

### A FLAT CONSUMPTION TAX CONCEPTS

Marina Kesner-Škreb MSc  
Institute of Public Finance, Zagreb

Glossary\*  
UDC 336.21  
JEL H20

The phrase flat rate tax is used to describe a tax system in which corporate and private income tax payers all pay income tax according to the same rate, and not at different and progressive rates. Accordingly, income tax is not paid at different rates, in that higher incomes are taxed at higher rates, rather at a uniform rate for all income. The marginal tax rate is a constant at all levels of income.

Flat tax is on the whole associated with two authors: Robert Hall and Alvin Rabushka, who put forward a plan for it to be introduced into the USA. This proposal became one of the central topics of the presidential campaign fought in 1996 by one of the candidates, Steve Forbes. This is the purest variant of the flat tax, which is also sometimes called a flat consumption tax, because all income minus investment is taxed, i.e., that which is spent is taxed. Income can be either spent, or invested, and consumption can thus be measured as income minus investment. The main idea behind this kind of tax is that whatever is invested in the economy is to be rewarded, and whatever is spent deserves to be taxed.

Theoretically, the simplest tax would be that which would be paid at a flat rate only on the total earnings generated in a corporation minus investment in plant and equipment. But such a tax would be inequitable, since it would be regressive. Thus the authors allow for the collection of tax at two levels: the firm pays tax at one rate for all earnings that it generates except for income paid to its employees. The employees pay tax on what they earn, but according to a progressive tax system. Hall and Rabushka are of the opinion that such a taxation system is just, efficient and easy to administer.

Their proposal, then, consists of the taxation of income at two levels: the taxation of corporate profit or income, and the taxation of individuals' incomes.

During corporate taxation, it is important to determine the tax base. In the Hall-Rabushka flat consumption tax system this is defined by the total earnings reduced by the total expenditure of the company, i.e., all sales made by the company minus all purchases it makes. It is essential that all the wages of employees are included as an item of expenditure, because these amounts will be taxed in the

---

\* Received: May 10, 2005  
Accepted: May 30, 2005

system of the taxation of individuals' income. It is also important that there should be no reductions for interest, dividends and all other receipts from capital. All such income is taxed at the corporate level, and individuals do not have to pay any further tax on it. Since tax on such income is already paid, the revenue service has no need to concern itself with what happens to interest, dividends or capital gains when this income goes out of the company gates. Hence there is no need for the application of complex methods of avoiding double taxation. There is also no complex system of depreciation and defining the depreciation age and rates. The Hall-Rabushka flat tax acknowledges the total amount of any investment in the development of the plant and the purchase of equipment, not just a part of this value in the form of annual amounts for depreciation, as in the classical corporate income tax. On a base defined in this broad way, without the usual exemptions, and including all income except for the employee wage bill, the company will pay tax at the single flat rate.

The base for the tax on individual incomes consists of the receipts (wages and pensions) that the individual receives for his work. Any arrangement of tax rates and any amount of personal allowance can be applied to the basis determined in this way, so as to include a certain measure of progressiveness in the tax system. But according to the Hall and Rabushka proposal, the income of the individual should be taxed at one rate that is equivalent to that by which the income (profit) of the corporation is taxed. Hall and Rabushka reckon that progressiveness in the taxation of the individual can be incorporated by the setting of the personal allowance and the marginal tax rate. A different level of

personal allowance means a different degree of progressiveness: the higher the personal allowance, the greater the number of taxpayers at the bottom of the income scale who will not be required to pay income tax, while those with higher incomes will pay a relatively higher income tax. Flat tax, in the Hall and Rabushka version, does not admit of any relief or exemptions other than the personal allowance. Since the tax basis accordingly becomes rather broad, it is possible to apply low rates of taxation. But when the personal allowance is set higher, and progressiveness becomes greater, the marginal tax rate has to be higher in order for the desired amount of tax to be collected. Hence in setting this tax, the trade-off between personal allowance and marginal rate of taxation is crucial.

The Hall-Rabushka flat consumption tax then is a tax on the income (with investments taken out) of the company and the individual, with a single, uniform, low rate of taxation, without any exemptions and reliefs (apart from the personal allowance), which means that it is applied to a very broad base.

The proponents of this tax think that the lowering of the marginal tax rate the system enables will at the same time mean the lowering of the surplus tax burden (and an increase in efficiency) and a reduction in the possibility of tax evasion. The simplicity that characterises the tax will lead to a reduction in the costs of tax compliance and increase taxpayer morality. All of this can be attained in conjunction with little loss of tax fairness, because progressiveness can be simply incorporated into the system with an appropriate determination of the personal allowance.

Opponents of the tax warn that, in spite of its attractiveness, it has some drawbacks. They are of the opinion that such a tax will probably redistribute the tax burden away from the rich and towards taxpayers with median incomes. But since it is always difficult to make a precise analysis of tax shifting, it is hard to confirm or to endorse this point of view. The critics also state that, irrespective of the simplicity of the tax, there is no shortage of problems related to the actual definition of the scope of income and the determination of operating expenditure.

The Hall-Rabushka flat consumption tax is actually the purest variant of this tax, which, although it seems very attractive, has never completely made it into practice anywhere. But in recent times, variations of this tax are increasingly making inroads into taxation practice. On the whole these are variants that graft a single uniform tax rate onto the old tax bases. Then this tax is called a flat income tax, the basic characteristic of which is that an identical tax rate is applied to all the components of income and that no exemptions or reliefs are allowed apart from a certain amount of personal allowance and strictly determined operating or business expenses. Accordingly, it is not a pure form of the Hall-Rabushka flat consumption tax that is concerned. In recent times, some ver-

sions of such a tax have been introduced into an increasing number of countries. First to bring it in was Estonia, in 1994, and by 1995 it had been introduced by Lithuania, Latvia, Russia, Serbia, Ukraine, Slovakia, Georgia and Romania. What all these have in common is that income is taxed at a uniform rate, and that the abolition of tax exemptions and reliefs has enabled a broadening of the tax base and a consequence reduction in the tax rate.

#### LITERATURE

---, **2005**. "The Case for Flat Taxes". *The Economist*, April 16<sup>th</sup> 2005.

**Hall, R. E. and Rabushka, A., 1995.** *The Flat Tax*. Stanford: Hoover Institution Press, Stanford University.

**Ivanova, A., Keen, M. and Klemm, A., 2005.** «The Russian Flat Tax Reform». *IMF Working Paper*, WP/05/16. Washington, D.C.: International Monetary Fund.

**Owens, J., 2004.** *Fundamental Tax Reform: The Experience of OECD Countries* [online]. Available from: [<http://www.taxfoundation.org/events/67/owens.pdf>].

**Rosen, S. H., 1999.** *Public Finance*. Boston: Irwin McGraw-Hill.