Why Flatter Taxes are Fairer

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Whatever becomes of Bob Dole's plan for a quick cut in tax rates, his longer-term agenda--moving toward a 'fairer, flatter' tax system--will continue to resonate with many Americans and to cause controversy. Opponents of a flatter tax system claim it would be unfair to lower-income people. In fact, it would be unfair to high-income people--just less so than the current system.

Economists use two fairness criteria to judge a tax system. The first is horizontal equity, the equal treatment of people with equal income. The U.S. tax system notoriously flouts this principle by taxing income two or three times when it is saved and invested but only once when it is consumed.

Imagine, for example, that you buy a share in General Motors. GM then earns a dollar per share. GM pays 34 cents in corporate taxes on that dollar and sends you a dividend check for the remaining 66 cents. You pay personal income tax on that dividend, probably at a rate of 28% or higher. After this double taxation, you end up with less than 48 cents of the dollar. Assuming that you have an estate of over a few million, the government isn't done with you yet. If you leave that 48 cents in your estate, the federal government takes a further 55% of the 48 cents when you die, leaving your heirs with a measly 21 cents of the original dollar of income. If your marginal tax rate on that dividend income was the top Clinton-imposed rate of 39.6%, your heirs are left with only 18 cents.

Why should you be taxed doubly--or triply--because you added to the capital stock when your neighbor avoided all but a small sales tax by cruising on the Caribbean?

The so-called flat tax, on the other hand, treats you the same whether you spend your income or invest it. Under a flat tax--really a proportional tax on all income above some threshold--you get taxed when you first make money, and then never again. So, judged by horizontal equity, the flat tax is more fair.

Economists also judge fairness by vertical equity--defined most broadly as the idea that better-off taxpayers pay more tax. But vertical equity is too weak a criterion; almost all taxes meet it. A true flat tax would take the same percent of everyone's income, thereby making a family with twice the income pay twice the tax. The kind of flat tax proposed by Hoover Institution economists Robert Hall and Alvin Rabushka, and the variants put forth by Congressman Dick Armey and Steve Forbes, would take 17% to 19% of a family's income above $25,500 to $36,000, thus making a family with $100,000 in income pay three to four times as much as a $50,000-income family. Under our current system, which imposes higher rates on higher-income people--economists often use the loaded word 'progressive' to describe it--the gap between high- and low-income taxes is even wider.

So what is a good guide to fairness in tax policy? My candidate is the so-called benefit principle: your taxes should be in proportion to the benefits you get from government. Consider national defense, one of the major benefits the federal government produces that would be difficult for individuals to provide for themselves. The more you have to defend--both in family assets and family size--the greater your benefit from defense. Because most people's assets are highly correlated with their lifetime income, a proportional tax on income would tax more heavily those with more assets. But giving a personal exemption for each family member would be hard to justify, since the more kids you have, the greater the benefit you receive. According to the benefit principle, then, a proportional tax with a deduction per dependent is more fair than the current system and less fair than a flat tax with no deduction per dependent.

A flat tax would probably benefit high-income people disproportionately. I say probably because, as Hall and Rabushka point out, there are no good data on who gets the $1 trillion of the $1.7 trillion in business income that currently does not find its way onto people's tax forms but that would be taxed under a flat tax. If fairness is the goal, high-income people would have to benefit disproportionately. The reason: they now pay a larger share of their income in federal income taxes than lower-income people do. According to The FORTUNE Encyclopedia of Economics, families in the top 1% of the income distribution in 1990 paid 27.2% of their income in total federal taxes, whereas families in the lowest 20% paid only 9.7%.

Moreover, when a recent Reader's Digest poll asked what percent of their income a family of four making $200,000 should pay in all taxes to all levels of government, the median response of virtually all income and demographic groups was that the maximum should not exceed 25%. That family now pays 39%, and the flat tax would lower it by at most a few percentage points. Based on that survey, the flat tax is indeed unfair: it still takes way too much from high-income people.