COMMENT

THE FLAT TAX IS NOT A FAIR TAX

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Advocates of the flat tax justify it on three grounds: fairness, economic efficiency, and simplicity. Although I question each of these claims, I would like to focus on the question of fairness. I believe that the arguments proposed in favor of the fairness of the flat tax are deeply flawed.

The fairness claim of flat tax advocates involves both a factual allegation and a principle. The factual allegation is that under a flat tax, all income is subject to tax at a single rate. The principle asserted is that it is fair to subject all income to a tax at the same rate. The factual allegation is false and the principle asserted is so untenable that even the proponents of the flat tax are unwilling to apply it rigorously.

Flat Taxes Do Not Tax All Income at the Same Rate

On their face, the various flat tax proposals currently being debated do seem to involve a single rate of tax on all income. However, a closer examination reveals that this is an illusion for two reasons. First, current flat tax proposals exempt certain forms of income from tax. Consequently, the rate of tax on those privileged forms of income is zero percent. Second, current flat tax proposals involve relatively generous personal exemptions. Because of these exemptions, even those individuals who receive all of their income in taxable form are subject to different effective rates.

Zero Rate On Income From Capital

The three major flat tax proposals (Hall-Rabushka, Congressman Armey, and Steve Forbes) all exempt income derived from capital, whether in the form of dividends, interest, or capital gains, from tax at the individual level. Individuals are, therefore, taxed

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only on their wages. As a result, at the individual level, the flat tax is actually a two rate system: zero on income from capital and the nominal rate on wage income.

One consequence of this aspect of the flat tax is that top corporate executives would pay tax on only a small fraction of their earnings, even if compensation packages retained their current form. For instance, in 1995, Stanley C. Gault, CEO and Chairman of the Board of Goodyear Tire and Rubber Co., received direct compensation of $16.5 million, but $13 million was in the form of stock-option gains which would not be taxed under the flat tax. Eckhard Pfeiffer of Compaq Computer received total direct compensation of $16.1 million of which $12.5 million was option gains that would not be taxable under the flat tax. Gault and Pfeiffer were not alone in receiving a large proportion of their income in the form of option gain. Reuben Mark of Colgate-Palmolive Co. received $15.1 million in direct compensation of which $11.6 million from option gains. Roberto C. Goizueta of Coca-Cola Company received $12.9 million in direct compensation of which $6.6 million in option gains.[1] At a nominal rate of 17%, the effective rate of tax on total direct compensation under the flat tax would range from 3.6% for Mr. Gault to 8.3% for Mr. Goizeuta.

If the flat tax replaced current income taxes, there would be a radical shift in the composition of compensation packages for top executives and probably for all employees who do not need a large percentage of their pay in immediately spendable form. Taxable salaries would dramatically decrease while various forms of non-taxable compensation would become the dominant form of compensation. Indeed, one can confidently predict that an entire subspeciality of tax law would grow up dedicated to inventing ways of converting what would normally be taxable salary into non-taxable capital gains or dividends.[2] The effective rate of individual tax

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1 *Executive Pay Survey*, WALL ST. J., Apr. 11, 1996, at R16-R17.

2 At some point the drain on the tax base and the decline in taxpayer morale caused by the spectacle of the most highly compensated people paying little or nothing in tax would force the enactment of some form of a blocking measure. Such a provision would probably be quite complex. The current code provision designed to block the conversion of service income into capital gains, section 341, has been described as "so complex that many otherwise careful practitioners are thought to ignore [its] existence." Noel B. Cunningham, *Colloquium on Partnership Taxation: Commentary: Needed Reform, Tending the Sick Rose*, 47 TAX L. REV. 77, 89 n. 51 (1991). Cf. Martin D. Ginsburg, *Collapsible Corporations: Revisiting An Old Misfortune*, 33 TAX L.

would range from the nominal rate to zero depending on how much income an individual could manage to convert from capital into untaxed income.

Proponents of the flat tax reply that the system does not tax income derived from capital at the individual level, but taxes it at the business level. This, proponents assure us, should assuage any concerns we may have about the zero individual tax rate on income from capital.[3] This response is unconvincing for two reasons. First, the income Mr. Gault derives in 1995 from exercising options on Goodyear stock may be measured by the income that market participants expect Goodyear to earn in future years, but it is not the same income. The taxes that Goodyear may pay at sometime in the future are not, therefore, an adequate substitute for taxing Mr. Gault on the $13 million of direct compensation that he received in 1995 under the form of option income.

The second problem with the argument is even more fundamental, although harder to grasp. It is true that the flat tax nominally imposes a business level tax on all business income, including income from capital. The flat tax, however, also allows businesses an immediate deduction for the full cost of capital assets rather than requiring capital investments to be depreciated over time. Tax theorists have understood for the last fifty years that allowing an immediate deduction for the cost of an investment is equivalent to exempting from tax the income from the investment.[4] Thus, the flat tax's immediate full deduction for capital investments is the equivalent of not taxing businesses on the income generated by capital. Therefore, under the flat tax, income from capital is effectively exempt from all taxation at both the business and individual level. Accordingly, leaving aside for the moment the effect of exemptions, the flat tax is really a tax at the nominal rate on wages and at zero on income from capital.

REV. 307 (1978) (exploring the provisions of section 341 and lamenting its complexity).

[3] *See* Robert E. Hall and Alvin Rabushka, THE FLAT TAX 177 (2d ed. 1995) (arguing that capital gains on stocks on bonds should not be taxed because they arise from the increased capitalization of business earnings that are taxed at the business level).

[4] E. CARY BROWN, BUSINESS-INCOME TAXATION AND INVESTMENT INCENTIVES IN INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN E. HANSEN, 330-416 (1948). Although difficult to grasp, this concept is a useful and universally accepted analytical tool that appears in many public finance texts. *See, e.g.*, CARL S. SHOUP, PUBLIC FINANCE 302 (1969).

Effect of Exemptions

All current flat tax proposals include relatively generous exemption amounts. Under Congressman Armey's plan, for instance, a family of four would pay no tax on the first $34,700 of wage income, and would pay tax on every dollar of wage income thereafter at a rate of 17%. The exemption is the equivalent of a zero rate on the exempted amount, so the tax actually has two rates even on wage income: zero and 17%. This means that the effective rate of tax will vary with income level. A family of four with income less than $34,700 will have an effective rate of zero. A similar family with wage income of $40,000 will have an effective rate of 2.3% (17 % of $5,300 = $901/ $40,000 = 2.3%). A family of four with wages of $150,000 will have an effective rate of 13.1% (17% of $115,300 = $19,601 / $150,000 = 13.1%). Finally, a family of four with wage income of $1,000,000 will have an effective rate of 16.4% (17% of $965,300 = $164,000 / $1,000,000 = 16.4%). I do not find this result undesirable. Quite to the contrary, it seems to me one of the redeeming features of current flat tax proposals. It is important, however, because it demonstrates the falseness of the factual allegation on which flat tax proponents rely in their attempt to show the fairness of their proposals. Even leaving aside the question of income from capital, the flat tax is not levied at a single rate on all income.

Is It Fair to Tax All Taxpayers at the Same Rate?

Proponents of the flat tax offer no serious theoretical justification for the principle that fairness requires every taxpayer to bear tax at the same rate. That principle is far from self-evident. If fairness is treating every taxpayer the same, perhaps each taxpayer should pay the same amount of tax irrespective of income, just as each user of a toll road pays the same toll irrespective of the user's income. This form of capitation tax could not raise sufficient revenue necessary for the operation of modern governments because the tax owed per person would exceed the total income of many poor individuals. This practical objection does not, however, demonstrate that it is fair to tax people in proportion to their income as the proponents of the flat tax assert should be done.

To justify charging more to those with larger incomes, proponents of the flat tax must at least implicitly embrace the principle that taxes should be based on one's ability to pay. Their position must be that tax should vary with ability to pay and that ability to pay increases proportionately with income. But it is far from clear that ability to pay increases proportionately with income. Our system has long been based on the perception that ability to pay taxes increases faster than income, and that therefore tax rates should increase with income.

Although proponents of flat taxes vigorously deny this principle, they are unwilling to accept the full consequences of their own position that ability to pay increases proportionate to income. If ability to pay increases proportionately to income, the taxpayer who earns only $5,000 should pay the same percentage of his or her income as the taxpayer who earns $5,000,000. As we have already discussed, however, the effect of granting exemptions is that taxpayers with small incomes pay a smaller percentage of their total income than taxpayers with larger incomes, and taxpayers with incomes below the exemption amount pay no tax at all. Although I find nothing objectionable in this outcome, it is incompatible with the principle espoused by proponents of the flat tax. A logically consistent advocate of the principle that fairness requires everyone to pay the same percentage would abolish all exemptions. No prominent proponent of the flat tax is willing to follow the principle to this conclusion, presumably because they find it unacceptably unfair.

The principle that fairness requires everyone to pay the same percentage of income could be made compatible with exemptions by invoking another independent principle, namely that no one should be required to pay taxes until the taxpayer and the family of the taxpayer's basic subsistence needs have been met. This principle rests on the perception that every individual is required to contribute to the well-being of the community, but that each individual's first contribution comes in the form of meeting the subsistence needs of self and family. Contributions to the well-being of the community through taxes are called for only when that first contribution has been made. This principle implies that their is no ability to pay until subsistence needs have been met.

Current flat tax proposals, however, contemplate exemption amounts that are roughly double the federal poverty level. They are far too large to be justified on the principle that subsistence needs should be met before there is any ability to pay taxes. Something else must be at work here.

The proponents of flat taxes apparently recognize that it is not fair to apply the same rate to all taxpayers as soon as they cross the poverty threshold. The reason is not far to find. Consider two hypothetical families of four. The first starts with income of $16,000 (just above the federal poverty rate) and increases its income to $17,000. The second starts with income of $1,000,000 and increases its income to $1,001,000. The burden of an additional $170 in tax on the first family is far greater than the burden on the second family of an additional $170 in tax. It would be unduly burdensome for a family that has just barely crossed the poverty line to pay taxes on its all its income above the poverty line at a rate that is not burdensome for a family with a much higher income.

Put in terms of ability to pay, this means that ability to pay does not increase proportionately to income at all income levels above mere subsistence. Flat tax proponents implicitly recognize this by proposing exemption amounts well above the poverty level. The importance of all this lies not in determining exactly how large the exemption amount should be, nor even in deciding on how steeply progressive rates should be, but as a demonstration that the demands of fairness cannot be satisfied by simply imposing the same rate on everyone without considering how much of a burden the tax will represent.

The position of flat tax proponents is inconsistent. They appear to take the relative burdensomeness of the tax into account in determining ability to pay for purposes of drawing a distinction between those it is not fair to tax and those it is fair to tax. However, they refuse to take it into account, the threshold at which they think it is fair to begin to impose some tax. There is no reason, however, why relative burden should be ignored once a taxpayer passes the threshold of taxability. It may be impossible to determine with precision how much of burden any given amount of tax represents for a taxpayer in a particular situation. It seems undeniable, nonetheless, that paying an additional $1,700 of tax is more burdensome for a taxpayer who goes from $40,000 to $50,000 of income than for a taxpayer who goes from $1,000,000 to $1,010,000 of income.

This is, of course, the classic argument in favor of progressive taxation that is usually formulated in terms of the decreasing marginal utility of money. Despite the difficulty or impossibility of establishing with precision the shape of the curve that describes the marginal utility of money, empirical observation strongly supports the conclusion that money does have a declining marginal utility such that the burden of an additional $100 of tax is less on a taxpayer with a very large income than on a taxpayer with a small income. If fairness demands that the burden of taxes be proportionate to taxpayers' ability to bear them, rates should increase as income increases to reflect the declining marginal utility of money.

Conclusion

In summary, current flat tax proposals are unfair both because they tax only wage income, exempting altogether income from capital, and because, in my view, fairness requires that the rate of tax increase as income increases.