

Flat-Tax Fever

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The recent interest among some prominent members of the Spanish Socialist Party (PSOE) in a so-called "flat tax" would certainly raise eyebrows among even the most socially and fiscally conservative leaders of the Democratic Party in the United States.¹ The flat tax has long been a center piece of the legislative agenda of the most ideologically zealous sectors of the U.S. Republican Party. The flat tax has its modern roots in Milton Friedman's "negative income tax" proposal developed in his 1962 classic *Capitalism and Freedom*, and, since then, even the mainstream of the Republican Party has given the idea little support. Instead, the idea has generally been championed by the most conservative elements of the Republican Party, including the eccentric millionaire Steve Forbes, who pushed the idea in his unsuccessful 1996 and 2000 bids for the Republican Party presidential nomination, and (now retired) Texas Republican Congressman and close ally of George W. Bush, Dick Armey, who wrote a book called *The Flat Tax* in 1996.

The idea of a flat tax lies sufficiently outside the mainstream of the US political debate that neither of the two major political party candidates in the 2008 U.S. presidential elections supports a flat tax. Republican John McCain would seek to lower the top rate on corporate income tax from its current 35 percent to 25 percent, but would otherwise largely preserve the existing progressive federal income tax rates. McCain has discussed his desire to create an optional alternative tax system with only two marginal rates, but the details are sketchy and he has not given the idea any prominence in the campaign so far. Meanwhile, Democratic candidate Barack Obama would actually take tax policy in the opposite direction, restoring the top two tax rates (36 and 39.6 percent), which were suspended under President Bush's 2001 and 2003 tax reforms. Obama has also proposed to increase the maximum capital gains tax to 25 percent (from 15 percent now). According to an analysis by the independent Tax Policy Center, under Obama's plans, the effective tax rate on the top 20 percent of tax payers would increase about 1.5 percent, with all of the increase for this group paid for by the top one percent of tax payers, who would see their taxes rise a substantial 6.1 percentage points of total income.²

The U.S. Tax System

While U.S. proponents of the flat tax generally tout its "simplicity" (an argument we will return to below), the real reason the right has pushed the proposal is that the flat tax would eliminate the last major progressive component of the US tax system. Over the last three decades, despite pressing social needs including, most critically, the rise to over 45 million in the number of Americans without any form of private or public health insurance, conservatives have succeeded in maintaining total federal, state, and local taxes at between 25 and 30 percent of gross domestic product (GDP), with only cyclical variations. Even more importantly, these same political forces have simultaneously managed to shift the tax burden away from the single most progressive form of taxation --the federal income tax-- toward a series of regressive federal, state, and local taxes. Replacing the still highly progressive federal income tax with a single-rate flat-tax would represent a virtual end to the principle of progressive taxation in the United States and pave the way toward the right's final goal of drastically reducing the size and role of government in the already *laissez-faire* US economy.

As **Table 1** demonstrates, the U.S. federal income tax remains highly progressive, even after President Bush's 2001 and 2003 tax-law changes. In 2005, the top one percent of income earners paid about 29 percent of their income in federal personal and corporate income taxes. The middle 20 percent of

1 See, for example, Miguel Sebastián, then the head of the Economic Office of the President of the Government, now Minister of Industry, Tourism, and Trade, writing in *El País* on March 11, 2007.

2 We draw these numbers from a detailed analysis performed by the Brookings Institution and the Urban Institute. See The Tax Policy Center, "A Preliminary Analysis of the 2008 Presidential Candidates' Tax Plans," Washington, DC: The Tax Policy Center, June 28, 2008.

taxpayers paid only 3.7 percent. The bottom 40 percent of taxpayers actually received net payments through the federal income tax, thanks to the Earned Income Tax Credit (EITC), which subsidizes the earnings of millions of low-wage workers.

The same table also shows that all other major forms of taxation in the United States are either regressive or highly regressive. Social insurance contributions, which primarily support the Social Security and Medicare programs, for example, tax the bottom 20 percent of tax payers more heavily (8.3 percent of total income) than they tax the top four percent (5.9 percent of total income) or the top one percent (1.7 percent of total income). State and local taxes, which include an uneven mix of progressive and single-rate income taxes, and regressive, sales, excise, property, and other taxes, are, on net, strongly regressive. Across the 50 states and the District of Columbia, the poorest 20 percent of taxpayers, for example, pay 11.4 percent of their income in state and local taxes, while the middle 20 percent pay about 9.9 percent, and the top one percent pay only 7.3 percent.

An important part of the political project of the right during the postwar period has been to change the composition of US tax collection by decreasing the weight of the progressive federal income tax and increasing that of the many regressive alternatives. **Figure 1** illustrates the shift over the period in the composition of the US tax system toward regressive taxes. The two most important changes were the large rise in regressive social contributions and the increasing importance of regressive state and local taxes in total tax revenues collected. Meanwhile, the progressive federal income tax has declined steadily as a share of total tax revenue.

In this context, a flat tax would represent an important milestone in the right's efforts to reduce the size and scope of the government while shifting the burden of taxation from high-income families to those at the middle and the bottom of the income distribution. The federal income tax is still highly progressive and is the only major form of taxation at the federal, state, and local level that is not regressive or highly regressive. Short of the outright abolition of the federal income tax,³ the establishment of a flat tax would do more than any other single measure to consolidate the right's steady gains achieved in the area of tax policy since Ronald Reagan won the White House in 1980.

The Flat Tax in Spain

In both the United States and Spain, proponents of a flat tax emphasize the "simplicity" of the flat tax, in opposition to what they portray as the disorienting complexity of the existing progressive income tax. It is difficult not to see this argument as a cynical attempt to manipulate tax-paying voters. In and of itself, the only simplification that a flat tax provides is the reduction from nine current tax rates in the United States or four current rates in Spain to one single rate applied to all levels of income.⁴ (Ironically, a variant of Miguel Sebastián's flat-tax proposal includes two rates, 30 and 35 percent; and McCain's underdeveloped alternative tax system also includes two rates.)

The complexity of the current tax system, however, has nothing to do with the existence of nine or even more progressive tax bands. In practice, neither the US nor the Spanish governments ever asks a tax payer to calculate his or her own tax liability "by hand" using the different marginal tax rates corresponding to different income bands. The tax agency or the individual determines tax liability using

³ This is the platform of Republican Congressman Bob Barr, who is running for president in 2008 as the candidate of the Libertarian Party. See <http://www.bobbarr2008.com/issues/>.

⁴ For US tax law, as of 2005, see Internal Revenue Service, <http://www.irs.gov/pub/irs-soi/05in01tr.xls>; for Spain as of 2007, see Ministerio de Economía y Hacienda, <http://reformaafiscal.meh.es/tramos.asp> and <http://reformaafiscal.meh.es/circunstancias.asp>.

a simple formula or a tax table once the individual's taxable income has been determined. Essentially all of the complexity of the progressive tax system resides in the determination of what constitutes the individual's taxable income, not the calculation of tax liability once taxable income has been determined. In both countries, for example, tax payers can apply complicated rules to reduce their taxable income to reflect some costs of home ownership or some contributions to private pension plans. (The United States has, relative to Spain, a bewildering numbers of exemptions, exclusions, carry-overs, and deductions for both individual and corporate tax payers.) In and of itself, the switch to a flat tax does nothing to change the actual source of complexity in the current system and, as a result, a flat tax would, in practice, yield no detectable reduction in complexity.

In (generally unspoken) recognition of the irrelevance of the number of tax rates for the tax payers' experience of the system's complexity, most flat-tax proposals also include other simplifications to the tax system. The most common of these are the elimination of deductions, such as those for home ownership or contributions toward private pension plans. Sebastián's plan for Spain, for example, ends both of these important deductions. (By contrast, the US home mortgage interest deduction effectively constitutes one of the country's largest social programs, transferring almost \$70 billion per year to home owners, and, for reasons of political viability, is generally preserved in flat-tax proposals in the United States.⁵) From the point of view of the left, however, the main problem with these two particular exemptions is not that they add to the complexity of the tax code --affected tax payers have a strong financial incentive to work with the regulations in order to reduce their tax payments substantially. The problem for the left with such exemptions is that they are highly regressive, reducing the tax liability of generally high-income tax payers that own their own homes or have sufficient disposable income to make sizable contributions to private pensions. Of course, reforms that would eliminate the home-ownership and pension deductions in Spain would be entirely possible in the context of the current progressive income tax system, without any need for a flat tax.

Proponents of the flat tax in Spain make one important argument not made by proponents of the flat tax in the United States: due to widespread tax evasion among the rich and the very rich in Spain, the progressive Spanish income tax (IRPF) is, despite best intentions, in practice, regressive.⁶ In response, flat-tax advocate Miguel Sebastián argues that the best way to deal with systematic and widespread tax evasion is to lower top rates in order to reduce incentives on the rich to hide their income.

The first concern here is that a senior member of the Spanish Socialist government is publicly acknowledging that his government lacks either the will or the ability to enforce existing Spanish law. Rather than arguing for improved enforcement of existing law in order to improve the progressivity of the IRPF, Sebastián instead calls for the abolition of the progressive income tax in Spain. The thinking is reminiscent of the famous declaration by a US officer during the Vietnam War that, in order "To save the town, it became necessary to destroy it."

5 See Fremstad et al (2008), p. 12.

6 Sebastián, writing in *El País*, March 11, 2007: "... [S]abemos ...que hay miles de [ricos] --de yates y chalés de lujo, quiero decir-- por toda la costa española cuyos propietarios, lamentablemente, no declaran estar en [el tramo más alto] del IRPF. El problema, por tanto, es que, la parte alta de la distribución de nuestro IRPF está casi vacía. Sólo los asalariados (trabajadores por cuenta ajena), en general, pertenecientes a la clase media y media-alta y que están sujetos al control de la Hacienda Pública, figuran en ese registro. ... El tramo alto del IRPF lo paga la clase media asalariada." (" ... [W]e know that there are thousands of [rich people] --with yachts and luxury homes-- up and down the Spanish coast who unfortunately don't report incomes that would put them at [the top tax rate] in the IRPF. The problem, as a result, is that the top of our distribution is almost empty. In general, only wage and salary workers (employees) in the middle and upper-middle class, who are subject to being monitored by the Treasury, appear in the tax registry. The people who pay the top tax rates [in Spain] are the salaried middle class.")

Sebastián presents his solution to tax evasion as pragmatic in its appeal to economic theory, which suggests that the volume of evasion will drop if incentives to evade (here, the marginal tax rates on the rich and the super-rich) fall. A pragmatic approach, however, would start with a realistic, empirically based assessment of the likely fiscal return to greater enforcement or to a less drastic reduction in top tax rates or to some combination of the two approaches. Sebastián, however, does not examine strategies based on enhanced enforcement. Nor does he consider the possibility of simply lowering top rates somewhat while still preserving the fundamental progressivity of the IRPF (an approach taken in the United States since the 1960s, when marginal tax rates on high-income tax payers were substantially higher than they are today). Instead, Sebastián takes a strongly ideological line to end explicitly progressive tax rates in Spain.

In practice, in the absence of improved enforcement mechanisms, lowering top marginal tax rates in Spain is not likely to have an important impact on the effective tax rates on high-income individuals. The current "tax evasion industry" in Spain, which includes bankers, lawyers, accountants and others in the financial sector will continue to have substantial incentives (30 percent at the margin, even at the generally proposed flat-tax rate) to continue to evade taxes.

Implicit in the arithmetic of Sebastián's discussion of tax evasion is an interesting observation about the relative tax rates of the "super rich" in Spain and the United States. Under a 30 percent flat tax, a Spanish "millionaire" earning one million euros per year would, in the absence of tax evasion, pay just under 30 percent of his or her income in taxes (assuming a small personal exemption). This is almost identical to the federal income tax paid in practice by a US tax payer in the top one percent of the US income distribution (29.3 percent). Since Sebastián argues that the flat tax would actually increase the portion of taxes paid by the rich and the super rich in Spain, we can only conclude that, under current Spanish law, the rich and super rich in Spain pay less income tax than the rich and the super rich already pay in the country recognized to have (with Japan) the lowest tax burden among the rich OECD countries. This arithmetic suggests that Spain actually has room to raise top rates, especially relative to Spain's natural peer group in western Europe.

The Progressivity of a Regressive Tax

A great irony of the flat-tax proposal in Spain is that its supporters often argue that --by setting an appropriate level for the personal exemption-- the flat tax can be constructed so as to make it progressive in practice.⁷ **Table 2** demonstrates this inadvertent progressivity under three different assumptions about the level of personal income exemptions for a range of incomes from €12,000 to €150,000 per year under the assumption.⁸ The first three columns of the table show the total taxes paid and the corresponding effective tax rate under the assumption that the personal exemption is €5,050 per year, the level set in Spanish tax law in 2007. As claimed, the flat tax with a personal exemption at this level is, indeed, mildly progressive. Taxpayers making €12,000 per year would pay about 17.4 percent of their income in taxes, compared to about 29.0 percent for taxpayers earning €150,000 per year. Moreover, as some proponents of a Spanish flat tax have emphasized, increasing the size of the personal exemption can significantly increase the progressivity of the flat tax. The second three columns, for example, show that a €12,000 personal exemption lowers the taxes for all taxpayers, but has the biggest effect on those with the lowest incomes. For taxpayers making €12,000, the new effective tax rate is zero, while the effective rate for those making €150,000 is 27.6 percent. The effect

⁷ The personal exemption is the portion of income that is entirely exempt from income taxation. In 2008, the standard personal deduction in the United States, for example, was \$3,500 per person in the tax-paying unit.

⁸ We have adapted the table from Ricardo Rodríguez, "A vueltas con el tipo único," *La República*, November 11, 2007; Rodríguez, in turn, bases his analysis on an analysis by Amparo Estrada in *Público*, November 5, 2007.

of a €20,000 personal exemption is even larger, as the last three columns of the table show. By definition, the effective tax rate for those earning €20,000 or less is zero, but the top taxpayer in the table is still paying about 26.0 percent of total income in taxes.

The progressivity of the flat tax combined with a personal exemption is, however, far from a compelling reason for the left or the majority of Spaniards to support the flat tax. First of all, to the extent that "simplicity" was ever a reason to support the flat tax, the straightforward calculations in Table 2 demonstrate that the flat tax actually taxes different taxpayers quite differently. Using a €12,000 exemption, for example, the effective rates vary from zero to almost 28 percent.

Second, if progressivity is indeed an important goal of an income tax, the flat tax, not surprisingly, compares poorly to a truly progressive income tax when it comes to achieving this goal. **Table 3** applies 2007 Spanish tax law to the same income levels used in the hypothetical 30 percent flat tax analyzed in Table 2.⁹ The 2007 Spanish tax law, with its €5,050 personal exemption, is substantially more progressive than the 30 percent flat tax with the same income exemption. Taxpayers earning €12,000 per year, for example, pay 13.9 percent of their income under 2007 tax law, but would see their effective tax rate rise to 17.4 percent under a 30 percent tax rate with the same personal exemption. Meanwhile, taxpayers receiving €150,000 pay 37.7 percent of their income in taxes under 2007 law, compared to only 29.0 percent under the 30 percent flat tax with an identical personal exemption. The same pattern holds for higher personal exemption rates. As long as the personal exemption rates are identical for the progressive tax and the flat tax, low-income taxpayers always pay less and high-income taxpayers always pay more under a progressive tax system structured like the 2007 IRPF.

A Social Democratic Tax Reform Agenda for Spain

In most respects, we don't disagree substantially with the diagnoses offered by the flat-tax proponents of the problems facing the Spanish IRPF. The most pressing problems are widespread tax evasion at the top and a series of deductions (for home ownership and private pensions) that are tilted heavily in favor of high-income individuals. As a result, a tax system that was designed to be genuinely progressive is far less progressive than it should be. Where we do differ from supporters of a flat tax is with respect to the correct prescription for these ills.

A truly social democratic income-tax reform for Spain would have at least two elements. The first would be substantially improved enforcement for what Sebastián calls the "rich and the super rich." If his analysis is correct, the richest Spaniards currently pay a lower share of their income in income taxes than their counterparts in the United States, and this difference is almost entirely due to tax evasion at the top. Moreover, if Barack Obama is elected president of the United States in November and he carries through with his plan to reinstate the top two tiers in the federal income tax, the gap between top taxpayers in Spain and the United States would actually widen in coming years. An obvious place to start these new enforcement efforts would be with the US Internal Revenue Service, which has substantial experience policing high-income tax payers (even if US enforcement efforts have decreased in intensity in recent years).

A second element of social democratic tax reform would be the elimination of the current deductions for home ownership and private pensions. Sebastián correctly criticizes these two deductions because they are so regressive, but the government can eliminate both of these while maintaining the

⁹ We ignore the regressive impacts of income deductions allowed in 2007 law for some home ownership costs and some private pension contributions. Both of these deductions could be excluded from the progressive IRPF without need to adopt a flat tax.

progressivity of the current IRPF and without implementing a flat tax.

A flat tax builds on the political tradition of the most ideological elements of the US right, where the flat tax is part of a long-standing effort to reduce the tax burden on high-income taxpayers and diminish the role of the government in economic activity. The PSOE does Spain and the party's own traditions a great disservice by seeking to abolish rather than to repair the country's progressive income tax system. Better enforcement of existing laws and the elimination of the most regressive deductions would go a long way toward providing Spain with the resources it needs to join the rest of Europe that already provides its citizens with economic opportunity and security.

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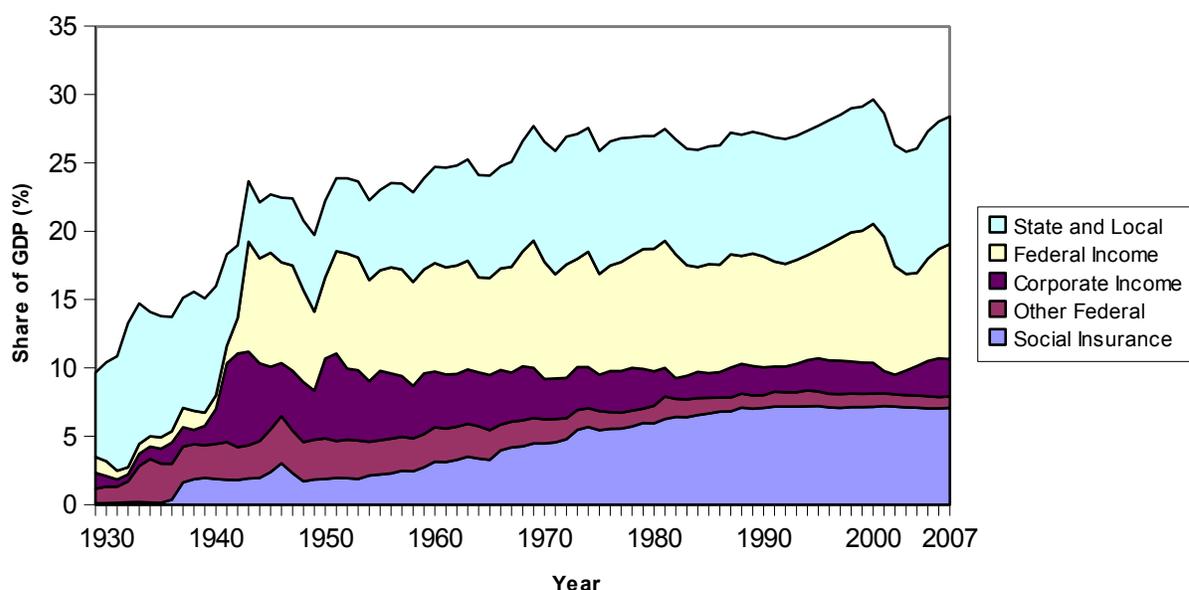
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FIGURE 1

Taxes as a share of GDP, United States, 1929-2007



Source: Bureau of Economic Analysis, National Income and Product Accounts, Tables 1.1.5, 3.2, and 3.4.

TABLE 1

Effective federal, state, and local tax rates, by income levels, United States, circa 2005

Income group	All federal, state, local taxes	Federal taxes (2005 law)						Total State and Local taxes (2002 law)
		Total	Income tax			Social Insurance Contribs.	Other	
			Total	Personal	Corporate			
Bottom 20%	15.7	4.3	-6.1	-6.5	0.4	8.3	2.1	11.4
Second 20%	20.3	9.9	-0.5	-1.0	0.5	9.2	1.2	10.4
Middle 20%	24.1	14.2	3.7	3.0	0.7	9.5	1.0	9.9
Fourth 20%	26.8	17.4	7.0	6.0	1.0	9.7	0.7	9.4
Next 15%	30.0	21.1	11.3	9.6	1.7	9.2	0.6	8.9
Next 4%	34.0	25.9	19.3	15.2	4.1	5.9	0.7	8.1
Top 1%	38.5	31.2	29.3	19.4	9.9	1.7	0.2	7.3

Notes: Federal data from Congressional Budget Office, "Historical Effective Federal Tax Rates, 1979 to 2005," December 2007. State data from the Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax System in All 50 States," January 2003; data based on 2002 tax law applied to 2000 income distribution.

TABLE 2**Effective tax rates under a 30 percent flat-tax, by level of personal exemption, Spain**

(euros)

Income	Personal exemption								
	€5,050			€12,000			€20,000		
	Taxable income	Tax paid	Effective rate (%)	Taxable income	Tax paid	Effective rate (%)	Taxable income	Tax paid	Effective rate (%)
12,000	6,950	2,085	17.4	0	0	0.0	0	0	0.0
18,000	12,950	3,885	21.6	6,000	1,800	10.0	0	0	0.0
25,000	19,950	5,985	23.9	13,000	3,900	15.6	5,000	1,500	6.0
35,000	29,950	8,985	25.7	23,000	6,900	19.7	15,000	4,500	12.9
50,000	44,950	13,485	27.0	38,000	11,400	22.8	30,000	9,000	18.0
60,000	54,950	16,485	27.5	48,000	14,400	24.0	40,000	12,000	20.0
80,000	74,950	22,485	28.1	68,000	20,400	25.5	60,000	18,000	22.5
100,000	94,950	28,485	28.5	88,000	26,400	26.4	80,000	24,000	24.0
150,000	144,950	43,485	29.0	138,000	41,400	27.6	130,000	39,000	26.0

Notes: Adapted from Ricardo Rodríguez, "A vueltas con el tipo único," *La República*, November 11, 2007.

TABLE 3**Effective tax rates under 2007 law and hypothetical modifications, Spain**

(euros)

Income	2007 tax law: €5,050			€12,000			€20,000		
	Taxable income	Tax paid	Effective rate (%)	Taxable income	Tax paid	Effective rate (%)	Taxable income	Tax paid	Effective rate (%)
12,000	6,950	1,668	13.9	0	0	0.0	0	0	0.0
18,000	12,950	3,134	17.4	6,000	1,466	8.1	0	0	0.0
25,000	19,950	5,094	20.4	13,000	3,426	13.7	5,000	1,400	5.6
35,000	29,950	8,131	23.2	23,000	6,463	18.5	15,000	4,438	12.7
50,000	44,950	13,681	27.4	38,000	12,013	24.0	30,000	9,988	20.0
60,000	54,950	17,840	29.7	48,000	16,172	27.0	40,000	14,146	23.6
80,000	74,950	26,440	33.0	68,000	24,772	31.0	60,000	22,746	28.4
100,000	94,950	35,040	35.0	88,000	33,372	33.4	80,000	31,346	31.3
150,000	144,950	56,540	37.7	138,000	54,872	36.6	130,000	52,846	35.2

Notes: For current tax law, income bands and marginal rates from Ministerio de Hacienda y Economía (MEH), <http://reformafiscal.meh.es/tramos.asp>: from €5,050 to €17,360, marginal rate is 24 percent; to €32,360, 28 percent; to €52,360, 37 percent; and above, 43 percent. Level of personal exemption (mínimo personal): MEH, <http://reformafiscal.meh.es/circunstancias.asp>.