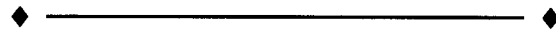


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An Efficient, Equitable Tax for the 1990s

◆ The 1980s saw remarkable changes in the U.S. tax system (and in those of many other nations as well). Legislation enacted in 1981 phased in tax rate reductions that instantly cut the top marginal rate from 70 percent to 50 percent, cut rates 25 percent across-the-board during the next three years, eliminated inflation-induced bracket creep, and injected a number of business investment incentives into the tax code. The net effect of these changes lowered federal income tax revenue from 11.9 percent of gross national product (GNP) in 1981 to 10.6 percent in 1986. Tax reform in 1986 cut maximum tax rates even more aggressively—from 50 percent to 28 percent for individuals and from 46 percent to 34 percent for corporations. The 1981 act improved incentives to work, save, and invest through lower marginal rates, but it largely left the tax structure unchanged. However, federal income tax revenue (excluding social security) fell in relation to national income. The 1986 tax reform, in contrast, extended the reach (broadened the base) of the tax system so that its large reductions in tax rates resulted in no loss of revenue in relation to national income. Both the president and Congress accepted the goal that the 1986 act be revenue neutral.

Many commentators are pessimistic about making further progress in improving the tax system in the 1990s. Merely defending the 1986 tax rates against pressures to raise federal revenue would be an important accomplishment, they say. Some financial advisers even recommend that individuals cash out of retirement plans and other tax-advantaged investments in

1988 or 1989 to take advantage of current low tax rates. These advisers foresee tax hikes intended to reduce the anticipated fiscal deficits of the 1990s.

In December 1981 we published an article in the *Wall Street Journal*, followed by two books in 1983 and 1985 along with a spate of academic and popular articles, advocating a complete revision of the federal tax system from the ground up. Under our proposal businesses and workers would each file a return that fits on a postcard. All income would be taxed only once, at a 19 percent rate on all income over an exemption level of \$15,400 for a family of four. The idea of a simple flat tax is not new. It was practiced in nineteenth-century Britain and has been advocated by such distinguished economists as Milton Friedman. What is new is that we developed a detailed, practical, workable plan that would eliminate a morass of forms, calculations, and paperwork. From 1981 through early 1986 we were considered hopeless visionaries, proponents of an ivory-tower tax reform that could never get anywhere in a Congress dominated by special interests. Tax rates would always remain at levels of close to 50 percent for higher incomes because the special interests defending tax shelters and other sources of untaxed income were so strong. Other critics of our flat tax vehemently argued that steep graduation in tax rates was an essential feature of a fair system—rich people should appear to pay a sharply increasing fraction of each dollar earned in taxes.

The Tax Reform Act of 1986 confirmed our dogged optimism. We proposed a reduction of 31 percentage points in the tax rate imposed on the incomes of the most successful Americans, from 50 percent to 19 percent. Congress enacted legislation that actually lowered the tax rate by 22 percentage points, over two-thirds of what we had proposed. This is one of the rare instances in modern U.S. political history in which the general interest of the public at large prevailed over special interests.

We remain optimistic about the prospects for further improvements in the federal income tax system. Although the 1986 tax reform made a number of key improvements, most notably the large reduction in the tax rates applied to the incomes of successful people, we believe that there are important further reforms that should and will be made. First, we believe that the 9 additional percentage points in lowering the top marginal tax rate are an appropriate goal. The 19 percent overall tax rate in our original proposal is still consistent with the revenue requirements of the federal government, provided the trend toward increasing discipline in federal spending continues. Second, we believe that the largest remaining category of untaxed income—fringe benefits—should be brought into the tax system in a politically sensible way. Third, we fault the 1986 tax reform for wiping out tax incentives for investment and would favor a rationalization of investment and saving incentives into a single powerful incentive.

All the improvements we propose can build on the important progress achieved with the Tax Reform Act of 1986. Enormous simplification and greater efficiency remain attainable goals. We do not believe that the nation should be reluctant to reopen tax issues in the 1990s for fear of slipping back from the major achievements of the 1986 act.

The Continuing Problem of Leakage

All tax reformers—certainly including the authors of the 1986 tax reform—recognize the problem of leakage in the tax system. Leakage (or tax base erosion) occurs when categories of economic income are excluded from taxable income. Some leakage is desirable; for example, almost all tax systems excuse some exemption level of income from taxation to limit the burden of taxes on the poor. But when tax rates are applied to a measure of income that falls far short of total national income, significant distortions occur. Those types of income singled out for taxes bear high rates, and people face a strong incentive to shift income from taxed to untaxed types.

The U.S. tax system suffers from three significant types of leakage:

1. *The underground economy.* Some types of business activities involving cash sales are invisible to the Internal Revenue Service (IRS). Many are perfectly legal except for tax evasion—moonlighting plumbers and the like. Others, notably the making and selling of drugs, would be illegal even if income were reported to the IRS. The IRS has numerous programs to bring businesses above ground. We do not have any surefire answers to the continuing problem of the remaining underground sector. But the payoff to remaining underground is measured by the tax rate. When tax rates fall, the underground economy shrinks simply because lower rates reduce the benefits of evasion in relation to penalties that may be imposed on those caught violating the law. Reduced leakages from the underground economy are one of the benefits of further reductions in tax rates.

2. *The long chain of business income.* A large amount of business income is taxed only after changing hands a number of times. The part of business income paid out as interest is not taxed at the level of the business—both corporations and noncorporate businesses are allowed to deduct interest payments when computing taxes. The recipient is supposed to declare the interest income as taxable income in certain cases. Enforcement of taxation of interest income has improved recently through the ponderous apparatus of over a billion Form 1099s that trace the movement of interest through the economy. But a great

deal of interest escapes taxation because it is paid to nontaxpayers such as pension funds.

3. *Fringe benefits.* Workers in the United States receive over a hundred billion dollars of untaxed fringe benefits each year. Medical benefits are the biggest single element of untaxed fringes, but life insurance, sick pay, country club memberships, company cars, and numerous other perks add to the leakage from taxable income. It is important to understand that taxation of these fringes would make it possible to cut tax rates on other types of income and need not add to the burden on the typical taxpayer. The enormous rise in untaxed fringe benefits over the past thirty years is clearly a response to high tax rates. The existence of fringe-benefit leakage stimulates wasteful consumption of the types of goods and services permitted as tax-deductible fringe-benefit payments by employers.

Adverse Incentives of the New Tax System

Though the reductions of tax rates to 28 percent on the highest personal incomes and 34 percent on corporations is a landmark achievement, the tax system created by the 1986 legislation has some significant incentive problems. Most acute are the severe penalties for risk taking. Consider an entrepreneur who builds a successful corporation by combining a good idea and a lot of hard work. The fruits of the success are primarily the buildup of the market value of the corporation, not the salary paid to the entrepreneur. The corporate income tax takes 34 percent of the buildup, because 34 percent of the corporation's income is collected by the IRS before it is capitalized in the market. When the entrepreneur chooses to make use of the value built up, either by paying dividends or by selling shares at a capital gain, an additional tax at 28 percent is due. The combined tax rate is 52 percent. The federal government takes over half the value created by the risk-bearing entrepreneur; many states take another 5 to 10 percent as well. Even with the seemingly low tax rates of the new tax system, entrepreneurial success is strongly discouraged.

The inefficiencies and distortions from excessive taxation of entrepreneurial activities affect many sectors of the economy. Talented individuals considering whether to become entrepreneurs at a 52 percent tax rate or to become lawyers or investment bankers at a 28 percent tax rate will usually choose the latter. And even within entrepreneurial activities, there is a serious distortion in favor of partnerships, where the income is taxed only at the personal rate. The tax system favors real estate and other businesses

with highly marketable assets where the partnership form of business organization is not a serious impediment. But in areas where a new business has an innovative product or process, the corporate form of business is essential. The 52 percent total tax on value created in corporations is a significant barrier to this form of expansion of the economy.

The 52 percent tax rate we have attributed to the new tax system does not apply in all cases. For one thing, the personal tax rate is actually 33 percent over a range of income from about \$100,000 to \$220,000. An entrepreneur who happens to fall in this range pays a combined tax rate of 56 percent in federal income tax. But there are ways to achieve lower taxes as well. An entrepreneur who chooses not to cash in capital gains gets the advantage of deferral of the capital gains tax. Most important, if the deferral lasts until the entrepreneur's death, the capital gains tax is never collected because the heirs pay tax only on the gain that occurs after the death. However, the trapping of the value reduces the incentive to create the value in the first place, so we cannot pretend that the capital gains tax does not exist.

The new tax system has also been faulted for its adverse impact on capital formation in established businesses. Under the new system, when investment is financed by equity (usually retained earnings), the total tax rate is roughly the same as the 52 percent falling on entrepreneurs. Again there is a substantial disincentive, with attendant inefficiencies and distortions. Corporations face a severe penalty for investing their equity capital in new plant and equipment. But the disincentives are not nearly as severe for borrowed capital. When a corporation finances a new plant by borrowing from a pension fund, the income from the plant is in effect not taxed by the corporate tax because the interest payment to the pension fund is tax deductible. The only tax is the one paid ultimately by the pension recipients, which may be at an average rate of only 15 percent. The distortions from that rate are far smaller than from the 52 percent rate on equity.

Two key investment incentives of the earlier tax system were ripped away by the reform of 1986: the investment credit and accelerated depreciation. Restoration of these incentives would not be a good solution to the problem of incentives for capital formation. Restoration would reduce the burden of taxation of equity-financed investment, which would be an improvement in efficiency. But it would also turn the taxation of debt-financed investment into a subsidy, one of the prime defects of the old tax system. In other words, restoration of investment incentives of the old type would bring back tax shelters. Subsidies are even more inefficient than taxation. An important accomplishment of the Tax Reform Act of 1986 was the taming of tax shelters. Further tax reform needs to preserve that step forward.

Complexity

The public's number-one complaint about income taxes is their sheer complexity. Middle-income home-owning taxpayers have to fill out a dozen or more pages of tax forms. High-income taxpayers with business interests, portfolio transactions, and the like may easily file fifty pages or more. The 1987 Form 1040 kit is even longer than its immediate predecessor. Each page involves complex rules, alternative calculations, and other features that require the advice of expensive expert advisers. And even those experts make frequent mistakes. The mere process of filling out tax returns is a tremendous psychological burden. More and more higher-income taxpayers are deferring filing from April 15 until August to postpone the grief of preparing returns (the law permits taxpayers to defer submitting the returns but not the payment, which has to be made in April).

The complexity of the current tax system has two causes. First, the taxation of business income at the destination (the individual taxpayer) rather than at the source (the business where it was generated in the first place) requires a complicated tracking process with Form 1099s and full reporting at the individual level. Source taxation of business income, widely used in other countries, makes individual tax reporting far simpler. Second, the tax system has grown by historical accretion. Essentially the same taxes could be collected from the same taxpayers with a vastly simpler system if it were redesigned from scratch, as we proposed in 1981.

The authors of the 1986 tax reform lost the opportunity to make many important simplifications. For example, rather than come to grips with the full problem of interest deductions and taxation, they chose the stopgap solution of restricting certain types of personal interest deductions. The result was hideous additional complexity for taxpayers who may be in danger of deducting more home mortgage interest than is permitted by the new law. The only important simplifications achieved in the new tax law were the collapse of the tax schedule from over a dozen tax brackets to three and the drop in tax rates, which make tax shelters less attractive. But this simplification has little practical value when the calculation of taxable income that goes into the tax schedule requires scores of pages.

Ideas for the Next Round of Tax Reform

The principles of an improved tax system are implicit in our earlier discussion of the defects of the current system. First, the tax system should control leakage by applying to a broad measure of income. Second, it should put a uniform low rate on all types of income rather than discouraging entrepre-

neurial effort and encouraging debt-financed investment. In this connection, it should provide a single uniform incentive for capital formation. Third, the system should be dramatically simplified. Fourth, it should not make any important change in the distribution of tax burdens; it should retain the important feature of the current system that the poor are excused from income taxes and the highest-income families pay the largest fraction of income as taxes.

The tax returns for a tax system with all of these characteristics could both fit on postcards (though to retain confidentiality, we suggest they be mailed in sealed envelopes). The two returns together constitute an airtight comprehensive tax at a uniform rate of 19 percent. All income is divided into two categories: wages and salaries, taxed on Form 1; and business income, taxed on Form 2. Before we explain the logic of each form, we need to stress that the two forms together constitute a tax system; it would not make sense to have one of the forms without the other. Moreover, there is no analogy between our Form 1 and the existing Form 1040; many of the components of income taxed on Form 1040 would be taxed on Form 2 (interest, dividends, and partnership income, among others).

Form 1 just taxes the wage and salary part of income. The great majority of families would file only Form 1. It puts a uniform tax of 19 percent on all earnings and pensions above a generous exemption level of \$15,400 for a family of four, indexed to inflation. Other than the exemption, no deductions would be permitted. Relative to existing provisions, the main discontinued deduction is for state and local income and property taxes. Allowing the deduction of these taxes essentially creates untaxed forms of consumption through government. Our proposal is simply an extension of the process that eliminated the deduction for sales tax as part of the 1986 tax reform legislation. Another deduction we would eliminate is charitable contributions. We do this mainly for consistency and simplicity. Continuation of existing provisions for deduction of contributions is a politically attractive alternative and would have little effect on revenue; however, its retention would invite other special interests to argue that their deductions are equally meritorious and put the simplicity of our proposal at risk.

Note that mortgage interest is not a deduction on Form 1. There is no change in the substance of taxation in our proposal, however. Changes in the taxation of interest income on Form 2 have the net result of giving home owners the same benefit they currently receive from mortgage deductions on their Form 1040s.

Form 2 is the complement of Form 1—it taxes all forms of income not taxed on Form 1. All businesses, including corporations, partnerships, and proprietorships, would file Form 2. The basic idea is to capture all income the moment it is generated in the business, rather than wait for it to make

Form 1		Individual Wage Tax		1990
Your first name and initial (if joint return, also give spouse's name and initial)		Last name		Your social security number
Present home address (Number and street including apartment number or rural route)			Spouse's social security no.	
City, Town or Post Office, State and ZIP Code		Your occupation †		
		Spouse's occupation †		
1	Wages and Salary	1		
2	Pensions	2		
3	Total (line 1 plus line 2)	3		
4	Personal allowance	4(a)		
	(a) <input type="checkbox"/> \$11,000 for married filing jointly	4(b)		
	(b) <input type="checkbox"/> \$5,500 for single	4(c)		
	(c) <input type="checkbox"/> \$9,800 for single head of household	5		
5	Number of dependents, not including spouse	5		
6	Personal allowances for dependents (line 5 multiplied by \$2200)	6		
7	Total personal allowances (line 4 plus line 6)	7		
8	Taxable wages (line 3 less line 7, if positive, otherwise zero)	8		
9	Tax (19% of line 8)	9		
10	Tax withheld by employer	10		
11	Tax due (line 9 less line 10, if positive)	11		
12	Refund due (line 10 less line 9, if positive)	12		

its way to households. Form 2 plugs multiple leaks in the tax system. It starts at the top of the long chain of business income. It taxes fringe benefits in the only politically practical way: the cost of fringe benefits is not allowed as a tax deduction for businesses. It offers the hope of progress in taxing the underground economy because of its low tax rate of 19 percent.

Form 2 completely solves the incentive problems laid out earlier in this essay. On the key issue of entrepreneurial incentives, it puts a tax rate of exactly 19 percent on the fruits of success. The successful corporation built by an entrepreneur pays a tax of 19 percent on the business income it generates. No further tax applies to the value created by the entrepreneur. If the corporation pays dividends, those dividends are from after-tax income and incur no further tax. If the entrepreneur sells appreciated shares, the appreciation is the capitalization of after-tax income, and no tax is imposed on the capital gain. The tax rate on entrepreneurship drops from 52 percent to 19 percent.

The problem of low taxation of debt-financed business is equally solved by Form 2. Since all business income is taxed at the same 19 percent rate, there is no preferential treatment of interest over dividends. The bias in

favor of partnerships and the ownership of marketable assets endemic in the current tax system disappears completely.

Form 2 provides one simple coherent investment incentive. On line 2c a business subtracts its purchases of plant, equipment, and other capital assets. The economic effect of this first-year write-off is to bring the effective tax rate on the earnings of capital to zero. Another way to express the economic effect of the tax is to call it a consumption tax. Consumption taxes are widely supported by economists for providing the correct incentive for investment. Note that the tax base for the combination of Form 1 and Form 2 is total private income less investment, which equals consumption. Hence the flat tax is a consumption tax.

Under our tax system all interest would be paid after tax. For example, the interest payments by a corporation on its bonds would be paid out of income that had been taxed on Form 2, which has no deduction for interest payments. The recipient would not have to pay any more tax on the interest because the corporation would have paid the tax already. By contrast, under present tax principles, interest is always before-tax income. The payer takes a tax deduction for the interest and the recipient has to pay tax. With other forces held constant in the economy, interest rates would be lower under the after-tax principle we favor than under the before-tax principle in current

Form 2		Business Tax		1990	
Business Name			Employer Identification Number		
Street Address			County		
City, State and ZIP Code			Principal Product		
1	Gross revenue from sales		1		
2	Allowable costs				
	2(a)	Purchases of goods, services and materials			
	2(b)	Wages, salaries and pensions			
	2(c)	Purchases of capital equipment, structures, and land			
3	Total allowable costs (sum of lines 2(a), 2(b), 2(c))		3		
4	Taxable income (line 1 less line 3)		4		
5	Tax (19% of line 4)		5		
6	Carry-forward from 1989		6		
7	Interest on carry-forward (6% of line 6)		7		
8	Carry-forward into 1990 (line 6 plus line 7)		8		
9	Tax due (line 5 less line 8, if positive)		9		
10	Carry-forward to 1991 (line 8 less line 5, if positive)		12		

use. Consequently the actual burden of interest on the borrower would be the same under our principle as it is today, even though the taxpayer would no longer get a tax deduction for interest payments.

Prospects

Our 19 percent universal flat tax was called visionary until 1986. Having achieved two-thirds of our goal for the tax rate applied to earnings, we believe additional progress is easily within the nation's grasp in the 1990s. Even without the adoption of a flat 19 percent rate, important structural reforms with lower effective tax rates for entrepreneurial activities could be achieved. We could keep the current three-rate tax rate schedule but move to the principle of source taxation of business income. This step alone could reduce the critical 52 percent rate on entrepreneurial success to 28 percent. At the same time the problem of leakage in business income could be solved, with tremendous savings from eliminating the process of tracking a billion Form 1099s. Less leakage permits lower rates, which would give the economy an additional supply-side kick. Economic growth is always the critical consideration in the design of any tax system and in the long run will generate higher, not lower, tax receipts.

We see the elimination of penalty taxation of entrepreneurial success as a central tax issue of the 1990s. Those calling for cuts in capital gains taxation are dealing with only a fraction of the problem. Far better would be the adoption of a completely coherent tax reform that puts a low uniform rate on all income. In addition, a truly simple tax system promises greater compliance and billions of dollars in savings in preparing tax returns. As the full benefits of the lower rates enacted in 1986 take hold in 1988, we hope that Congress and the executive can work together to make a low, simple flat tax a reality.