The Flat Tax Is Not Flat

The roots of the modern income tax in the United States go back to the War Between the States. Congress first passed a 3 percent tax on incomes over $600 and a 5 percent tax on incomes over $10,000. This was soon increased to 5 percent and 10 percent. After the war ended, forms of a flat tax were tried until 1872 when the first income tax came to an end. Although many attempts were made in Congress to reinstate an income tax, one was not enacted again until a 2 percent tax on income over $4,000 was instituted in 1893. This was ruled unconstitutional in 1894 because the Supreme Court ruled that the tax was not apportioned according to the population of the states as required by the Constitution.

Our current income tax system, which was established with the adoption of the 16th Amendment, began with a 1 percent tax on taxable income above $3,000 ($4,000 for married couples). A series of surcharges of up to 6 percent were applied to higher incomes, with the maximum rate being 7 percent on taxable income over $500,000. Less than 0.5 percent of the population ended up paying income tax.

From its humble beginnings, the income tax soon blossomed, thanks to World War I, into a tax with a minimum rate that doubled and a maximum rate that reached 77 percent on income of over $1 million. The rates did not fall significantly until 1925. In the middle of the Great Depression, the top rate rose to 79 percent. During World War II, the tax rate for those in the highest income bracket reached an astounding 94 percent. The Internal Revenue Code of 1954 resulted in 24 brackets with rates ranging from 20 to 91 percent. The top rate remained at 91 percent until 1964. Under the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986, the top marginal tax rates were lowered to 50 and 28 percent respectively.

The Economic Growth and Tax Relief Reconciliation Act of 2001 established the current tax brackets of 10, 15, 25, 28, 33, and 35 percent. This progressive system results in Americans who earn in the top 5 percent of income paying about 57 percent of the income taxes. Those who earn in the top 50 percent pay about 97 percent of the income taxes. This means that the bottom 50 percent of wage earners pay only about 3 percent of the income taxes. It is clear that any talk of the “rich” not paying their fair share is bogus. Tax cuts benefit the “rich” because the “poor” not only don’t pay taxes, they usually receive a refund on top of that due to refundable tax credits like the child credit and earned income credit.

There is no question that the current federal tax code is a confusingly complex monster of a system that results in millions of wasted hours and dollars in compliance costs. Unfortunately, tax-reform plans usually focus exclusively on simplifying the tax code rather than on making the code less progressive. And even worse, no major tax-reform plan even hints at lowering American’s overall tax burden. This, of course, is the real issue. It is no consolation to a wealthy person who is stripped of his money by the federal government that a poorer person is likewise relieved of his money by the same percentage.

The most radical tax-reform plan is a consumption tax in the form of a national retail sales tax called the FairTax. The FairTax has been introduced in the U.S. House of Representatives by John Linder (R-Ga.), and is heavily promoted by radio talk-show personality Neal Boortz. The FairTax would replace with a national sales tax not only the personal income tax, but also the corporate income tax, estate tax, gift tax, unemployment tax, Social Security tax, and Medicare tax. The only problem is that in exchange for all of this Americans would have to pay a 30 percent sales tax on all new goods and services — including cars, houses, and medical procedures. Additionally, every family in America would receive a monthly rebate to offset the taxes paid on basic necessities. This makes the FairTax not only progressive but also an income redistribution scheme under the guise of tax reform.

Other tax-reform proposals include a proposal to have different tax rates for property-type income and earned income from work and a plan like a Value Added Tax (VAT) that would replace both the corporate and personal income tax. Social Security and Medicare taxes would remain unchanged.

The federal government, ever wanting to increase its revenue while at the same time making Americans feel better about paying income taxes, has its own tax-reform plans. In 2005, the President's Advisory Panel on Federal Tax Reform released two tax-reform proposals. The Simplified Income Tax Plan would create four tax brackets (15, 25, 30, & 33). Excluded from taxation would be 100 percent of dividends and 75 percent of corporate-stock capital gains. The Growth and Investment Tax Plan would create three tax brackets (15, 25, & 30) and tax dividends, capital gains, and interest received at a rate of 15 percent. Both plans would replace the personal exemption, standard deduction, and child tax credit with a family credit and leave Social Security and Medicare taxes unchanged.

The tax-reform idea that has been around the longest is the flat tax. Under a flat tax, there are no tax brackets — everyone's income is taxed at the same rate — and generally no deductions. First proposed by economist Milton Friedman in 1962, the flat tax entered the mainstream through a 1981 *Wall Street Journal* article by Hoover Institution economists Robert Hall and Alvin Rabushka called "A Proposal to Simplify Our Tax System." This article grew into a book, called simply *The Flat Tax* (Hoover Institution Press, 1985). A second edition was published in 1995. After the flat tax's silver anniversary, Hall and Rabushka issued an "updated revised edition" in 2007 that can hardly be called either. Aside from this book, the flat tax gained national prominence when House Majority Leader Dick Armey (R-Texas) pushed the idea of a flat tax after the Republicans gained control of the Congress in the 1994 mid-term election. A few bills based on the Hall-Rabushka plan were introduced in Congress. Other incarnations of the flat tax were pushed by both Democrats and Republicans.

The most recent, and very prototypical, incarnation of the flat tax is that of former Republican presidential candidate (1996 & 2000) and overseer of the Forbes publishing empire Steve Forbes. In his book *Flat Tax Revolution*, Forbes calls for a flat tax of 17 percent on all income, with the exception of capital gains, Social Security benefits, interest earned, and dividends received, along with "generous exemptions for adults and children." Like most other tax-reform plans, Social Security and Medicare taxes would remain unchanged. Under the Forbes Flat Tax, no taxpayer would have to itemize deductions for medical expenses, home mortgage interest, or charitable contributions because there would not be any deductions for these things. The Hall-Rabushka plan likewise calls for generous personal and dependent allowances; however, the rate they propose is 19 percent.

According to flat-tax advocates, moving to a flat tax would create millions of new jobs, invigorate the economy, stimulate economic activity, lead to an economic boom, increase investment, increase GDP, make America move competitive overseas, liberate Americans from the tax code, lead to more people making higher incomes, and dramatically improve incentives to work, save, and invest. Thus, flat-tax proponents say the same thing about their plan that FairTax supporters do: it will all but usher in the millennium. One could say the same things about the current version of the tax code if all of the rates were substantially decreased.

The real arguments for a flat tax basically come down to two things: simplicity and fairness. There is no doubt that a flax tax would greatly simplify the tax code. This would result in the elimination of compliance costs, as well as a tremendous reduction in the complexity, number, and length of income tax forms. However, whether a flat tax is fair or fairer is quite subjective.

Like all major tax-reform plans, all flat-tax proposals are revenue neutral; that is, the federal government would be funded at the same obscene level that it is now. Yet, under the Forbes plan, a family of four would pay no federal income tax on its first $46,165 of income; a family of six would owe nothing until its income exceeded $65,930. Not only would many families pay no income tax, they still might get a refund because of the refundable child credit and earned income credit included in the Forbes Flat Tax plan. This generosity comes at a price, however. With a revenue-neutral tax, a lower tax bill for some Americans means that other Americans will have to pay more.

The truth, then, is that the flat tax is not flat at all. No one actually pays 17 percent or 19 percent. In fact, everyone doesn't pay the same percentage at all. Progressivity doesn't require graduated tax rates. The flat tax is actually more progressive than our current system. The flat tax effectively has its own tax brackets: the single bracket, the single mother bracket, the married bracket, and a series of married with children brackets. Yet, Hall and Rabushka actually claim that the flat-tax system they propose is both "fair and progressive — the poor pay no tax, and the amount that a family pays rises with income." Huh? A system that punishes success and fosters class envy is "fair"?

People generally support a progressive system that results in taxpayers and tax-consumers — people who pay taxes and people who live off the taxes of others — because there are many more tax-consumers than there are taxpayers. This is why Barak Obama can get away with running a campaign commercial which openly boasts that no taxes will be raised on any American making under $250,000. What this means, of course, is that any American making over $250,000 better hang onto his wallet.

The root problem with any version of the flat tax is that it is still an income tax. Hall and Rabushka maintain: "Our system rests one basic administrative principle: Income should be taxed exactly once, as close as possible to its source." But why should income be taxed at all? We should not lose sight of the real issue: Americans are taxed to death, and after death. The only trustworthy tax-reform plan is one that proposes the lowering or elimination of an existing tax. It is not enough just to make the income tax less progressive. As the late economist Murray Rothbard explained: "The flat-tax movement is part of a process by which the government and its allies have been able to split and deflect the tax protest movement from trying to lower the taxes of everyone, into trying to force everyone into paying some arbitrarily defined 'fair share.'"

The federal budget for fiscal year 2008 ended with a record $438 billion deficit. The current budget for fiscal year 2009 of over $3 trillion is also unbalanced. The national debt is over $10 trillion, and is increasing by over $3 billion a day. The war in Iraq is costing over $200 million a day. But like a flat coke or a flat tire, flat is not always a good thing. Although it is certainly true that the current U.S. tax system is too complex, too confusing, and too intrusive, what really needs to be flattened is skyrocketing congressional spending, not the procedure used by the government to confiscate the wealth of its citizens.

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