The Daily Dish

June 19th Edition

DOUGLAS HOLTZ-EAKIN | JUNE 19, 2015

Despite the threat of a veto from the White House, 280 congressmen voted in favor of repealing the medical device tax. The tax is a 2.3 percent hit on net revenue, meaning if a company has $1m revenue after allowable expenses, and $200,000 profit, will now pay an additional $23,000 tax. Out of the 7,000 device manufacturers in the U.S., 80 percent have fewer than 50 employees.

In the face of a White House veto threat, again, congress advanced a $612 billion defense bill. The Senate approved the bill 71-25. When speaking at AAF, Senator McCain said that "[h]olding the NDAA hostage to force that solution would be a deliberate and cynical failure to meet our constitutional duty to provide for the common defense." AAF's new insight takes a look into what a veto threat on this bill means.

Eakinomics: Flat Taxes

Rand Paul's announcement yesterday of his proposed 14.5 percent flat tax has renewed attention on the staple of tax reform discussions. The Flat Tax was a proposal by economists Robert Hall and Alvin Rabushka in 1981. Since then there have been myriad flat tax proposals, some — Steve Forbes comes to mind — that served as the centerpiece of campaign policy platforms. But what is a flat tax? Put differently, what should one look for in the details?

1. The rate. Probably the least interesting thing about a flat tax is that it has a single rate on all individuals and businesses. The level of the rate — the original Hall-Rabushka rate was 19 percent — depends more on decisions made elsewhere (e.g., how much spending) than as a matter of policy design.

2. What does it tax? You might think the answer is simply "income" but not so fast. Indeed, the original flat tax was a tax on consumption (or consumed income). This was done by running the business part of the tax just like a traditional Individual Retirement Account (IRA): businesses get a 100 percent deduction for all investment (also called expensing investment) but pay tax on the principle and returns to that investment in the form of revenue. At the individual level, there was no tax on the dividends, interest, or capital gains generated by families' savings; they were taxed only on labor compensation (wages, health insurance, pensions, etc.). In this way, individual saving that is routed into a business is only taxed once via the business tax. A consumption tax is a very efficient tax toward saving and investment.

The Rand Paul flat tax includes dividends, interest, and capital gains — it is a flat income tax. This has a higher tax hurdle for saving and investment, but makes the tax base larger and allows a lower rate, other things being equal.

3. How pure is the flat tax? The Hall-Rabushka tax was pure — no extraneous credits or deductions. The Rand Paul flat tax retains a deduction for mortgage interest and charitable contributions, either as a statement of the desirability of these activities or an acknowledgment of the political difficulty of eliminating them. Paul also retains the earned income tax credit, a policy that has been widely recognized as successful in promoting work, especially among single mothers.

4. What does the flat tax replace? Usually the flat tax is part of income tax reform; it replaces individual and corporation income tax revenue. The Rand Paul flat tax replaces the income taxes and payroll taxes, as well as the estate and the gift taxes. This has two immediate implications. First, it replaces a lot more tax revenue. In 2014, income taxes were $1.7 trillion and payroll taxes another $1.0 trillion. This either means a higher rate, or places much more pressure on controlling federal spending to have the budget add up.

It also makes this flat tax more pro-work. Payroll taxes are a 15.3 percent wedge between what the employer pays, and what the employee receives. Eliminating this wedge permits higher wages without additional costs on the employer.

5. Flat tax and global competition. The flat tax could be based on individual and business earnings (and deductions) globally (a "worldwide" system) or only on those earnings (and deductions) in the United States (a "territorial" system). International tax rules have become increasingly important as the U.S. has clung to its worldwide regime and become steadily more out-of-step with global competitive norms. The Paul description is silent on this issue.

6. Is the flat tax "fair?" Ultimately, this question is unanswerable; fairness is in the eye of the beholder. Some people think everyone paying the same share of their income as taxes is fair. Others think that those with a greater income should pay higher fractions. Regardless, the flat tax is progressive. The typical flat tax has a large standard deduction — in Paul's case it is $50,000 for a family of four. That means there are really two rates: zero on the first $50,000 and 14.5 percent on the remainder.

A standard attack on flat taxes from the left is that not taxing interest, dividends, and capital gains is just a give-away to the rich (remember, they believe it is the government's money to begin with), which compounds the sin of having a lower tax rate. Paul's decision to tax capital income insulates him form this particular attack. In addition, the decision to eliminate the payroll tax — the largest tax paid for a majority of taxpayers — makes the distribution of taxes much more progress in his reform.

The future of Rand Paul's proposed tax reform has yet to be determined. But it would be a mistake to simply say "it's a flat tax." Not all flat taxes are created equal.

From the Forum

NDAA: Examining The Veto Threat by Rachel Hoff, AAF Director of Defense Analysis; and Gordon Gray, AAF Director of Fiscal Policy

The FCC Shouldn't Expand Spectrum Reserves by Will Rinehart, AAF Director of Technology and Innovation Policy