

ECONOMIC ANALYSIS OF FLAT-RATE TAX PROPOSAL

The flat-rate 12% personal income tax proposal by itself will not generate nearly so much federal tax revenue as the prevailing federal tax system. The tax yields of the prevailing federal tax structure is shown below for the years 1981 and 1982 (all amounts in billions).

	<u>1981</u>	<u>1982</u>
Actual Personal Income Tax Collections	\$ 282	\$ 298
Actual Corporate Income Tax Collections	<u>61</u>	<u>49</u>
Total Actual Income Tax Collections	\$ 343	\$ 347

To compare the prevailing tax structure with the 12% tax, we examine the following:

	<u>1981</u>	<u>1982</u>
Aggregate Gross Personal Income	\$2402	\$2570
Government Transfers are given by	<u>336</u>	<u>376</u>
Subtracting the Transfers yields	\$2608	\$2195
Aggregate Personal Exemptions at \$1000 each totals	<u>209</u>	<u>212</u>
The Personal Income Tax base net of both Transfers and Exemptions equals	\$1859	\$1983

Assuming that Aggregate Personal Income is unaffected by a switch to the flat-rate 12% Income Tax, the 12% tax yield would be

\$ 223	\$238
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Thus, the flat-rate 12% Personal Income Tax being proposed (i.e., the tax base in Personal Income, less both government transfers and the \$1,000 Personal Exemptions) generates insufficient revenue to be equivalent to the present income tax structure.

To make up the deficiency, a tax on Aggregate Gross Receipts, less government purchases (on final sales) could be levied. According to the calculations provided below, such a tax could be levied in the range of 4.8%, concentrating on the calendar years 1981 and 1982.

	<u>1981</u>	<u>1982</u>
Gross Receipts (final sales)	\$2917	\$3083
Gross Receipts <u>less</u> all government purchases	2320	2436
Tax rate needed to make tax systems of equal yield is	5.2%	4.6%

The weighted average of the two rates is 4.8%. Thus, the flat-rate 12% Personal Income Tax rate (as defined above) coupled with a 4.8% tax on Gross Receipts (net of government purchases) would yield the same federal tax revenue as the prevailing Personal and Corporate Income Tax structures. This conclusion, it should be noted, assumes that the flat-rate 12% tax does not alter the value of Personal Income or government transfers and that the 4.8% tax has no net disincentive effects on production, investment and consumption of expenditures.

If revenue requirements decline by a net of, say \$30 billion due to reform in the food stamp program and elimination of farm price supports, then the revenue deficiencies of the flat-rate 12% tax become \$90 billion in 1981 and \$79 billion in 1982.

Assuming such policies do not significantly affect aggregate personal income or aggregate gross receipts, the 12% flat-rate personal income tax would than have to be accompanied by a gross receipts tax (exclusive of government purchases) of only 3.6%.

Let us now focus on a new federal tax system, one consisting of (1) flat-rate 12% personal income tax and (2) a 4.8% (or, if \$30 billion is cut from the budget, a 3.6%) tax on final sales net of government purchases. The analysis below deals with the 5-year period from 1981 - 1985. Where actual figures were not used, forecasts have been made using standard econometric techniques. Naturally, the forecasts are only estimates.

First, the tax yields of the 12% flat-rate tax are provided. Projected federal revenues are provided in the last column (in billions of current dollars):

REVENUE YIELDS OF FLAT-RATE 12% PERSONAL INCOME TAX

	Actual or Projected average personal income	Less Transfer	Less \$1,000 Exemptions	Estimated Revenue Yield
1981	\$2404	\$2068	\$1859	\$223
1982	2570	2196	1984	238
1983	2790	2401	2187	262
1984	2980	2557	2347	282
1985	3089	2657	2439	293

The imposition of a 4.8% tax on final sales (net of government purchases) may act to make capital goods more expensive relative to labor. Let us assume that a 4.8% tax reduces private investment in new plant and equipment by 4.8%. Clearly, this is an arbitrary figure. Nonetheless, it serves to make the revenue projections provided below all the more conservative. The revenue yields of the 4.8% (or, 3.6%) tax rates are shown in the last two columns. The sums of the yields of the 12% flat-rate tax plus the 4.8% tax on final sales are roughly equivalent to the yield of the combined prevailing federal income taxes.

	GNP	Aggregate government spending	Investment adjusted downwards by 4.8%	Net tax base after adjustments for less investments & after subtracting government outlays	Tax Yield at 4.8%	Tax Yield at 3.6%
1981	\$2938	\$597	\$429	\$2298	\$109	\$ 83
1982	3059	647	423	2415	115	87
1983	3208	677	436	2532	120	90
1984	3475	709	447	2725	130	97.5
1985	3609	745	453	2841	136	102

Conversion from the prevailing personal income tax system to the flat-rate 12% system discussed above is likely to have a variety of impacts:

HOUSING. The deductibility of the home mortgage interest from adjusted gross income presently acts as a significant subsidy to the homeowner (actual or potential). Once the 12% flat-rate is enacted, the home mortgage interest is no longer deductible. The tax benefit is no longer capitalized into the price of housing. People will be less willing to purchase homes. Lower prices will be necessary to induce purchases. How much housing prices would fall is impossible to predict accurately. However, relating the value of the interest deduction to the average taxpayer/homeowner is a possible once-and-for-all 10 to 15% initial price cut. Once the market has adjusted initially, however, future housing inflation will be possible in response to changing market forces.

INTEREST RATES. With nondeductibility of mortgage interest, interest on credit cards, interest on automobile loans, etc., the demand for credit will fall. This in turn will act to reduce interest rate levels, although, due to the exigencies of the Federal Reserve System and the borrowing needs of the U. S. Treasury, it would be folly to predict the net decline. To the extent that interest does fall, purchases of new capital goods, automobiles, homes, etc., should rise and elevate employment output, and tax revenues as well! Moreover, the overall stock price level (e.g., the Dow Jones) may rise as well.

The net aggregate price-level effects of conversion to the flat-rate 12% personal income tax are unclear. Clearly, the redistribution of demands among products will alter relative prices. The net effect is likely, for various reasons, to be upwards.

PRICES. (Aside from housing.) Assessing in large measure the tax on final sales, with the corporate profits gone, profits will rise. Where the rise is most dramatic, competition will enter the industry and either cause price cuts or a tendency for less inflation. In service industries, the short run effect will be for the new tax to be absorbed. Where the services industry is most competitive, little price effect can be expected in the long run. Where the competition is most limited, the long run price effects may be upwards. In agriculture, where federal taxation is already modest and where most sales are not final sales of the output involved, little price change is likely. In industries such as supermarket groceries, where profits are a small portion of total sales, the price effect can be expected to be mildly upwards. Overall, the price effects of the 4.8% tax are difficult to predict but likely to be minor. However, where the profits tax has been replaced by a milder tax on final sales and, in the process, accompanied by higher profits, the levels of wages and dividends, and hence personal income tax collections are all likely to rise.

WELFARE POLICY REFORM

Outlays for AFDC (Aid to Families with Dependent Children) have long been under critical attack. The attacks take a number of forms, including the effects of a very uncoordinated and geographically differing welfare benefit schedule upon the geographic mobility of the would-be or actual welfare recipients. The latter population group has traditionally moved to those areas with the highest levels of welfare benefits, a movement which has caused: (1) gross inequities among welfare recipients in the United States since equally deserving people in different areas received drastically different welfare; (2) financial problems for state and local governments, especially those who offer the highest benefits, since they experience a very large growth in their welfare rolls and hence, total expenditures; (3) regional unemployment problems (see R. J. Cebula, Determinants of Human Migration, 1979 chapters 9 and 10 and attendant references) as the poor move to high welfare areas, fail to find jobs, and hence worsen unemployment problems. The estimated pattern of AFDC costs alone are given below for the years 1980 and 1981:

	<u>AFDC Benefits</u>	<u>Cost of Administration</u>
1980	\$39.9 billion	\$12.3 billion
1981	\$40.3 billion	\$12.4 billion

Standardization of welfare at the national average for AFDC will sharply reduce the attractiveness of the system and the incentives under the system to bear illegitimate dependents, thereby reducing total AFDC outlays. The reason is that, with standardization benefits at only the average for the nation, many people will no longer receive sufficient rewards for malingering. The lost income from lower benefits will force many into the labor force (and into paying taxes). If people are discouraged only by a mere 10 percent from going onto the welfare rolls, a 10 percent reduction in AFDC from standardization plus the additional savings resulting from IRS (whose computers and existing personnel, whose auditing work will be sharply reduced with the new tax system, will basically replace the welfare bureaucracy) administration of the welfare system will result in net reductions of total welfare (AFDC) costs amounting to:

1980	\$15.9 billion
1981	\$16.1 billion

The gross receipts tax then needed, in conjunction with the 12 percent flat rate income tax, to make the new tax system equivalent to the current system would be 3 percent.

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BUDGET ANALYSIS AND REFORM:

Housing	<u>1981</u>	<u>1982</u>
Total Outlays, Federal: (excludes administrative costs)	\$10.2 billion	\$12.5 billion
Total Outlays, Federal+State+Local:	\$14.8 billion	\$16.9 billion
Number of Recipients:	15.5 million	15.7 million
Foods Stamps		
Federal Outlays(=Total): (excludes administration costs)	\$11.1 billion	\$12.3 billion
Number of Recipients:	21.2 million	21.5 million
Welfare(all other cash payments)		
Outlays(exclusive of administrative costs)		
Federal+State+Local:	\$40.1 billion	\$40.4 billion
Federal only:	\$24.1 billion	\$24.2 billion
Number of Recipients:	16.1 million	16.2 million
Estimated Administration costs:	\$19.9 billion	\$23.8 billion

If all benefits were standardized and consolidated, with the Federal government administering the welfare system through IRS computers and data, and with the Food Stamp program replaced by food-in-kind allocation by the CWF, the estimated aggregate savings to the government would have been:

	<u>1981</u>	<u>1982</u>
	\$21.8 billion	\$24.4 billion

Naturally, there is no way to estimate accurately the precise savings from repalcing bureaucrats with the CWF.

Sincerely,



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Professor of Economics