

## **The flat consumption tax**

Financial journalism has provided the most recent addition to the list of Republican Presidential hopefuls in the US. Malcolm Forbes – the proprietor and editor of *Forbes* – has now convinced himself that the American people need him. South Africans may well ask: so what? The answer lies in the tax system Forbes wants to see introduced. He is an advocate of the so-called flat tax, and his proposals have already been well canvassed on a bipartisan basis in both the House and Senate. Senators Sam Nunn and Pete Dominici, a Democrat and Republican, have advocated a consumption-based income tax (Center for Strategic and International Studies, Washington, *First Report of the Strengthening of America Commission* – 1992). So too has the House majority leader, Dick Armey, who proposes a flat tax.

The origins of the current upswing of interest in the idea stretch back 14 years to the Hoover Institution at Stanford University. Here Robert Hall and Alvin Rabushka have been shaping the proposal. Their most recent book, *The Flat Tax* (1995), argues the case, spells out the administrative and political hurdles and describes how they can be overcome.

## **The benefits of a flat tax**

The proposals are particularly relevant in SA, where a new government is in place; the Katz commission is still sitting; nurses, like many on lower incomes, find it increasingly hard to make ends meet under the current tax regime; savings for investment are disturbingly low; the Receiver of Revenue's offices are buckling under the strain of trying to collect the uncollectable; and thousands of lawyers and accountants make a good living helping to minimise the tax burdens of their more affluent clients.

What should an ideal tax system look like? Taxes should be equitable and fair in the judgement of the taxpayers. They should have minimal compliance costs. They should be neutral with respect to choices that would otherwise be made in the absence of taxes. They should raise revenues at least cost in terms of their distorting effects on the rest of the economy. And they should have low collection and monitoring costs. Of course in the real world such a tax system can never be fully attained. Complete neutrality, for instance, is only a norm by which to judge current practices. But it can help us to identify excesses of bias.

## **Encouraging investment**

The current tax code is conspicuously biased against saving. Savers are penalised and consumers are not. Income saved is subject to double taxation. A rand saved and not spent has tax imposed on most subsequent earnings as well. The incentive is to spend now rather than save for future gains. Thus an individual willing to defer R1 000 consumption this year in order to receive R1 100 next year should be prepared to invest at an interest rate of 10%. But under current tax treatment such an individual in the 50% tax bracket would not be prepared to give up consumption now unless the return was at least 20% before taxes. Taxpayers know they will have to pay R100 on the gain of R200 (i.e. 50 % of the amount realised) to end up with the extra R100 in hand next year. This bias against saving inclines taxpayers to view saving and investing as short-term endeavours. Some of the anti-savings bias is offset by, for example, retirement annuity legislation. Still other tax practices, however, aggravate the bias against saving, like fringe benefits, which are not fully taxed. In SA corporate earnings are double taxed. In the US, if they are retained, a rising share price is subject to capital gains tax (including any inflation component). This reduces the incentive to invest in business. It also encourages firms to seek debt finance rather than equity.

## **It is simple and cheap to operate**

Firms inevitably focus on cash flow and the short term. Investors prefer to see firms ploughing back funds rather than themselves receiving the cash as dividends which can then be channelled to more

highly valued uses. The flat tax would, for one, encourage tax simplification. For example, all expenses would be amortised in the year of outlay rather than over arbitrary periods, which would make corporate accounting much simpler. How would it work? The Hall and Rabushka proposals – carefully costed for the USA – begin with a tax allowance of \$25 500 (say R85 000) for a family of four. Millions of US taxpayers would therefore no longer pay tax. All families above that threshold would pay 19%. The tax meets all of Adam Smith's requirements. It is equitable, for it is only levied on those who are able to pay; the higher one's income, the more one pays – it is progressive. A family of four with an income of R86 000 pays R190, a family on R87 000 pays R380 and so on. (In present day SA a similar family would pay several times that amount and would be in the highest tax bracket.)

### **Lower taxes and less tax dodging**

It is predictable, convenient and easy to collect. Individual tax returns can fit on a form the size of a postcard. Pension contributions and other fringe benefits paid by employers are not counted as wages (for tax purposes). Pensions are taxed only when received. Capital gains, interest and dividends are all ignored in the individual tax return. The business tax return (also a postcard-sized form) picks up the tax due by the owners of a business on the income it produces. The system is airtight since the tax rate to be levied on the owners of the business is already known – the flat 19%. To compute business income the present hodge-podge of depreciation schedules, allowable and non-allowable interest and dividend payments, ambiguous treatment of distributed and non-distributed earnings would be replaced.

Taxable earnings would simply be gross sales (including sales of assets) less allowable costs (namely inputs, cash wages and equipment purchases). Initially, investment would be boosted by a first-year write-off. Interest payments and fringe benefits would not be allowed as deductions from taxable income, thus accomplishing the goal that all income should certainly be taxed, but only taxed once. This business tax would thus eliminate the need for a dividends tax, as well as for a capital gains tax. Also a low flat rate, like 19%, reduces the benefits of cheating, which would encourage fuller reporting of business income. And then there would be the realisation by all taxpayers that they would pay higher taxes in the same proportion for new government programmes. Populist demagogues would no longer be able to offer voters free lunches because supposed faceless "capitalists" would be footing the bill. Of course the incomes on which the flat tax is levied have little relation to real wages or profits as defined by economists. In fact, the flat tax is not really an income tax, it is a consumption tax. People are taxed on what they take out of the economy, not on what they put in. This has for long been seen as just, at least since Thomas Hobbes suggested a consumption tax in the 17th century. Savings are no longer discriminated against. A R100 return on a R1 000 investment is now just that. Individual savers no longer have to think in terms of after-tax returns. They will not be taxed on their R100 interest or dividend.

### **Less work for accountants and tax lawyers**

But last May, in the *Wall Street Journal*, the Nobel Prize-winning economist Milton Friedman predicted that the flat tax had scarcely a hope of being adopted. Why? Friedman did not fault the concept, but believed the unemployment its adoption would create would result in such overtime lobbying that the proposals would never be enacted.

Increased unemployment from a tax change which encourages investment? Friedman identified the victims: the lawyers, accountants and bureaucrats who administer and operate the existing cumbersome system. They are what economists call rent-seekers; individuals who profit from the use of resources which create no useful output. Washington's corridors of power are crowded with civil servants and lobbyists who have vested interests in the status quo and will fight the mother of all battles to preserve them. Perhaps the 220-year-old American republic cannot change. Possibly the one-and-a-half-year-old SA democracy has a better chance. Over to you, Prof. Katz.

*This Briefing Paper was written by Henry Kenney and Duncan Reekie  
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