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Evaluating Flat Tax Theory: A Conceptual Framework

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Abstract

Tax receipts form one of the key tools of current macroeconomic fiscal policy. As governments are forced to increase spending levels satisfy their respective social, political or economic goals, they are consequently are forced to review new or additional sources of tax review. Government officials and political candidates theorize that new expensive programs can be paid for by increased taxes. A flat tax system has also been theorized to be an equitable solution to satisfy the increased tax revenue requirements. This paper reviews in general terms the current progressive tax system as well as a regressive flat tax system.This study further illustrates various approaches to the flat tax system, its benefits, and demerits on individuals and the general economy. The conclusions, recommendations and implications reached are generalizable and appropriate for use in developing best practice solutions.

Keywords: Flat tax**,** Progressive and regressive tax systems, economic environment

1. *Introduction*

The current United States (U.S.) tax system has been described as complex and detrimental to the growth of small business which is crucial to economic growth. Crawford and Crawford (2011) noted that the current system is based on a progressive tax regime where the high-income earners pay a higher amount of the proportion of their income to taxes with the low-income earners paying a lower proportion of their income.

Some scholars indicate that this regime is biased, unfair and could have a negative impact on innovation and the incentive to work(Forbes, 2015). Furthermore, high marginal tax rates on the capital owners and numerous tax distortions will discourage productivity of business processes thus derailing the growth in wages and the general economy. Elsewhere, Forbes (2015) highlighted that high corporate taxes have been identified as one of the factors that negatively impact on the competitiveness of business at the global stage. Other studies highlighted that the current tax system is embedded with numerous rules and exceptions thus making it less transparent, unfair and relatively complicated (Crawford & Crawford, 2011). Given the current global economic environment, the United States need a tax system that is neutral and does not lead to distortion in the economic decision making of the savers, investors, and workers. In this regard, a flat tax system has been proposed by a section of policy makers and tax experts.

2. *An overview of the current tax system*

Generally, U.S. federal income taxes are levied on an individual's taxable income. The gross income of an individual encompasses all gains and receipts from all the economic activities that the person directly or indirectly participates in. These gains and receipts include compensation for services rendered, income from business activities, property gains, interest and rent payments, alimony payments, pensions and others (Crawford & Crawford, 2011). In order to determine the taxable income out all these sources of income, there are several deductions that are available to the individual according to the taxation laws in the United States. Some of the deductions include but are not limited to interest, state and local taxes, charitable contributions as well as numerous other deductions and exclusions.

Using a progressive tax regime to determine the amount of taxes payable,the U.S. and where applicable, state authorities will access tax. In a progressive tax system, high-income earners are taxed using a higher tax rate while low-income earners are taxed at a lower tax rate depending on the tax bracket that the individual falls. This creates a rate disparity at different income levels. As a result of the system, studies show that 38% of all federal income taxes are paid by the top 1% percent earners while the bottom 50% earners account for only 3% of the federal income taxes (Angelini &Tuerck, 2015). Even with a variety of refundable and nonrefundable tax credits for lower income earners. This system has been criticized by a section of taxpayers, scholars and tax experts as being complex and unfair. In this regard, the U.S. has been particularly identified to be in a critical need of tax system reforms. According to most experts, the new tax regime should focus on job creation and economic growth.

However, there is still confusion and disagreements regarding the provisions and approach of the new tax reform. Nevertheless, a flat tax system has been proposed by a section of policy makers.

3. *Flat tax system*

Flat tax rate can be simply defined as a single rate that can either augment all other taxes including income taxes, payroll taxes, and death taxes or just replace taxation of income. According to Crawford and Crawford (2011), this rate should be set at a level that it is able to generate the same amount of taxes as the current tax system i.e. about 18.5% of the GDP. Additionally, this system is regarded to be distributionally neutral and will reduce the tax burden while promoting an incentive to pay taxes (Kaplow, 2006). In this context, a flat tax system is a simple, neutral and transparent tax system that would enhance the ability and capacity of the U.S. to realize its full economic potential.

Kaplow (2006), advanced the notion that a flat tax can also be described as a tax system where all taxpayers are within the same tax bracket or percentage. There are several approaches to this system. One of such approaches is the cash outflow approach that is based on each individual's consumption. Value Added or VAT tax is an example of consumption-based tax. The proponents of this approach argue that a consumption-based tax system is highly efficient, and a flat rate can be effectively applied on the consumption expenditure but not the income (Forbes, 2015). This approach is favored for its simplicity in applicability. Here, the taxpayer is not expected to trace all the receipts and gains for the entire year but it relies on the indirect calculation of consumption where consumption expenditure is taken to be equal to income less savings: $C = I - S$ (Evans & Stokes, 2012).

Another approach to the flat tax system is the tax prepayment approach where a flat tax is described as an income tax less tax on investment income. In this regard, investment income such as interests, dividends, and capital gains are exempted from taxation (Evans & Stokes, 2012). However, in this approach, there will be no capital loss deductions as in the current system. In this model, all incomes are taxed at their initial stages including the savings. This approach is preferred to the current system since it guarantees a higher level of efficiency thus minimal opportunities for tax evasion (Kaplow, 2006). Additionally, the cost of enforcement is also relatively lower. Nonetheless, this approach has been criticized for being pro-wealthy since it does not tax savings, dividends and capital gains which are some of the main sources of income for the wealthy.

Unless the government significantly reduces its spending, determining the sufficient flat tax rate to cover the government expenditure remains a big challenge to the policy makers. In this case, the flat rate adopted should be able to narrow the gap between the revenue collected and the total expenditure of the government (Evans & Stokes, 2012). Additionally, the new tax regime should be able to facilitate spending and saving among consumers within the economy. Just like the current tax system, the flat tax system can lead to more problems as individuals attempt to exploit opportunities to avoid taxes for instance through an underground retail economy where consumption taxes are not levied. Subsequently, consumption-based tax model is also attractive since it avails a legal way for individuals to reduce the tax owed thus effectively encouraging savings within the economy (Forbes, 2015).

4. *Benefits of a flat tax system*

Proponents of a flat system favor the flat tax system for its operational simplicity. The flat tax system will impose a single tax rate for all individuals, businesses and families e.g. 28%. This way it will effectively combine payroll taxes, death taxes and all other taxes into one convenient tax rate. If a flat tax rate was designed to replace income taxes only the rate could be substantially less.The flat tax system also avails two forms of tax credits. According to Angelini and Tuerck (2015), the earned income credit will set aside a level of income support for low-wage workers while a tax credit of $3000 is proposed towards the purchase of a health insurance. Given the tax credits, there could be only three forms of deductions to be affectedfor the flat tax. These deductions may include higher education deductions, contributions in the form of gifts and contributions towards charities and the home mortgage interest deduction with most exclusions being eliminated (Angelini &Tuerck, 2015).

A simplified tax system will encourage investment activities among smaller businesses which are unable to do so under the current system. The complexity of the current system impacts negatively on the effectiveness and productivity of small businesses since they are unable to afford the services of accounting firms (Decoster & Orsini, 2015). A simplified tax system will, therefore, allow small businesses to focus on their business goals and invest their time and resources towards business expansion thus leading to the creation of employment opportunities. It also provides an incentive to save since personal savings are tax-free and individuals are exempted from taxes until such incomes are spent on consumption.

Proponents of a flat tax system argue that taxation regime should be fair to all individuals and businesses (Angelini &Tuerck, 2015). That is, every taxpayer should pay the same rate of tax or a similar proportion of incomes should be contributed in the form of taxes.

Flat tax should, therefore, be imposed at a relatively lower rate such that the government should be able to finance its core programs. Flat tax proposal is based on the premise that market is the most effective tool in income, wealth and opportunity distribution (Forbes, 2015). Consequently, studies show that a flat tax system will lead to fewer social burdens on taxpayers.Flat tax systems also lead to fewer distortions on the market rules. That is, a flat tax system does not irregularly change income distributions which result from the operations of the market (Decoster & Orsini, 2015).

Flat tax system can lead to a stronger economy by enhancing investment activities thus creating job opportunities. For instance, the system encourages savings thus ensuring a greater financial security within the economy. Due to the availability of finances, companies will be able to implement their competitive strategies thus leading to the growth of wages. Additionally, greater private investments will lead to the creation of more employment opportunities. Angelini and Tuerck (2015) outlined that the current tax system imposes taxes on capital gains, dividends and interest. This form of taxation lead to double taxation since companies have already paid taxes on their profits. Proponents a flat tax system argues that since corporations have paid profit taxes, investors should, therefore, be levied taxes on their capital gains, dividends and interests earned from the operations of these corporations (Angelini &Tuerck, 2015). These instances of double taxation make investing in companies unattractive to some investors thus it is more desirable to spend the money on current consumption.

Finally, a flat rate tax system can lower incentives for individuals and businesses to avoid taxes. According to a 1998 study by the Ontario Coalition for Social Justice, more ninety thousand corporations, accounting for a combined profit of $18,566 billion, did not pay taxes in 1995 (Freedman, 2006). The figure was stated to have increased to more than 110000 corporations in 1997. These figures show how it is easier for major firms to avoid taxes in the United States and Canada. According to research on multinationals, it was found that most of the multinational corporations used international tax schemes in order to avoid their tax obligations to the United States government (Freedman, 2006). The United States has a unique corporate tax law which taxes U.S corporations on their worldwide incomes. However, this law is only applied to foreign incomes repatriated to the United States (Kaplow, 2006). Corporations, therefore, avoid tax by not repatriating their income to the United States. A flat rate tax system will eliminate this problem since corporations will be taxed on their consumption and not on their incomes.

5. *Demerits of a flat tax system*

Despite the outlined benefits, critics of the system claim that it ignores the poor while enhancing wealth for the rich and large corporations. Unlike the current progressive tax system, a flat rate tax system assumes that 'fairness' means paying a similar proportion of incomes as taxes across the entire population thus ignoring the individual circumstances (Freedman, 2006). Furthermore, a flat rate system focuses on the market system while ignoring the conspicuous failure of the market to distribute income and wealth in a fair manner. These critics prefer a progressive system since it acknowledges every individual circumstance and treat people differently depending on such circumstances (Decoster & Orsini, 2015). They argue that some of the circumstances are beyond individual control.

Critics of the flat tax system argue that a less complex flat tax system as proposed by some scholars may not lead to fairness after all. They argue that the legitimate concerns of many policy makers regarding the complex nature and unfairness of the progressive tax system may not be addressed using a simple flat tax system. These critics argue that a flat tax system will offer enhanced benefits to large corporations and wealthy individuals since they will be exposed to a lower marginal tax rate (Decoster & Orsini, 2015). Furthermore, these wealthy individuals and corporations will not pay taxes on numerous sources of income such as dividends and interests. As a result, a flat rate system will be more unfair compared to the current system.

Lastly, a flat rate tax system will greatly reduce the revenues that the government can collect using taxes that are as a result of reduced sources of taxable incomes and a reduced rate of taxes. As a result, the capability of the government to implement public programs and services that benefit average citizens will be greatly diminished (Decoster & Orsini, 2015). In this regard, the government will have less power to redistribute income and wealth within the economy. Due to the declining power of the government in wealth distribution, less developed regions, and less privileged individuals are destined to suffer economically.

6. *Current proposals*

Emanating from the sources reviewed, a flat rate tax system has been found to offer several benefits to individuals and businesses. However, the system was found to suffer from certain limitations.

In this regard, the study proposes a tax system that will facilitate the ability of the government to realize its economic goals such as employment creation and economic growth. In the development of a fairer tax system, the policy makers must consider fairer tax measures such as fair taxes to worldwide income of large corporations. Additionally, the system should give equal and fair treatment to all sources of income to businesses and individuals. As such, sources of income such as salaries, wages, interests, dividends and capital gains must all be taxed.

The paper also proposes that the flat tax system should adopt a consumption-based approach. In this system, businesses will not be taxed net investments and savings thus encouraging expansion of investment opportunities by the businesses. Businesses will be taxed upon their expenditures. In order to ensure fairness, the government should, therefore, eliminate all forms of business taxes and focus only on taxing the retail sales of goods and services. Various studies have also found that there was no need to levy different taxes to corporate incomes as compared to other incomes. According to this study, corporate income was found to negatively influence economic growth and fairness of the tax regime.

7. *Conclusion*

This paper sought to examine various flat tax proposals and identify their relative merits and demerits. A flat tax system was found to be a tax regime where all individuals and business are charged a similar proportion of their income as taxes regardless of their income. This system was found to enhance economic growth, employment and it was simple to implement. However, the system diminished the ability of the government to distribute wealth and income. Furthermore, the system was found to ignore circumstances faced by every individual. In this regard, the paper suggested a fairer tax system which treats all sources of income equally and it is consumption based. While various governmental agencies and political groups have advocated various flat tax proposals, further research into each proposal may shed light on additional flat tax theory possibilities.

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