimental impact on California's economy. While the direct costs to California are estimated to be almost \$9 billion, the indirect impacts on California's economy are currently unknown, but they could significantly offset that cost.

IV. Summary and Conclusions

If adopted, the flat tax would affect California taxpayers in a variety of ways. Some Californians would experience a dramatic tax increase under the flat tax, while others would enjoy a substantial reduction in taxes. This chapter will briefly recapitulate the dominant themes that were explored in the preceding chapters.

The flat tax described in HR 2060 would reduce federal tax collections by \$8.8 billion (including the tax on nonprofit and government organizations)⁸⁰. HR 2060 has not yet, however, been determined by any federal analysts to be revenue-neutral. Since the sponsors have indicated a desire that the proposed tax system be revenue-neutral, a version of the flat tax that has been found to be revenue-neutral was analyzed. In this model it was estimated that a flat tax that is revenue-neutral at the federal level would raise the federal tax paid by Californians by 6.6 percent, or \$5.4 billion. In addition, organizations that are currently tax-exempt, including state and local governments, would pay \$4 billion in new taxes. Thus, the total increase in the tax bill for California under the flat tax would be \$9.4 billion.

The effects of tax reform will not be distributed evenly throughout the population. It has been shown above that the change in taxes will vary across different classes of taxpayers and across different industries. The simulation suggests several tendencies in the distributional impact of the flat tax. For the most part, taxpayers who do not itemize deductions will fare better than those with the same gross income who do itemize. Also, taxpayers with complicated business activities will tend to pay more in taxes than taxpayers with similar income and no business activities. The flat tax also differs from most other consumption taxes in that it does not increase taxes on the elderly.

Perhaps the most interesting of the changes presented above is that the flat tax would shift much of the tax burden from wage income to business income. Generous exemptions and deductions and the decrease in the tax rate on large incomes drive down the tax on wages. Meanwhile, the loss of certain business deductions and the removal of the practice of using business losses to offset income earned elsewhere raise the effective tax rate on businesses. In particular, the top one percent of taxpayers by AGI will have a substantial decrease in taxes, while those with business losses will have especially large tax increases.

⁸⁰The \$8.8 billion tax decrease consists of a \$11.8 tax reduction to individuals and businesses and a \$3 billion tax increase to nonprofit and government organizations.

Despite the direct cost to the taxpayers and governments of California, proponents of the flat tax argue that, in the long run, the American economy will be more efficient under the flat tax. It is, indeed, possible that the general increase in prosperity will more than compensate many of those who pay more initially under the flat tax. The magnitude of any long-run benefit or detriment of tax reform to the California economy is, however, very difficult to estimate.

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APPENDIX I

APPENDIX II

APPENDIX III