The Flat Tax: Questionable Economics, Bad Politics

It would privilege investment income and hit low-income households hard.

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Once again, Republican presidential candidates are flocking to the flat tax. So far, Rand Paul, Ted Cruz, Ben Carson, Rick Perry, Scott Walker, and John Kasich have either endorsed the idea outright or praised it, and Jeb Bush has said that he's at least open to it. But why?

First, let's briefly consider the economic case. The original flat tax, championed by the economists Robert Hall and Alvin Rabushka, which formed the basis of Steve Forbes's flat-tax proposal in 1996, is a single-rate tax on consumption, with a substantial exemption to make the tax progressive at the low end of the household-income distribution. Overall, however, the Hall-Rabushka tax would be highly regressive, in part because high-income households tend to consume less of their income than lower-income households and because investment income would not be taxed (or rather double-taxed). If the U.S. were to adopt a flat tax on consumption that would raise as much revenue as the current code, it is hard to see how taxes on low- and middle-income households wouldn't increase.

Of course, it's possible that the dynamic or growth-enhancing effects of moving from income to consumption taxation would be so great that a flat tax on consumption wouldn't need to be so burdensome. And if this were indeed true, we could decide to use a more regressive tax system to finance more-progressive spending. But there is some dispute over whether ending the double taxation of savings would yield significant growth dividends. Chris William Sanchirico of Penn Law School takes a skeptical view in a review of the academic research on the subject, in part because cutting capital-income taxation as part of a revenue-neutral reform would require offsetting increases in labor-income taxation, which would dampen long-term economic growth in their own right. As Sanchirico puts it, "attempting to spur economic growth with tax preferences for capital income may be like trying to repair one side of the roof with shingles from the other."

Second, there is the political case. Last year, Emily Ekins summarized the findings of a Reason-Rupe poll, which found that "the flat tax has broad appeal that extends across income groups." Among people living in households earning $100,000 or more, 73 percent supported the idea, while 62 percent of those earning less than $30,000 supported it as well. More important, in the context of a GOP presidential primary, the flat tax is overwhelmingly popular among Republicans: 66 percent of them favor it, as do 68 percent of independents and 52 percent of Democrats. At the same time, however, the Reason-Rupe poll finds that two-thirds of voters consistently favor higher taxes on upper-income households. In a follow-up question, Reason-Rupe found that while a bit more than half favored higher taxes on upper-income households because they can afford it, the next most common explanation was that upper-income households pay less in taxes than middle-income households.

One can imagine Republicans making an effort to disabuse voters of the notion that upper-income households pay less in taxes than middle-income households do (it all depends on which upper-income households we're talking about and which taxes we're taking into account), but implementing a revenue-neutral flat tax on consumption would almost certainly benefit households with a large amount of investment income more than middle-income households that rely on wages. Whatever enthusiasm voters might have for the flat tax in theory might quickly evaporate in a campaign, when opponents of the flat tax will point out that it will greatly reduce the tax burden on (say) people like Mitt Romney.

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Instead of campaigning for a flat tax, GOP candidates ought to consider backing Universal Savings Accounts (USAs), a tax reform devised by Chris Edwards of the Cato Institute and Ernest Christian in 2002. Essentially, USAs are supercharged Roth IRAs: "Individuals would contribute to USAs with after-tax income, and then earnings and withdrawals would be tax-free." The main difference between USAs and Roth IRAs is that "withdrawals could be made at any time for any reason," a change that would make the accounts far more attractive to far more people. Edwards cites Canada's Tax-Free Savings Accounts (TFSAs) as a successful precedent. Unlike a wholesale shift to consumption taxation, USAs with a contribution limit are a modest step in the same general direction, which future reformers can build on.

And to emphasize that they're not just committed to helping savers, Republicans should put Earned Income Tax Credit expansion and other measures to improve work incentives for low-income households at the heart of their tax-reform agenda. When Republicans debate lowering the top rate of tax with Democrats, they lose. When they emphasize tax reforms that encourage work and that help middle-income families climb the economic ladder, they win. The GOP candidates who realize this will go far. Marco Rubio has, to his credit, gone further than most in moving beyond the flat tax, yet his innovative tax-reform proposal shares many of the flat tax's political liabilities — and if Rubio makes it to the general election, his Democratic rivals will make him pay for that.