Can Flat Taxes be Progressive?

C. Eugene Steuerle

"Economic Perspective" column reprinted with permission.

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Although the debate over progressivity is usually heated, it is often uninformative. The current debate over flat taxes exemplifies this confusion. Here I continue to try to deal with two more myths that have grown up around the issue of progressivity.

- Conservative Myth: Progressive taxes always mean larger government.
- Reality: Today flatter taxes often mean larger government.

Over the course of much of this century, government growth went hand-in-hand with the adoption and expansion of a progressive income tax system. Certainly many early advocates of progressive taxes considered them an important means by which to finance more government activity, while many early opponents opposed large government and progressive taxes simultaneously. Often the debate over progressivity centered on rates of tax paid by high-income taxpayers, who, in the initial stages, were the only ones who paid any income tax at all. If these rates were raised, more expenditures might be financed. Even today, connections between rates on the rich and the size of government are made by most people, particularly those who identify themselves in an ideological way. An ideology, of course, demands connections across disparate items, a line in the sand that divides the world into two dichotomous camps. After all, it's hard to form an ideology only about progressive taxes, or value added taxes, or food stamps and environmental protection, for that matter.

But historical correlation does not imply causation. Think about it closely and you will realize that there is no reason that a tax system with higher rates at higher incomes necessarily means a larger government with more expenditures. After all, this type of tax system also means lower rates at lower incomes. At the beginning of this century, federal expenditures were small and paid for largely by tariffs and some excise taxes. Governments everywhere were looking for elastic and flexible tax bases. Soon progressive income taxes were adopted in every major country and expanded significantly, especially during war years. After the wars, these taxes seldom were reduced back to their pre-war status. Thus, during the first half of the century, progressive income taxes did support higher levels of expenditures.

The movement toward an inflationary environment in the post-World War II period, in turn, began to raise taxes even more, as individuals moved into higher tax brackets. The net effect, however, was more ambiguous. In the United States, Congress would periodically enact tax reductions that would offset many of the past inflationary increases.

Even without legislative offsets, inflationary bracket creep had mixed results on progressivity. For most people in the middle classes, the inflation tax was like a proportional surtax; that is, it raised their taxes by about the same percentage. The largest percentage increases, however, were faced by low-income individuals who often moved from paying little or no tax to a much more significant level of tax. Individuals in the highest tax bracket, on the other hand, would not face a higher marginal tax rate. Although their income tax might increase -- for instance, a larger proportion of income might become subject to tax at the top rate -- total taxes usually increased by a smaller proportion than did total taxes paid by middle-income individuals.

In the last few decades, growth in most governments in the industrial world has not been financed so much by expansion of income taxes, but by taxes with flat rate schedules and even by taxes that collected a smaller percentage of the incomes of higher-income individuals; that is, taxes that are sometimes defined as regressive when looked at by themselves. The most obvious case in the United States is the social security tax, which has grown dramatically over the past half-century, from a combined employer and employee tax rate of 3 percent in 1950 to 15.3 percent today. Meanwhile, the corporate income tax has declined quite dramatically in importance, while the individual income tax has held relatively steady -- with inflationary bracket creep often offset by congressional action. In Europe, significant expansion of government was made
possible by a flat rate value added tax, with tax rates often in excess of 15 percent of the value of purchases. As a percent of national income, European income taxes by themselves collect about the same amount as do U.S. income taxes. These countries on average rely much more heavily on the flat rate value added tax or on employment-related taxes and mandates that by themselves are even more regressive in their tax impact.

A fascinating aspect of the current flat tax debate is that many of those favoring a flat tax want smaller government, but they propose a tax that is similar in many respects to the type of tax that has financed significant expansion of government in Europe. Of course, they also want to replace the existing corporate and individual income taxes along the way. One reason that flat taxes tend to support larger government is that they also tend to be more hidden. That is, like the social security tax, little individual filing or record-keeping is often required with flat taxes, and so the public protests these taxes less than more visible income taxes and property taxes.

- Liberal Myth: Flat taxes mean that government is not progressive.
- Reality: Flat taxes often support progressive government.

A constant source of confusion in the flat tax debate derives from separating tax and expenditure functions. As noted above, many European governments often have flatter taxes overall than the United States, but they redistribute more. Even a tax with declining rates--for instance, the U.S. social security tax that eventually imposes a zero rate on earnings above a maximum tax base-- can be progressives if on net there is redistribution to lower-income individuals. Suppose two people, one with $100,000 of income and one with $10,000 of income, pay 10 percent of income in tax, and the government then redistributes to each of them half of their combined tax payments. Then the high-income person pays $10,000 and the low-income person pays $1,000. Each gets back $5,500. This example shows easily how flat taxes can support progressive government. It can also support bigger government. We could double the tax rate on each person in the previous example, and continue to redistribute half of total collections back to them. In this case, there is even a larger transfer from rich to poor. Given the equal per capita expenditure rule and the distribution of resources in this example, we can increase tax rates on the poor person by up to 10 times the increase in rates on the rich person and still achieve some additional redistribution. For instance, if we raise the poor person's rate from 10 to 20 percent and the rich person's from 10 to 11.01 percent, and distribute the excess equally among them, the poor person would gain-- ignoring, of course, possible behavioral adjustments.

Lowering taxes on the poor also creates a more progressive tax rate schedule in the traditional sense of imposing higher rates on higher-income individuals. But it may actually improve the distribution of income toward the poor. Whether lowering rates on the poor creates a more progressive government overall depends on what eventually is displaced by those lower taxes. Thus, if the poor get more tax cuts than they do eventual expenditure reductions, then the move is likely to enhance progressivity.

Suppose the top federal rate society is willing to impose is 40 percent--a rate not too far from the top individual rate applying to individuals today. Everyone else's rate could be raised to 40 percent and this would create a flat rate tax system--but not necessarily a less progressive government. The eventual progressivity of the change would depend on the distribution of those additional tax collections on poor and middle-income individuals.

What makes today's flat rate debate so difficult is that, in fact, marginal rates have already been raised implicitly for many low- and middle-income individuals so that their rates are already well in excess of 40 percent on income above some subsidy amount. These taxes are often hidden in expenditure programs. Like the social security and value added tax increases mentioned above, these are among the many nonincome tax means by which government paid for its activities over the past few decades. If tax rates were to be taken into account, then movement toward a flat tax might first have to lower tax rates for low-income and moderate-income individuals before it could even begin to touch the tax rates faced by higher-income individuals.

In sum, one shouldn't be too quick to presume that flat taxes mean either smaller government or less progressive government.

Other Publications by the Authors

- C. Eugene Steuerle