*Richard Murphy**

Flat Tax: Not as Simple as They'd Have You Think

I have read much of what Alvin Rabushka, who will speak at the "International Academic Forum on Flat Tax Rate" has to say with regard to flat taxes (Hall and Rabushka 1995, etc.). What he has had to say is interesting. I therefore regret to say that I cannot agree with a great many of his conclusions.

I would like to have time to deal with many of the economic issues and assumptions which underpin Alvin Rabushka's theories. But whilst I trained as an economist I am first and foremost an accountant and upon reflection I decided that it was from that perspective that I wished to talk today.

There is a very good reason for saying that. Accountants have not been heard enough in this debate and if anyone knows about the realities of tax then we should. It is a curious fact that very little has been written by any of the major accounting institutes on the subject of flat tax. The AICPA in the USA devoted just 10 out of 113 pages to the subject when it issued a document on tax reform in September 2005 and it cannot be said to be overly enthusiastic in its comments[1]. In addition no UK accounting institutes has yet issued a major paper on this subject, although I am working on correcting that right now. So what I have to offer will, I hope add new perspective to the debate. In the circumstances I trust you will forgive the rather limited range of footnotes and references within my presentation. Almost everything I have to say is original thinking.

The Claims Made

The proponents of flat taxes do, it seems to me, make a limited but quite substantial range of claims as to the benefits that arise from them. In summary the claims made for flat tax can be grouped under the following headings:

Simplification

simplify the tax code;
reduce the burdens on individuals who have to file tax returns;
simplify business administration;
cut the number of state employees who administer tax;
reduce the number of taxpayers;

Taxation

reduce the tax rate;
reduce the incentive for tax evasion;
cut or eliminate tax avoidance;
close all loopholes for tax abuse;
increase the fairness of the tax system;

Economics

stimulate the economy;
increase tax yields in the long term;
reduce inflationary pressure;
reduce interest rates;
encourage saving;
stimulate investment;
encourage international competition;
improve corporate transparency.

Social

provide an incentive to work;
protect wealth;
support the family;
enhance the status of government.

No doubt I have missed at least one claim in Steve Forbes' book "Flat Tax Revolution" (Forbes, 2005) which, I have to admit I regard as the third edition of Alvin Rabushka's book on the subject with Robert E. Hall, (Hall and Rabushka, 1995) so close is it to the latter in structure and content.

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[1] American Institute of Certified Public Accountants; Understanding Tax Reform: A Guide to 21st Century Alternatives, September 2005

Now, if all these claims were true I have little doubt that more than 20 years after Hall and Rabushka first wrote the whole world would now be operating a flat tax because no politician would be able to resist it.

The simple fact though is that most of the world is not using flat taxes, and more seriously, they could not achieve many of these objectives even if they did. As I said, I will ignore most of the economic issues simply due to lack of time. This does, however, leave plenty of accounting issues that show that all is far from being as simple as Alvin claims.

So let's agree where we can. I did, incidentally indicate where I agree with Hall and Rabushka by italicising claims on which we agree within my slides. So, I do think that a flat tax will simplify the tax code. And I do think that this will reduce the administrative burdens on individual taxpayers. There may be fewer taxpayers under a flat tax, but that is not a foregone conclusion. And it is possible that there may be fewer employees in state tax departments, but again, that could not be guaranteed. And after that we cease to have common ground, which means that out of 22 claims I agree on two and accept it is possible that two more might be right. That leaves 18 where I beg to differ.

In half an hour I cannot cover all that ground, so as I said, let me focus on one or two accounting issues.

Business Administration

I have to be ambiguous. I do not think business administration will be eased in any way by a flat tax. The reasons are obvious:

In every country but the USA the most commonly accounted for tax is a VAT. No country that has introduced a flat tax has abandoned its VAT. The administrative burden of this will continue. Business will continue to suffer it.

Even Hall and Rabushka agree that under a flat tax regime an employer should have a duty to deduct tax at source on payments being made to an employee, and not at a flat rate. That means that full payroll taxation administration systems will have to be maintained, as will be the case for social security contributions, which will continue without alteration in a flat tax world. In other words, there can be no saving in this area.

One of the biggest problems in all tax administration is that of benefits in kind provided be employers to employees and disallowable costs with regard to travel and entertaining for taxation purposes. The problem of accounting for benefits in kind remains in a flat tax system, with every potential expense incurred for this purpose requiring identification within an accounting system so that they can be disallowed as a deduction in a company's accounts. And Hall and Rabushka also say 'the cost of business inputs includes the actual cost, if reasonable, of travel and entertainment expenses for business purposes' which does of course mean that someone has to assess this and agree it. There is little chance of that being a simple process unless the Estonian approach was adopted and a proportionate allowance was made.

Business will, of course, still have to prepare accounts. Most countries require accounts prepared in accordance with accepted national or international financial reporting standards to be prepared, as do the financiers of such concerns. To date these have been the basis for taxation charges. But under a flat tax quite separate accounts will be required for taxation purposes. The cost of preparing these quite separate accounts will be an additional burden upon business. And please be under no pretence that this will be a simple process. Some quite substantial accounting adjustments will be required which I would expect to be considerably more time-consuming than those undertaken by most European corporations for the purposes of company taxation at present.

It is true that corporations and the self employed would not need to submit separate claims for relief for expenditure on capital items. But let us be realistic about this. These items will still need to be identified for accounting purposes and depreciation will have to be charged upon such assets under the rules of international financial reporting standards applicable to small and medium-size enterprises which will shortly be in operation throughout Europe. In that case the opportunity for time saving will be minimal because once that necessary accounting exercise is complete it probably takes a little more than 15 minutes a year to make the adjustments required for the purposes of UK taxation, for example. The burden will not change in other words.

Indeed, far from reducing the burdens, I suspect that a flat tax would increase the burden of taxation administration for almost all small businesses precisely because it will require two forms of accounting which will confuse, and annoy them. Large business may find the process somewhat easier but even they should expect few savings.

I believe the claim Hall and Rabushka that the administrative burdens upon business will fall under a flat tax regime are wrong.

Reduction in the Tax Rate

Hall and Rabushka promoted a flat tax rate of 19%. Forbes reduced the rate to 17%. As we know, rates in Europe are settling at around these levels. In the UK the Adam Smith Institute proposed a rate of 22%. For the 11% of taxpayers in the UK who now pay at 10% that will, of course, be an increase. For the 75% of taxpayers who now pay at basic rate this will be no change at all, because for them tax is already at 22%. That means there will be a guaranteed tax cut for just 14% of taxpayers in the UK who currently pay at higher rates[2]. That is not a persuasive argument. And I stress, from an accountant's point of view it is the marginal rate of tax that counts when planning, not the absolute level, so I am entitled to ignore any changes in allowances when making this suggestion.

Nor will this 22% rate actually affect the rate of tax paid by most companies. 98.5% of the UK's companies pay tax at rates of between 0% and 19%[3]. Whilst large companies are meant to pay tax at 30%, the reality, as I showed in research published last month[4], is that they actually pay about 22.1% on average at present. So they will get no benefit from a flat tax at the rate proposed for the UK.

In other words, the case that tax rates will fall under a flat tax regime is not proven in my opinion.

Reduce the Incentive for Tax Evasion

Tax evasion should not be an accounting issue but, inevitably, one sees it. And when an accountant does see it the evasion almost always relates to suppression of cash income or misrepresentation of an expense so that it would appear to be of business benefit. That this is likely to be the case is obvious. As Hall and Rabushka themselves point out, 90% of tax evasion is on legally earned income. The motive for evasion is not avoiding declaration of an illegal income stream but it is the desire to keep all of a legal income stream whatever the tax rate.

It is also wise to bear in mind the fact that much tax evasion also relates to income not declared for VAT purposes as well. The combination of VAT as a tax on the top line as well as flat tax on the bottom line has to be added together to determine the likelihood of evasion taking place. That probability cannot be assessed in isolation. Since sales (VAT) tax evasion is the more profitable of the two in most cases adoption of a flat tax will not eliminate this risk.

In other words, the argument that a flat tax will reduce tax evasion is not proven.

Cut or Eliminate Tax Avoidance

Steve Forbes says in his book that "the tax code's ambiguity and incomprehensibility invites abuse" (page 8). I have to say that as a law-abiding citizen I do not share that view and I think it reveals an odd approach to the law. But he is right to say that tax avoidance is a massive and wholly unproductive industry. The question is, therefore, whether a flat tax code would eliminate the opportunity for abuse, as he suggests it will.

In essence there are three reasons why Hall and Rabushka say a flat tax will reduce tax avoidance:

- Lower tax rates will reduce the incentive to avoid tax;
- The elimination of allowances and reliefs will remove the opportunity to avoid tax;
- The flat tax base will close loopholes.

I have already suggested that for many people and almost all corporations flat taxes will not represent a reduction in tax rates in my country and I think that true of very many others as well. In fact, my research elsewhere, which I cannot cover in detail today, suggests that flat taxes would require considerably increased tax rates in the UK. This argument does not, therefore, hold true.

What I cannot dispute though is that the elimination of allowances and reliefs will remove some opportunity to avoid tax. But, and I cannot make this point strongly enough, the answer to this problem is to avoid the proliferation of those allowances and reliefs. This does not require the abandonment of income tax. Allowances and

[2] Table 2.5, Income Tax Liabilities by Income Range 2005-06, Published by HM Revenue & Customs in the UK, December 2005 as part of the 2005 pre-Budget Review

[3] Table 11.8, Corporation tax payable by size category of liability, Published by HM Revenue & Customs in the UK, October 2005

[4] "Mind the Tax Gap", Richard Murphy, The Tax Gap Limited, January 2006, available as a download from www.taxjustice.net

reliefs could just as readily be given under a flat tax regime, and probably will be as such systems mature. It is a completely false argument to say that flat taxes solve this problem. They do not. As such, yet again, the argument for flat taxes is not proven.

The only way to stop avoidance is if the flat tax base is comprehensive and without risk of loopholes.

Unfortunately for Forbes, Hall, Rabushka and everyone else who proposes flat taxes, the flat tax base that they have invented has more holes in it than a Swiss cheese. In summary the gaping chasms that it creates in which tax planning can take place are the consequence of the fact that under a flat tax regime there are:

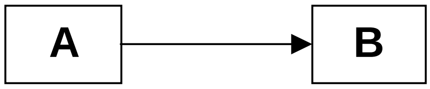
- no taxes on income per se;
- no taxes on capital gains;
- no taxes on investment income;
- no taxes on overseas earnings whether from trade or employment.

To understand the implications of this I must be clear about how tax planning works. First of all an accountant tries to get an income stream out of tax altogether. That is by far the most effective course of action they can adopt. Only if that fails do they look to use reliefs and allowances to mitigate the liability.

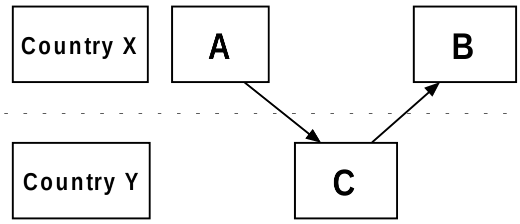
It is a fact that most countries are now pretty good at ensuring that all the income of companies and individuals resident in their territories is subject to tax. That is precisely why they have a range of taxes. Without them tax avoidance is inevitable. It is because this range of taxes is so effective at tackling tax avoidance that accountants have had to look to allowances and reliefs to undertake tax planning. You can understand therefore why they are so pleased at the prospect of a flat tax which might give them so many opportunities to exempt a client's income stream from liability. The tax planning opportunities flat taxes provide are enormous.

Their first cause for celebration is the fact that, if flat taxes were implemented, savings income will be outside the scope of tax because it will not be taxed in the hands of the recipient. Now I am well aware that Hall and Rabushka claim that this is only intended to prevent double taxation of savings and gains, something that I think a good imputation system can do just as well. But I would even lay that misgiving aside if their claim was true. But it is not. Hall and Rabushka's claim that their tax base is comprehensive is wrong precisely because all foreign source income is exempted from tax. This creates opportunities for tax avoidance of almost unlimited extent.

Let me give just one simple example of how this will happen. Let's suppose someone (A) from country X supplies services to another person (B) in country X by way of trade. The services A supplies will be consumed immediately in the course of B's trade. That is an everyday occurrence the whole world over. Under almost all existing tax regimes, and under Hall and Rabushka's proposed flat tax, the income A receives is taxable. The expense B incurs is tax deductible. All seems fair in consequence. The flow of services (with cash returning in the opposite direction) is:



Now suppose A sets up a company (C) in country Y. He contracts his services to that company. Company C contracts to supply the services A previously supplied to B. Now we have a situation where the flow of services is like this:



Cash will, again, flow in the opposite direction. But international boundaries are crossed twice now. And let us suppose that country Y is somewhere like Jersey where a company may be registered and pay no tax on its profits if it does not undertake its trade in that territory, as will be the case here. What are the flat tax consequences? Without doubt individual B can still get a deduction for the expense paid to company C for flat tax purposes. Hall and Rabushka quite specifically say that business inputs include the "market value of business inputs brought into the (United States)". The market value of the purchase by B has not changed here; it is identical to that in the first scenario. B's tax situation is not changed as a result.

A's situation is, however, transformed. He or she now owns company C which has cash in it. In principle he or she can extract that reward either by way of salary or dividend. Since he or she has provided their services to the company to enable it to fulfil its obligations to B logically a salary should be paid. But, as Hall and Rabushka say, compensation for flat tax purposes only excludes "wages, salaries and other payments for services performed outside the (United States)". There must be some doubt in this case whether the services were in fact performed outside country X, even though the payment would be from country Y. Almost inevitably an accountant could disguise where the services were performed if that was necessary. However, they would not need to do so. An offshore company, such as one in Jersey, can pay a dividend. A dividend is savings income. In Hall and Rabushka's flat tax such income is free from tax in the hands of the recipient because it is presumed to have been taxed in the hands of the person paying it. This, however, is clearly untrue in this case. The income of the Jersey company would have never been, and never will be taxed.

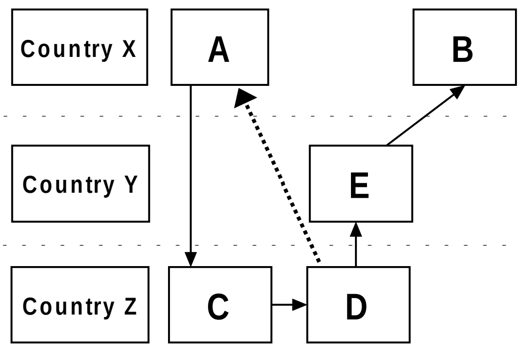
As a result, by setting up this arrangement person A had achieved three objectives. First of all they have moved their trading profits out of charge to the flat tax. Secondly they have recategorised their earnings from employment as investment income. This might have the additional benefit of avoiding any social security charges if the arrangement were to be challenged. Thirdly they have avoided the tax liability arising upon that investment income source. And therefore, as was their objective, they have entirely avoided a charge to flat tax.

Now, I notice that Estonia, at least, has realised the problems this poses. It has, as a result, had to create three anti-avoidance measures:

controlled foreign company rules have been introduced. These require residents to declare and pay tax on the income of any offshore companies under their control. Strict transfer pricing rules are in operation.

Withholding taxes of 24% are required when payments are made to offshore companies for the provision of services.

I have to point out that these completely negate the tax exemption for foreign source income that Hall and Rabushka sought to create but they still do not solve the problem of tax avoidance. If I modify the model slightly I create this structure:



A has now created a discretionary trust in country Z, which might be Jersey. It owns it had actually supplies his or her services, which is D in the diagram. This company is offshore so a withholding arrangement will apply to it in country X. As a result a company, E, is created in somewhere benign, such as the UK where costs are low and inquiries are infrequent. It is used to re-invoice the services from D to B. Now B does not have to withhold tax. And A is not paid by the trust in which he does not, in any event, officially have an interest. Either the trust or company D lends him back the money that has accumulated offshore, and the receipt of a tax free loan is not, of course, a taxable event.

Such arrangements are, I assure you easy to create and the result is that tax avoidance will be undertaken in flat tax states. Having a theoretical structure that encourages the idea that it should be possible will simply encourage it. And Estonia shows to what degree you have to abandon the theory to tackle it.

Most worrying is the fact that such schemes will inevitably be used most commonly by:

- the better educated;
- the best advised
- the well off.

By definition these people are those with the highest level of income. As is well-known, these same people do at present contribute a significant part of the taxation revenues collected under income tax rules in most countries. For example, 21% of all income-tax in the UK is paid by the top 1% of earners, and 51% of all income tax is paid by the top 10% of earners[5]. It is these groups who

[5] Table 2.4, Shares a total income-tax liability published by HM Revenue and Customs in the United Kingdom, December 2005.

will be able to be recategorise their income to avoid tax liabilities using the source basis of taxation inherent in flat tax rules.

The consequences are inevitable. The proportion of untaxed income amongst those able to manage their affairs will rise. The tax base will, inevitably shrink in consequence. That is the precise opposite of what Hall and Rabushka predict.

The Fairness of the Tax System.

Hall and Rabushka's final tax claim for their system is that it is fairer than the alternatives that are available, a claim reiterated by Forbes who deals with the question on page 10 of his book. I will leave the ethics of fairness aside and consider this issue as an accountant.

As an accountant I have massive reservations about removing income from taxation as flat taxes do. Anything that in taxation law provides a loophole, as this does, gives opportunity for abuse. The double taxation of consumption which will, in Europe, inevitably result from such a change also over-stresses one particular source of taxation which is always a mistake as it encourages people to recategorise their income and so avoid the charge if that is possible, as I have shown it will be under a flat tax system.

Looking at Forbes, Halls, and Rabushka's proposals one has to presume that they are being advised with regard to taxation matters because they are intelligent men and most certainly in Forbes' case he can command the necessary resources that would let him seek appropriate advice. In that case one has to presume that they deliberately created the opportunities for tax planning that I have outlined above which would be exceptionally difficult for anyone to tackle in an effective fashion given the source basis of taxation that their system adopts. Those planning opportunities favour particular sections of society including the well-off the self employed. Again, whilst I would like to think otherwise I can only presume that this was deliberate.

The consequence of these factors in combination is, however, that some of the other claims made for the flat tax system are unlikely to hold true. For example, the claim that flat taxes are progressive is entirely dependent upon all income above the exemption level being subject to the flat rate of tax. As I have shown, that is unlikely to be true, and most especially that will not be true as the income of the taxpayer rises. Therefore flat taxes are very likely to be regressive both in comparison to income, and quite probably in comparison to consumption. My own research, to be published shortly with regard to the United Kingdom suggests that this is the case.

However it is viewed, a tax that is largely optional for those with the greatest resources in society is not a fair tax. I regret to say, therefore, that yet again the case for flat taxes has not been proved.

What Is This All About?

Given that of the claims made for a flat tax none make any sense to me as a professional accountant let me offer you my thoughts as to what I think is really going on here.

I would like to think that Hall, Rabushka and Forbes are seeking to promote a new system of taxation. But, given that taxation systems are designed to collect revenue and given that, as I show, theirs appears extraordinarily unlikely to be effective in achieving this objective I have my doubts. I have therefore looked for alternative explanations, and they are not hard to find.

Hall and Rabushka are at the Hoover Institution at Stanford University. Herbert Hoover's 1959 statement on the purpose and scope of the Hoover Institution included the statement:

"Ours is a system where the Federal Government should undertake no governmental, social or economic action, except where local government, or the people, cannot undertake it for themselves."[6]

Steve Forbes, in an editorial in his own magazine in January 2006 said "*As long as Washington spends so much of our money—$2.6 trillion a year at last count—and exercises so much life-and-death power over so many segments of our economy, affected people and interests will find ways to get their points of view across*." He continued "*Our tax code—all 9 million words of it—is the biggest source of lobbying and corruption in Washington. ....Tax bills have become feeding frenzies for special interests, as well as a way for pols (sic) to try to buy votes through manufacturing ever more tax credits. The flat tax would eliminate all of this*."

These comments are in both indicative of another priority for proposing this tax. First of all, neither Hoover, or presumably those who work in the Institution named after him, like government. His

[6] http://www-hoover.stanford.edu/main/mission.html

policy statement is quite explicit. He does not want government to do anything he (and they) think it need not undertake. Of course, the best way to ensure it cannot do something is to deny it revenue. The flat tax would, and I suggest it is deliberately designed to do just that.

Forbes takes things a little further. He does not want politicians to interfere in the tax code. He suggests that very high constitutional barriers to changing the tax code be put in place as part of a flat tax regime. But if you will let me put on my hat as a political economist for a moment, let us explore what this means. Flat tax means tax rates will be fixed and tax allowances will not be allowed to change. And no doubt Forbes would also approve monetary policy being kept out of the government's control. What is left for government to do? Well, there is no serious tax system for a start because it will be bad at collecting revenue.

More importantly though, it is also clear that government itself is undermined, as Hoover clearly desired. In fact, as Prof Joel Slemrod of the University of Michigan said at the annual lecture of the Institute for Fiscal Studies in London 26 September 2005 "You can have democracy, and you can have flat taxes, but you can't have both".[7] And the reason is obvious to see, for under a flat tax system as proposed by Hall, Rabushka and Forbes there is no tax system to argue about and little tax revenue to manage either. But those two things are at the core of democratic government of the nation state as we have known it. Which is precisely why it is clear that countries cannot and have not adopted flat taxes using anything like the model Rabushka recommends. They are simply adopting single rate tax systems, which are something quite different designed to help the well off and large corporations reduce their tax burden.

So let me offer in summary the conclusions I included in my article which gave rise to my initiation to speak to you today. I said "Firstly, (flat tax) is designed to be a means for the rich to avoid their responsibility to society by letting them pay little or no tax. Secondly it is designed to ensure the state gets less income, and so shrinks in size. Thirdly, that means it is in effect an attack on the whole structure of the society we live in. Seen in this light the flat tax is not a serious attempt at taxation at all, but is instead an exercise in social engineering. That is why its innocent appeal is so dangerous."[8]

Thank you.

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