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# Real Tax Reform: Flat-Tax Simplicity with a Progressive Twist

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## Abstract

In a contribution to the Christian Science Monitor, Donald Marron agrees that there are good reasons for a simpler tax system, as found in the flat-tax plans of GOP hopefuls Perry, Gingrich, and Cain. But they need to be made more progressive to amount to real tax reform that can pass muster politically.

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Tax reform has emerged as a key issue for GOP presidential hopefuls. Texas Gov. Rick Perry wants to scrap our current system and replace it with a 20 percent flat tax on individual and corporate incomes. Former Speaker of the House Newt Gingrich wants to do the same, but with even lower rates.

Then there's pizza magnate Herman Cain. His "9-9-9" plan would replace today's income and payroll taxes with a trio of levies: a 9 percent flat tax on individuals, another on businesses, and a 9 percent retail sales tax. But Mr. Cain's ultimate vision is to eliminate anything remotely resembling today's tax system in favor of a national retail sales tax, which proponents call the FairTax. These three plans have much in common. Catchy names, for one. More important, they all focus on taxing consumption - what people spend - rather than income.

The flat tax is most famous, of course, for applying a single rate to all corporate earnings and to all individual earnings above some exemption. It's also famous for allowing taxpayers to file their returns on a postcard by eliminating all the special deductions, credits, and other rules that complicate today's tax code. (It also proved too radical for Governor Perry and Mr. Gingrich; their modified flat taxes keep some select deductions, including for charity and mortgage interest, and they also allow individuals to choose to remain in the current system.)

Equally important, however, is the way the flat tax handles investment income. Individuals would pay taxes on their labor income but not on capital gains, dividends, or interest.

That doesn't mean capital income would escape taxation. Instead, the taxes would be collected at the business level. Businesses would pay taxes on all their income, regardless of whether it's paid out as dividends or interest. They would also be allowed to write off the entire cost of new investments when they are made.

The net result of these rules is that people would be taxed only to the extent that they consume. In the words of Robert Hall and Alvin Rabushka, the economists who invented the flat tax 30 years ago, "people are taxed on what they take out of the economy, not on what they put in."

The flat tax is thus a very close cousin to the FairTax and other retail sales taxes (which many Republicans like) and to value-added taxes (which they don't). The logistics differ: A sales tax is collected on retail purchases, a VAT from businesses at each stage of the supply chain, and a flat tax from individuals and businesses. But the underlying economics work out the same: People get taxed only on their consumption.

There are good reasons to favor a simpler tax system that emphasizes taxes on consumption over income. Some policy experts across the political spectrum embrace exactly that approach to tax reform. But all these plans would be much less progressive than our current income tax, and that's neither appropriate nor politically viable.

What we need are tax-reform proposals that would maintain progressivity while harvesting many of the benefits of simplicity and consumption taxation. The late Princeton economist David Bradford offered one simple approach: Add progressive rates to a flat tax. Columbia Law School Prof. Michael Graetz offered another: Pair a broad-based VAT with an income tax for folks with high incomes. These ideas might not have much traction among GOP primary voters. But they offer a much better starting point for reform than the plans on the table today.

## Other Publications by the Authors

- Donald Marron