

Comments on
“Taxing Sales Under the Flat Tax
By BHKST

Bill Gale
Brookings Institution, Tax Policy Center

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Estimates of the Required Rate in a
NRST: A Brief History*

• AFT (~1995)	23%	Made “The Mistake” Favorable assumptions
• Others** (1997-2005)	28-35%	Without “The Mistake” Favorable assumption
	40-50%	Without “The Mistake” With realistic assumptions
• BHKST (2006)	24%	Without “The Mistake” Favorable assumptions

*Tax-inclusive rates

** Others include Feenberg, Mitrusi, Poterba (1997); Gale, Koenig, Rogers, Sablehaus (1998); Gale (1999); JCT (2002); President’s Advisory Panel (2005); Gale (2005)

“The Mistake”

- When calculating government revenues under the NRST, assume that
 - Consumer prices (inclusive of tax) will rise by the full amount of the sales tax
 - Producer prices will remain the same as under the current tax system
- When calculating required government spending under NRST, assume that
 - Consumer prices (inclusive of sales tax) will remain as under the current system
 - Producer prices will fall by the full amount of the sales tax
- These are obviously inconsistent. The net effect is to show a NRST rate that is too low to maintain real government spending.

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Correcting the Mistake

- Under consistent assumptions, the tax-inclusive NRST rate is given by:

$$T=R/(C-X+G)$$

R= Revenues to be replaced by the sales tax

C= Sales tax base in pre-sales tax economy (consumption + SL govt)

X= Prebate

G= Total federal spending in pre-sales tax economy

- The rate does NOT depend on what happens to the price level, or how much, if any, federal spending is taxed under NRST
- Both BHKST (eq. 26) and Gale (2005, eq. 13) use (essentially) this formula

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Same Formula, Different Results

	<u>2007</u>	2015 <u>Current Law</u>	2006-15 <u>Current Law</u>
<u>Gale (2005)</u>			
Required rate	28.2	33.0	30.6
Revenue loss at 23%	\$400 B	\$1.1 T	\$7.1 T

BHKST

Required rate	23.8
Revenue loss at 23%	\$76 B

(All rates tax-inclusive)

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Why the Difference?

- The difference is NOT due to different assumptions about
 - Avoidance
 - Evasion
 - Legal erosion of the tax base
 - Taxation of state and local government
 - Definition of R, C, X, G
- Difference must be “in the weeds”
 - Measurement of C, X, G
 - Data updating

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Reality Check from the Hall-Rabushka Flat Tax

- Flat tax is an aggregate consumption tax with personal exemptions
- Required rate (tax-inclusive, mid 1990s):
 - To replace income and corp: 20 percent
 - To replace income, corp, payroll, and estate 33 Percent
(Income and corp revenues are ~60% of revenues from all four taxes)
- But wait, there's more: The flat tax exemption is less generous than the NRST prebate.
- So...the required NRST should be higher than the implied required flat tax rate

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Evasion

- The sales tax does NOT get at more of the underground economy than the income tax.
- Income tax Drug dealer's income not taxed
- Consumption tax Drug dealer's sales not taxed

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Other issues:

- The vicious cycle
 - Legal erosion of the base (Credit card interest? Food? Health care?)
 - Leads to higher required rates
 - Leads to demand for more erosion of the base, and so on.
- Public debt
 - Is debt repudiation a smart move for the world's biggest debtor?
- Growth effects
 - 7-10% max, if done exactly right
 - 0-3% if transition relief/adjustment costs, etc...