

**BY ROBERT P. MURPHY**

**LAWRENCE J. MCQUILLAN  
PROJECT DIRECTOR**



# Ending the Revenue Rollercoaster

## The Benefits of a Three Percent Flat Income Tax for California

By Robert P. Murphy, Ph.D.

Project Director Lawrence J. McQuillan, Ph.D.



Ending the Revenue Rollercoaster:  
The Benefits of a Three Percent Flat Income Tax for California

By Robert P. Murphy  
Project Director, Lawrence J. McQuillan

May 2008

Pacific Research Institute  
755 Sansome Street, Suite 450  
San Francisco, CA 94111  
Tel: 415/989-0833 | 800/276-7600  
Fax: 415/989-2411  
Email: [info@pacificresearch.org](mailto:info@pacificresearch.org)

Additional printed copies of this study may be purchased by contacting PRI at the address above, or download the pdf version at [www.pacificresearch.org](http://www.pacificresearch.org).

Nothing contained in this briefing is to be construed as necessarily reflecting the views of the Pacific Research Institute or as an attempt to thwart or aid passage of any legislation.

©2008 Pacific Research Institute. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopy, recording, or otherwise, without prior written consent of the publisher.

# Table of Contents

ACKNOWLEDGEMENTS	1
EXECUTIVE SUMMARY	3
I. INTRODUCING THE PRI FLAT-TAX PLAN	4
What Is a “Flat Tax”?	6
California’s Recurring Fiscal Crises	6
II. THE BENEFITS OF A FLAT TAX IN THEORY	12
A Flat Tax Is Simpler and Has Much Lower Compliance Costs	13
A Flat Tax Spurs Economic Growth and Employment	15
A Flat Tax Yields a Less Volatile (More Consistent) Revenue Stream	19
III. THE BENEFITS OF A FLAT TAX IN PRACTICE	24
The United States Experience	25
Flat-Tax Success around the World	29
IV. A PRIMER ON INCOME TAX THEORY	30
The Starting Point: Net Income	31
Net Income in a Business Enterprise	32
Dealing with Durable Assets	32
Dealing with Capital Gains and Losses	34
Handling Sales of Durable Assets after Several Years of Use	36
Handling Interest and Dividends	37
A Note on Complexity and Tax Evasion	39
V. THE PRI FLAT-TAX PLAN FOR CALIFORNIA	42
Calculating the Static, Revenue-Neutral Flat Rate	43
Dynamic Estimates	46

APPENDIX: DEALING WITH CONCERNS AND COMPLICATIONS	48
What about a standard deduction or personal exemption to help the poor?	49
Will I lose my mortgage-interest deduction, child tax credit, etc.?	50
Will my tax bill go up or down?	51
Isn't a flat tax a handout to the rich?	52
Doesn't the PRI plan tax savings twice?	53
What is comprehensive versus targeted tax reform?	54
If we get a flat tax, how do we keep it?	54
ABOUT THE AUTHOR AND THE PROJECT DIRECTOR	56
ENDNOTES	59
TABLES AND FIGURES	
FIGURE 1: The profligacy of Gov. Gray Davis's administration wasn't so bad after all	7
FIGURE 2: Politicians underestimate revenues in good times and overestimate revenues in bad times	8
FIGURE 3: No thrills: California's revenue rollercoaster has bigger dips and climbs than other states	9
TABLE 1: California is the fourth most volatile state in terms of Growth of Income-Tax Receipts (1997-2006)	10
FIGURE 4: Affluent Californians come and go, depending on their tax rate	11
TABLE 2: 1,597 filers with adjusted gross incomes of \$200,000 or more had no tax liability	16
TABLE 3: A high-income shareholder under the PRI Flat-Tax Plan would receive 19% more income after taxes	18
TABLE 4: Tax Receipts for Hypothetical Economy (not California's) under Progressive versus Flat-Rate Tax System	21
FIGURE 5: Tax Rates and Revenues during the 1920s	26
FIGURE 6: Tax Rates and Revenues during the 1960s	26
FIGURE 7: Tax Rates and Revenues during the 1980s	27
FIGURE 8: Tax Rates versus Taxes Paid by the Rich during the 1920s	28
FIGURE 9: Tax Rates versus Taxes Paid by the Rich during the 1960s	28
TABLE 5: Calculating the PRI Flat-Tax Income Base, 2001-2005	44
TABLE 6: Historical Revenues and PRI Flat-Tax Rate Derivation	45

# Acknowledgements

**M**y largest debt in preparing this study is to Arthur Laffer, for whom I worked from September 2006 to June 2007. In my time at Laffer Associates, I learned that supply-side economics isn't just good in theory; it really works in practice. I would also like to mention Dan Mitchell, now at the Cato Institute, whose article on the three tax-cut episodes<sup>1</sup> provided the inspiration for many of the figures in the present study. In addition, Bill Ahern of the Tax Foundation provided assistance in tracking down income-tax data, while Lloyd Brown and Wayne Winegarden provided very helpful comments on early drafts of the study. Michele Pielsticker from the California Taxpayers' Association and Jon Coupal from the Howard Jarvis Taxpayers' Association provided assistance with my questions about compliance costs and a previous study of a national flat tax. Roland Boucher of United Californians for Tax Reform helped with interpreting the Franchise Tax Board reports. The staff of the Joint Economic Committee was very timely in providing me with a copy of its important study on the Mellon and Kennedy tax cuts.<sup>2</sup> I would also like to thank Alvin Rabushka for clarifying the difference between a flat consumption versus a flat income tax.

Naturally, the most input came from project director Lawrence J. McQuillan. Finally, I would like to thank my wife for tolerating my irregular sleeping habits as the study neared completion.

Robert P. Murphy  
May 2008





# Executive Summary

**T**he PRI flat-tax plan for California will greatly simplify the current tax code. It will **completely eliminate** the alternative minimum tax, as well as estate, inheritance, and gift taxes. It will also revamp the convoluted, loophole-ridden corporate and personal income-tax codes with a **simple flat rate of 3 percent** on personal and corporate net income.

There are many benefits to the PRI flat-tax plan. The recommended reforms will give tremendous supply-side incentives for stronger economic growth. By eliminating the current progressive tax system and replacing it with a single bracket of 3 percent, as well as eliminating the millionaires' surcharge of 1 percent and the double taxation of corporate dividend payments, these reforms will make an enormous difference in after-tax earnings for the state's most productive citizens. The elimination of arbitrary tax credits and other loopholes, to be replaced by a neutral flat tax on all forms of income, will encourage businesses to make decisions on the basis of profitability, not the tax code.

The state treasury will benefit from the plan as well. Currently the highly progressive tax code causes huge swings in state revenues depending on the economy. The PRI flat tax will provide a more stable flow of revenue, helping to avoid future budget crises.

Perhaps most important, the average taxpayer will literally be able to complete his or her tax return in minutes. All it will take is a list of major income from various sources, to be multiplied by 3 percent. The individual will literally file a return the size of a postcard. There will be no more saving of receipts, searching for eligible credits, or worrying at night over the legitimacy of a claimed deduction.

# One: Introducing the PRI Flat-Tax Plan

It is possible to revamp California's current tax system to make it much simpler, more conducive to growth, and fairer, all while retaining the same revenues to the state.

**I**n a recent address to the Sacramento Press Club, California Assembly Speaker Fabian Nuñez called for a “conversation about California’s tax structure.” In this spirit, the Pacific Research Institute has conducted this study on flat-tax reform for the state of California to add to the growing conversation. Over the years, economists and businesspeople have cited the numerous benefits of a flat tax for both the economy and the government’s budget, but have often met with strong resistance. Ironically, the most successful implementations of flat-tax reform have occurred in foreign countries, including Albania, Bulgaria, Estonia, Georgia, Guernsey, Iceland, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Mauritius, Mongolia, Montenegro, Romania, Russia, Serbia, Slovakia, and the Ukraine.

The present study is a guide for flat-tax reform for the state of California. As the following sections will demonstrate, it is possible to revamp California’s current tax system to make it much simpler, more conducive to growth, and fairer, all while retaining the same revenues to the state. California corporations are already taxed at a single rate, so why not individuals as well? By replacing California’s current personal and corporate income tax with a single flat tax of 3 percent—with no special credits or other loopholes, except for allowing businesses to deduct the costs of operation—the state would raise at least the same revenues in a typical year, while saving taxpayers millions in compliance costs.

Further, the enhanced incentives to economic activity from this simple, low-rate system would spur economic growth, so that the state would enjoy a higher revenue flow in practice. Of particular importance to California is that the revenues from a flat-tax system would be much more stable than the wild ups and downs generated under the current system. This extra stability would allow for easier budget planning in order to put an end to California’s recurrent fiscal crises, such as the current emergency.

The study is organized as follows. Section I explains the flat tax and offers a brief description of the boom-bust cycle that plagues California’s budget process—a cycle that the flat tax can help end. Section II explains the theoretical case for a flat tax, while Section III details real-world case studies—from both the United States and other countries—of the power of tax reform, including the successful implementation of actual flat-tax codes. Section IV provides a

primer on tax theory, to explain the philosophy behind the PRI flat-tax plan. Section V provides the quantitative analysis of California's economy and tax revenues, and explains the derivation of the 3 percent flat rate recommended by this study. Finally, the Appendix addresses common questions and concerns about flat-tax reform.

## What Is a “Flat Tax”?

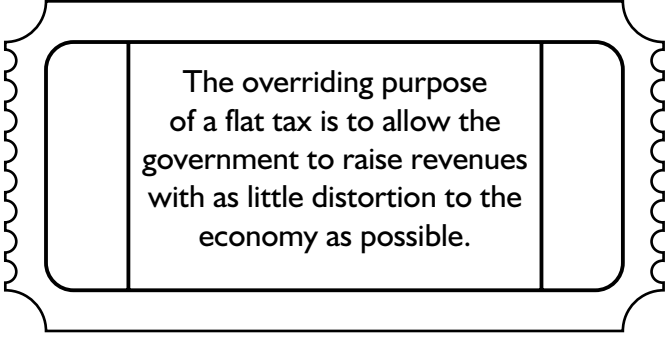
A flat tax is a system in which all incomes are taxed at the same percentage rate, regardless of the taxpayer's income. This stands in contrast to the current California (and federal) progressive (more accurately, punitive) tax code, where taxpayers with higher incomes pay not only more dollars in taxes, but also a higher rate of their income in taxes.

Building on the seminal *Wall Street Journal* op-ed of Robert Hall and Alvin Rabushka in 1981, over the years economists and businesspeople have proposed various plans for a flat tax.<sup>3</sup> All these plans feature one tax bracket, but beyond that they differ in the details. Even so, they all aim to eliminate (or at least reduce) the numerous deductions, exemptions, and credits that plague the current tax code. The spirit of flat-tax reform is to make the tax code simpler and “neutral,” so that the legislature does not penalize or reward certain activities through the tax code. Many observers also consider a flat tax fairer, in that it applies the same tax treatment to everyone. The overriding purpose of a flat tax is to allow the government to raise revenues with as little distortion to the economy as possible.

## California's Recurring Fiscal Crises

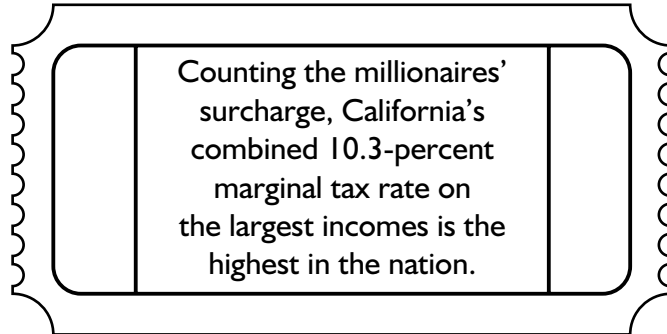
California residents are well aware of the current fiscal crisis. In his January budget proposal, Governor Schwarzenegger warned of a \$3.3-billion shortfall in the current fiscal year, which would mushroom into a \$14.5-billion deficit through the next fiscal year unless swift action was taken. Among other remedial measures, the governor proposed an across-the-board cut of 10 percent in virtually all General Fund programs. As of late February, Legislative Analyst Elizabeth Hill announced that state revenues had slipped another \$1.5 billion; absent remedial action, the projected deficit through June 2009 would be \$16 billion.<sup>4</sup> This current fiscal emergency, unfortunately, is nothing new.

Arnold Schwarzenegger found his way into office during the last crisis, when he campaigned to “cut up the credit cards.” As Figure 1 demonstrates, the profligacy of Governor Gray Davis's administration wasn't so bad after all. The worst General Fund deficit under Davis (in 2000-01) was \$6.6 billion,



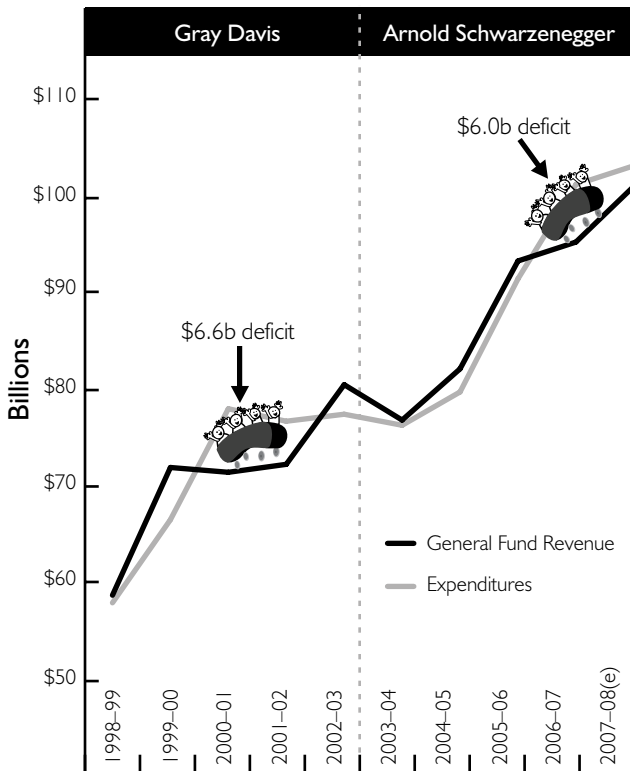
The overriding purpose  
of a flat tax is to allow the  
government to raise revenues  
with as little distortion to the  
economy as possible.

while under Governor Schwarzenegger the official deficit was \$6.0 billion in fiscal year 2006-07. Although the governor's budget projects a much smaller deficit for fiscal year 2007-08, this estimate assumes that General Fund revenues will grow by more than \$5.8 billion this fiscal year—quite an optimistic forecast given the current economic outlook.



## Figure 1

The profligacy of Gov. Gray Davis's administration wasn't so bad after all.

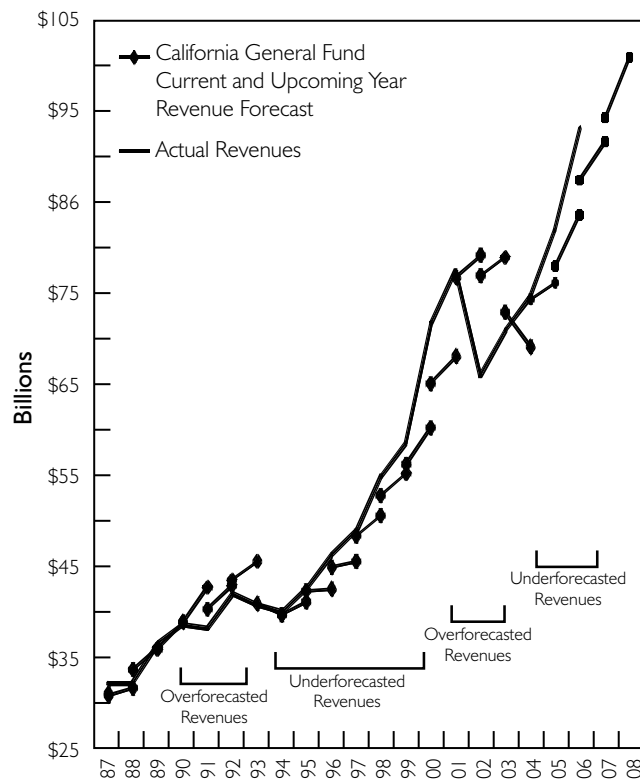


Source: California Legislative Analyst's Office, Governor's Budget 2008

The obvious explanation for California's recurrent fiscal crises is: "It's the economy, stupid." The dot-com bust caused a huge crash in revenues in the early 2000s, while the current bursting of the housing bubble and the general economic slowdown are causing revenues to come in well below forecasted levels. During recessions, the tax base shrinks, yielding lower revenues, while the state's spending (on unemployment benefits, etc.) increases. The politicians consistently underestimate revenues during good times and (more disturbing) consistently overestimate revenues during bad times. Figure 2 illustrates this pattern, contrasting each year's January and May forecasts with the actual revenues the state collected.

**Figure 2**

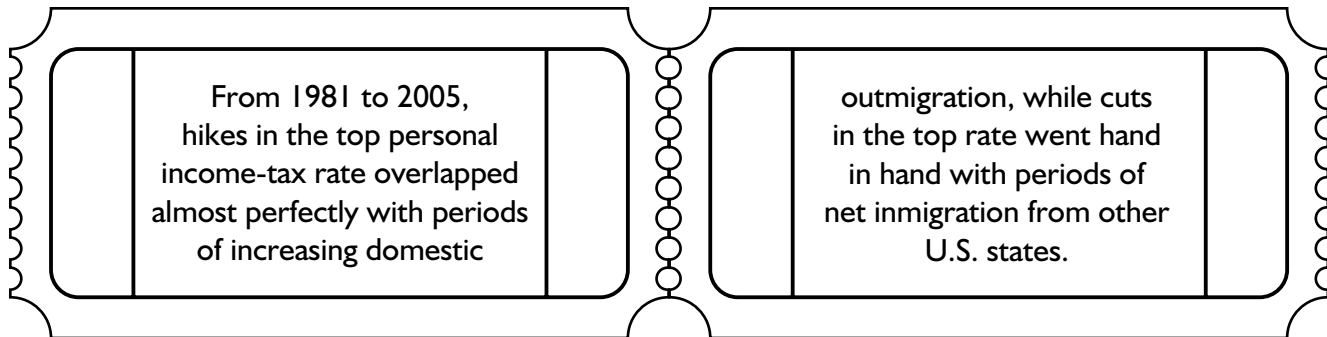
Politicians underestimate revenues in good times and overestimate revenues in bad times.



Source: Laffer Associates<sup>5</sup>

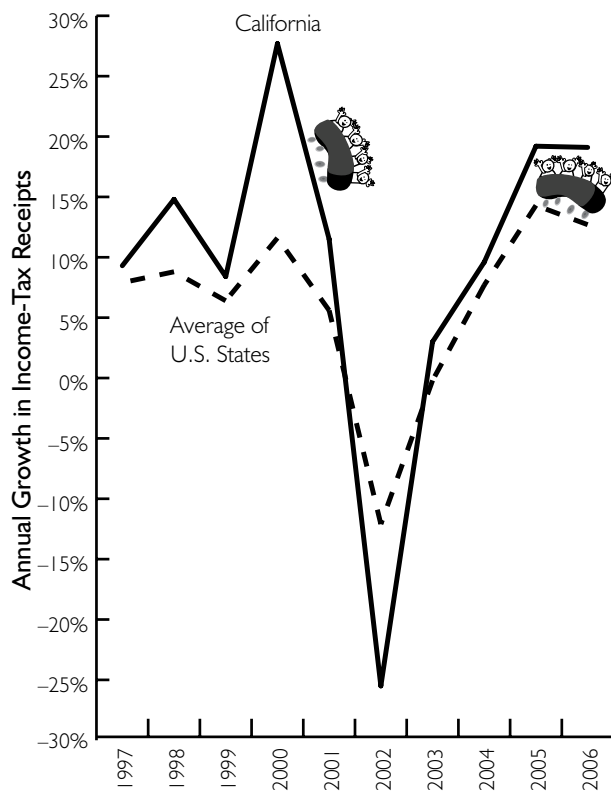
Although the economy is the primary explanation for recurrent crises, the California tax code bears partial responsibility. Counting the millionaires' surcharge, California's combined 10.3-percent marginal tax rate on the largest incomes is the highest in the nation. Because of its highly progressive system of seven brackets and its convoluted web of loopholes, the California tax code exaggerates the booms and busts in the state's revenue collection.<sup>6</sup> During good times, revenues experience a huge upswing, which leads legislators to enact new spending programs. This makes belt tightening all the more difficult when the inevitable downturn occurs.

To reinforce the point that California's rollercoaster finances are not merely the fault of the business cycle, we can compare California tax revenues with those of other states.



**Figure 3**

No thrills: California's revenue rollercoaster has bigger dips and climbs than other states.



Source: U.S. Census Bureau

Figure 3 plots the annual growth in income-tax receipts for California versus the average of all the states. It is clear that during good times, revenues rise more quickly in California than in other states, and during bad times they fall more severely.

The situation is even worse than Figure 3 indicates. It is not merely that California's income-tax receipts are more volatile than the average; indeed they are among the most volatile in the nation. Table 1 lists the 10 most volatile states, measured by the standard deviation in the growth rates of their income-tax receipts. California's rank of fourth highest (i.e., fourth worst) in the nation is itself misleadingly optimistic. The top two states (Alaska and Florida) tax corporate but not personal income, while the third-ranked state (Tennessee) taxes corporate income as well as dividends and interest income for individuals,

**Table 1**

California is the fourth most volatile state in terms of Growth of Income-Tax Receipts (1997-2006).

RANK	STATE
1	Alaska
2	Florida
3	Tennessee
4	California
5	South Dakota
6	Idaho
7	Louisiana
8	Arizona
9	Connecticut
10	Massachusetts

Source: U.S. Census Bureau

but no other form of personal income. The budgets in these three states are not nearly as dependent on income-tax receipts as California's budget is, and consequently their higher ranking in the table should give little comfort to Californians.

To better understand the large swings in California's revenues, we must consider that a stultifying tax code causes citizens to "vote with their feet" by moving to more hospitable states.<sup>7</sup> This is yet another snowball effect that magnifies fiscal crises. Just when the state's revenues fall and spending needs to rise, the government has often chosen to increase the taxation and regulation of beleaguered citizens. When these new tax hikes come in the midst of a general downturn, many citizens take the plunge and leave. Ironically, it is the state's most productive and wealthy individuals who can most easily relocate to more favorable tax environments, providing yet another amplification to the state's fiscal crisis.



**Figure 4**

Affluent Californians come and go, depending on their tax rate.

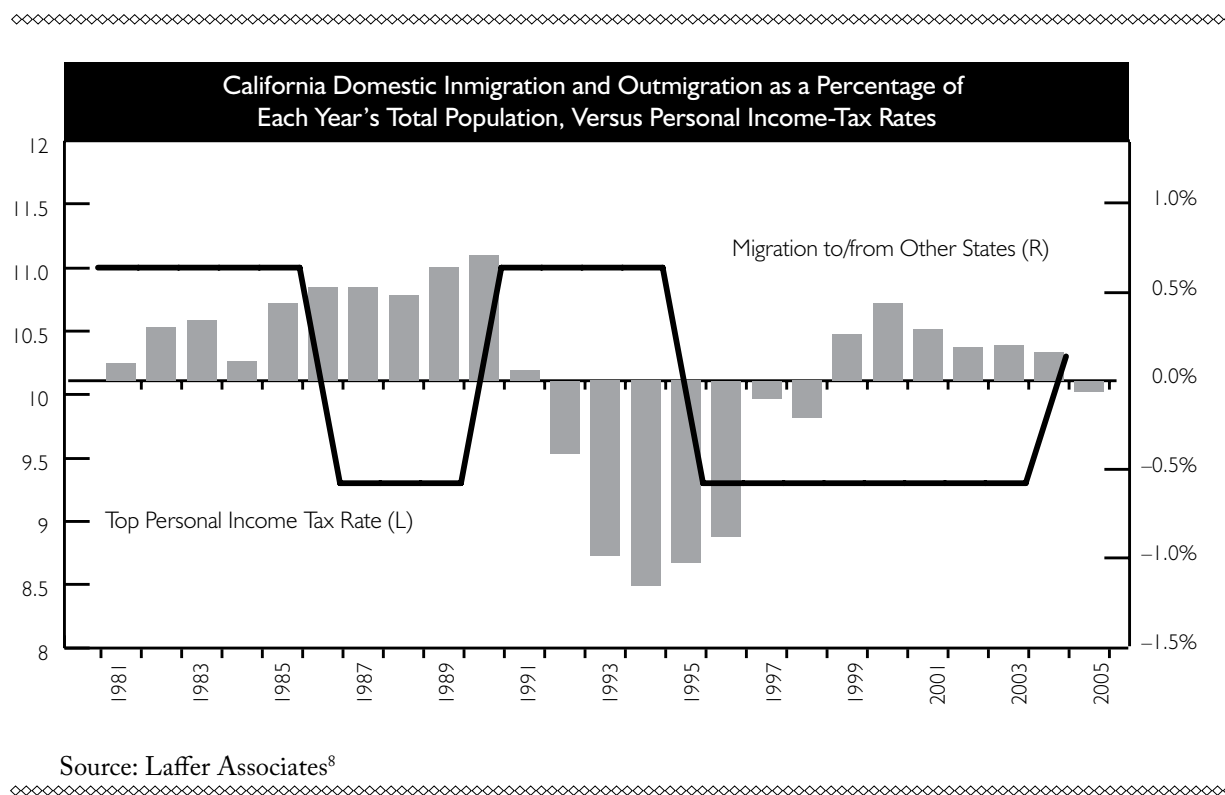


Figure 4 illustrates just how significantly migration patterns can be influenced by government policies. In the 1990s, Governor Pete Wilson enacted major tax increases and other interventions in the economy, and Governor Schwarzenegger (after the disastrous 2005 special elections) has unfortunately gone the same route. Although common sense tells us that taxes will influence people's decisions on which state to settle in, Figure 4 may nonetheless prove surprising. From 1981 to 2005, hikes in the top personal income-tax rate overlapped almost perfectly with periods of increasing domestic outmigration, while cuts in the top rate went hand in hand with periods of net immigration from other U.S. states. There are heated arguments over the net benefit or cost of immigrants from abroad, but clearly if California is to return to fiscal solvency, it must once again become a magnet for American citizens from other states. This is especially compelling when we reflect that some of those most able and willing to move from one state to another in response to tax incentives are the very affluent. Imagine the huge growth in wealthy individuals moving back to California—and thus expanding the tax base—if the top rate in Figure 4 were slashed to 3 percent, as the PRI flat-tax plan calls for.

## Two: The Benefits of a Flat Tax in Theory

As other advocates of a flat tax have stressed, the individual filer's return could literally be done on a postcard.

**T**his section explores the theoretical case for a flat tax. Economists have pointed out numerous advantages, but in the present paper we focus on three: lower compliance costs, incentives for economic growth, and more stable government revenues.

## A Flat Tax Is Simpler and Has Much Lower Compliance Costs

The most obvious advantage of a flat tax is simplicity. Without the various income brackets, deductions, exemptions, credits, and other loopholes that typify the California and federal tax codes, “doing your taxes” would no longer be a nightmare. As other advocates of a flat tax have stressed, the individual filer’s return could literally be done on a postcard.

Under a flat tax, individual taxpayers wouldn’t need to accumulate receipts during the year, buy computer programs or hire professionals, or worry whether they had overlooked important credits, or had misunderstood the rules and were breaking the law. To compute their tax liability for the year, individuals would simply tally up their total income and multiply it by the single flat rate of 3 percent. The entire procedure would literally take minutes. Businesses would still need to maintain records in order to calculate net income for the year, but of course businesses already keep such records for their own accounting purposes. The compliance costs for businesses would still fall under the PRI flat tax, compared to the present convoluted system. To give a concrete example, businesses would be less likely to set aside allowances in case the government ruled dubious tax practices illegal. With a simple flat tax, businesses would know the rules and could concentrate on their customers. An additional savings in compliance costs would come from the government itself: the low flat rate of 3 percent would reduce the incentives for tax evasion, so that the government would need to spend fewer tax dollars enforcing the code.

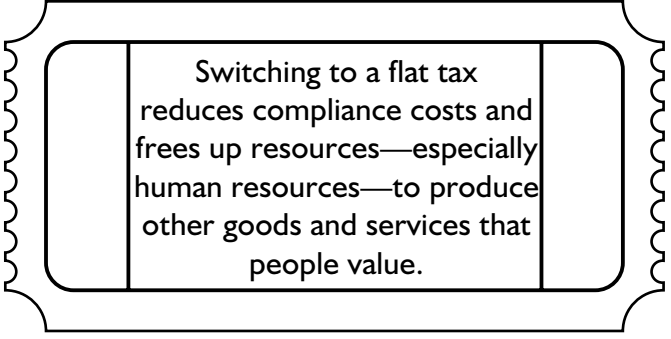
The complexity of the current tax system does not simply cause the taxpayer headaches. On the contrary, the current system saps our economy of real resources and makes us poorer, quite literally. Individual taxpayers devote money to software or professionals, and spend at least several hours (over the course of a year) just to *comply* with the tax code. For businesses the situation is much worse. Large corporations often devote an entire group of employees to keeping up with the latest changes in the code to ensure compliance.

To gauge just how large these compliance costs are—and remember, these costs are over and above the revenues that flow to the government—we can get a rough idea from a Tax Foundation report that estimated the 2008 total compliance cost for the federal income-tax code at more than \$325 billion.<sup>9</sup> Because California accounts for more than 10 percent of the United States population and total output, it is safe to conclude that at least \$32.5 billion of these compliance costs for the federal tax code fall on California taxpayers. Unfortunately, there are no comparable studies for compliance costs for the California code itself. There is surely not an additional \$32.5 billion in state compliance costs, because much of the bookkeeping done for filing federal returns can simply be used for the state return. On the other hand, the California code is quite complicated and has the highest marginal rate of any state, giving wealthy taxpayers and businesses the need and incentive to respond, in addition to whatever they do to minimize their liability under the federal tax code. All in all, we believe it is conservative to estimate a 2008 compliance cost of \$5 billion for the California state income tax. To repeat, this estimated \$5 billion is taken away from California taxpayers but does not end up as revenues in state coffers.

Under the PRI plan for a flat tax, businesses would still need to report expenses, maintain depreciation tables, etc., for tax purposes. (These technical details are explained fully in later sections.) The PRI plan, however, is rooted in economic and accounting theory, meaning that businesses will not need to devote significant resources to tax preparation, beyond those necessary to report activities to shareholders. Furthermore, the PRI plan is much less susceptible to “inventive” accounting and other tax-evasion schemes, meaning that the government will need to spend less on enforcement. We again hazard a conservative estimate that the PRI plan will reduce tax-compliance costs statewide by 5 percent, or \$250 million per year.

Before moving on, we should clarify an important point. We believe it is fair to refer to the hours devoted to tax compliance as “wasted” because they are unnecessary to achieve their purpose. The whole point of the tax system is to channel revenues to the government. Because a flat tax system can achieve this goal at much lower compliance costs, the cost of compliance under the present system is indeed true waste. Our economy would immediately become that much richer if we switched to a tax code with lower compliance costs.

For example, if both the federal and state governments adopted a flat-tax plan, then, rather than spending anywhere from \$19.99 to \$89.99 (depending on the version) on Turbo Tax software, individual filers could instead take their family out to a nice dinner. To reiterate, this isn’t simply a shell game: switching to a simple tax system makes this family richer, and this gain to the family is a



Switching to a flat tax reduces compliance costs and frees up resources—especially human resources—to produce other goods and services that people value.

net benefit to society. It's true, employment and sales in the tax software sector shrink, but this is counterbalanced by more business activity for restaurants and other sectors.

Switching to a flat tax reduces compliance costs and frees up resources—especially human resources—to produce other goods and services that people value. Under the current, complicated tax code, programmers and tax attorneys are certainly productive and are contributing to the economy through their efforts. But the central point is that this complicated code is an arbitrary human invention, and is unnecessary for its goal of raising revenues. As a former deputy chief of staff of the Joint Committee on Taxation put it: “You can’t underestimate how many of America’s greatest minds right now are being devoted to what economists would all say is totally useless economic activity.”<sup>10</sup>

Eliminating the need for these compliance professionals would be a boon to society, because these intelligent people can switch occupations and produce goods and services that currently are unprofitable. Society ends up richer, just as surely as if cancer were cured tomorrow so that medical students had to pursue other specialties and drug companies could concentrate their efforts on other diseases.

As added benefits, the simplicity of a flat tax promotes fairness and also brings in additional revenues. The flat tax is fair because everyone pays the same rate; there are no loopholes that tax attorneys can find for their richest clients, nor are there special provisions written into the tax code on behalf of corporate lobbyists. Because of the lower costs of compliance, a flat tax also gives less reason for individuals or businesses to falsify their reported incomes. The flat tax brings these evaders in from the cold, which widens the tax base and allows the government either to collect more revenues or to lower the tax rate for everyone.

15

## **A Flat Tax Spurs Economic Growth and Employment**

Adopting a flat tax will allow the government to slash the top marginal tax rates on individuals and businesses. There are two reasons for this: First and most obvious, if we replace a schedule of graduated tax rates with a single rate to be applied to all income levels, then the single rate necessary to raise the same revenues will be lower than the top rate under the graduated system. A second reason is that the flat-tax approach eliminates the myriad deductions, exemptions, credits, and other loopholes that typify the current tax code, thus widening the tax base to which the single flat rate is applied. If the goal is to choose the flat rate that will raise the same revenues as the previous system, then this rate will be lower when the tax base is widened.

Although everyone knows that the tax system is out of control, and that the rich can exploit loopholes far more expertly than the average Joe, few citizens are aware of just how bad the situation is. For tax year 2005, the Franchise Tax Board reports that there were 1,597 filed returns with adjusted gross incomes of more than \$200,000 and yet with no net tax liability.<sup>11</sup> Table 2 lists the elements of the current tax code that were the major sources for this shocking result.

1,597 filers with adjusted gross incomes of \$200,000 or more had no tax liability. Below are their favorite loopholes.

\* Three or fewer returns, not shown in frequency data but included in totals.

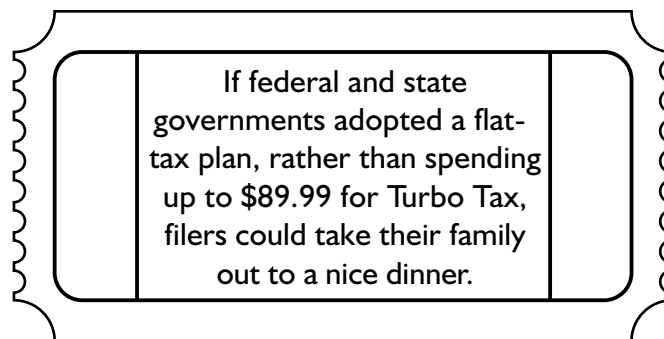
Source: Franchise Tax Board

Even though most proposals for reform, including this one, calibrate the single rate to ensure that tax revenues do not fall because of the switch—a so-called “revenue-neutral” approach—we must emphasize that there are still huge gains to the economy from the reform. To put it simply, there are various ways the legislature can extract a given amount of revenues from the taxpayers, and it definitely matters which method they adopt. To suppose that there is a fixed amount of income, out of which the government takes its portion, is incorrect. Instead, the tax system itself greatly alters the incentives citizens face, and thus the tax system itself can greatly influence the size of the pie from which the legislature takes its slice.

Economists believe that the vast majority of people make decisions based on the after-tax consequences. Ironically, an economy’s most productive citizens are the ones whose behavior is most sensitive to the incentives of the tax code. For example, a blue-collar worker who makes \$40,000 per year at a factory job probably won’t change his career path if income-tax rates are increased. On the other hand, if a corporate executive is offered a promotion with a significant raise, but which requires him to travel frequently, his decision might well be influenced by the tax rate applicable to the bigger salary. And even more obviously, investors considering a real-estate project are more likely to walk away if the capital gains tax is raised.

Although the above observations are reasonable enough, people often overlook just how important even modest cuts in tax rates can be. The PRI flat tax will eliminate the alternative minimum tax (AMT) and the millionaires’ surcharge of 1 percent,<sup>12</sup> and it will replace the progressive income tax—currently with a top rate of 9.3 percent—with a single flat rate of 3 percent. The casual observer might conclude, therefore, that the PRI tax plan represents a cut of 7.3 percentage points in income-tax rates for California’s most productive citizens (i.e., those who earn more than \$1 million a year and who do not claim many deductions). Although Reagan Republicans might welcome such a cut, surely it won’t have a very large impact on how much these individuals work and invest, right?

This reasoning understates the supply-side impact of the PRI plan. The percentage increase of after-tax returns due to a rate cut works out to be larger than the size of the cut itself, and this effect is amplified the higher the original tax rate. (For example, if tax rates are originally 50 percent, then a 10-point cut actually translates into a 20-percent increase in take-home pay.) More important, for income that is earned at the corporate level, federal and state corporate taxes kick in at rates of 35 percent and 8.84 percent, respectively. If part of that income is then passed on to shareholders in the



form of dividends, the shareholders have to pay income taxes on it—the double taxation of corporate dividends. Because of these two effects, a high-income Californian who does not qualify for the AMT—in short, just the type of citizen that the legislature wants to encourage—could see a tremendous boon of 19 percent to his after-tax returns from investment under a flat tax, as illustrated in the following chart.

**Table 3**

A high-income shareholder under the PRI Flat-Tax Plan would receive 19% more income after taxes.

	STATUS QUO	PRI PLAN
Pre-Tax Corporate Income	\$ 1,000.00	\$ 1,000.00
State Corporate Tax (if Dividend Not Deductible)	\$ 88.40	\$ -
Federal Corporate Tax (w/State Deduction)	\$ 319.06	\$ 350.00
Dividend Paid to CA Shareholder	\$ 592.54	\$ 650.00
State Income Tax on Dividend	\$ 55.11	\$ 19.50
State Surcharge (Prop. 63)	\$ 5.93	\$ -
Federal Income Tax (w/State Deduction)	\$ 186.03	\$ 220.68
After-Tax Return to Individual from \$1000 Earning	\$ 345.48	\$ 409.83
PRI Plan's Increase to After-Tax Returns	19%	

Source: Author's calculations, Pacific Research Institute

Besides increasing total output, a flat tax also improves the efficiency of output, meaning that labor and other resources are devoted to the areas that will generate the most income or profit. Under the complicated current system, with its high marginal rates and numerous loopholes, individuals and businesses often make important economic decisions guided by tax consequences, not by what would most satisfy consumers.

Without tax considerations, the corporation might have been more modest in decorating the office, deciding instead to plow its earnings back into R&D.



For example, a corporation might lavish its resources on decorating its office with plush carpet and expensive furniture, and providing its employees with catered lunches and free parking, because these can be written off as deductible business expenses. Without tax considerations, the corporation might have been much more modest in decorating the office, deciding instead to plow its earnings back into research and development, or distribute them as dividends to the shareholders. And as for its employees, they might have preferred to get larger paychecks rather than the expensive lunches and other perks. But because of the perverse tax code, these economic decisions are no longer sensible. The higher the tax rates on corporate profits and individual salaries, the artificially cheaper it becomes to spend money on items that qualify as “business expenses.”

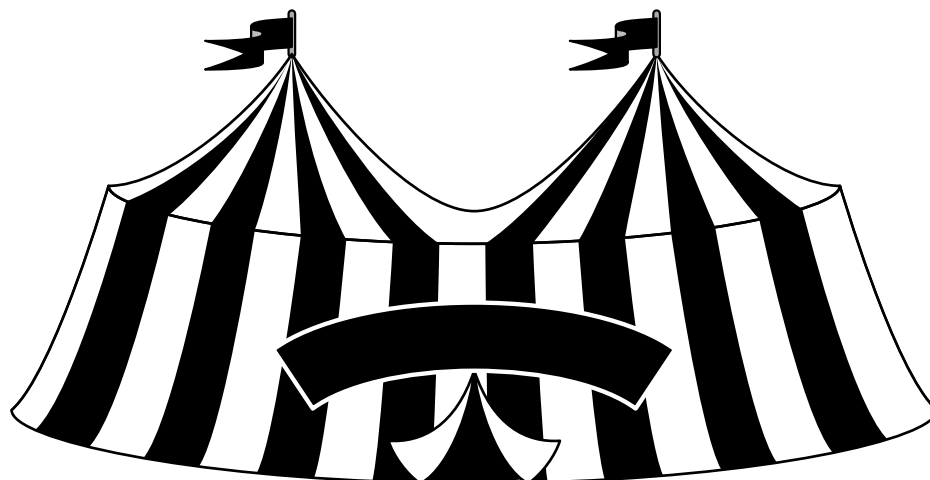
Although it is perfectly rational for individual corporations and taxpayers to behave this way, it is wasteful for the economy as a whole. Something that would clearly be extravagant in the absence of tax considerations—such as an employee making \$40,000 per year eating a \$15 catered lunch every day—doesn’t suddenly become efficient, just because the legislature imposes high tax rates. On the contrary, those uneconomical decisions are still inefficient, but the tax code masks the inefficiencies.

The perverse incentives of the current tax code are even more obvious when it comes to specific loopholes. For example, in 2007 the legislature restored the ability of purchasers of boats, motor homes, and airplanes to avoid use taxes, as long as they take possession of the purchase out of state and leave the vehicle outside the state’s boundaries for a specified period. This “yacht tax break” leads to economically wasteful behavior (such as unnecessary use of fuel and time) and reduces the enjoyment derived from the item. Of course, the owners of these vehicles benefit from the “sloop hole,” as it has been called—that is why they exploit it. But if all such loopholes were eliminated, marginal tax rates could be slashed, which would offset the loss of each person’s favorite exemption.

Switching to a flat tax with no arbitrary loopholes, and with a low rate of 3 percent, returns all investments and expenditures to a level playing field. Businesses and individuals will make economic decisions based on the true pros and cons, without particular sectors being penalized or favored by provisions of the tax code. Because of this neutrality, the flat tax will lead to more productive behavior and will boost economic growth.

## **A Flat Tax Yields a Less Volatile (More Consistent) Revenue Stream**

As we documented in Section I, California’s current tax code gives legislators a very volatile revenue stream. During years of solid economic growth, money pours into state coffers, which naturally leads to a ratcheting up of grandiose spending programs. But when the inevitable downturn comes, revenues crash more than proportionately, creating yet another budget crisis for the Golden State.



Beyond its other benefits, a flat tax would address this specific problem. Obviously, the revenues flowing from a flat-tax system would be higher during boom times than during downturns. Yet because the flat tax applies a constant marginal rate to incomes of all levels, tax revenues rise and fall in proportion to general economic activity.

With today's graduated income tax, the ups and downs of the business cycle are exaggerated.

In contrast, with today's graduated income tax, the ups and downs of the business cycle are exaggerated. In good times, not only are taxpayers earning more, but more of them are pushed into higher tax brackets. The reverse holds as well: During downturns, not only does the legislature forfeit tax revenues from a shrinking base, but much of the taxable income is hit with a lower marginal rate.

Table 4 illustrates this phenomenon. The numbers were chosen for simplicity rather than realism. Nonetheless, Table 4 shows quite clearly that a flat income tax can yield the same average revenues with much less volatility from year to year. This relative stability reduces the temptation for legislators to overspend during good times, and consequently makes it that much easier to cope during bad times.

Table 4 shows how a flat tax can yield much more stable revenues than a progressive tax. This table tells the story of a hypothetical state economy over the course of five years. During Years 1, 4, and 5, there is a boom, but during Years 2 and 3 there is a recession. The state has a total of 10 million taxpayers, and the number remains constant over the five years. During a boom year, three million taxpayers earn salaries of \$200,000, while the other seven million earn \$100,000. During a recession year, incomes fall significantly: only one million taxpayers earn \$200,000, while the remaining nine million earn only \$100,000.

Under a progressive income tax, where the rich pay an effective rate<sup>13</sup> of 10 percent while others pay a rate of 5 percent, the state legislature receives \$95 billion in income-tax revenues during

**Table 4**  
**Tax Receipts for Hypothetical Economy (not California's) under Progressive versus Flat-Rate Tax System**

	Year 1	Year 2	Year 3	Year 4	Year 5	
State of Economy	Boom	Recession	Recession	Boom	Boom	
Number of Taxpayers Earning \$200,000	3 million	1 million	1 million	3 million	3 million	
Number of Taxpayers Earning \$100,000	7 million	9 million	9 million	7 million	7 million	
Revenues from 10%/5% Progressive Tax	\$95 billion <sup>a</sup>	\$65 billion <sup>b</sup>	\$65 billion <sup>b</sup>	\$95 billion <sup>a</sup>	\$95 billion <sup>a</sup>	Average Revenue Per Year: \$83 billion
Revenues from 6.8% Flat Tax	\$88 billion <sup>c</sup>	\$75 billion <sup>d</sup>	\$75 billion <sup>d</sup>	\$88 billion <sup>c</sup>	\$88 billion <sup>c</sup>	Average Revenue Per Year: \$83 billion <sup>e</sup>

Source: Author's calculations, Pacific Research Institute

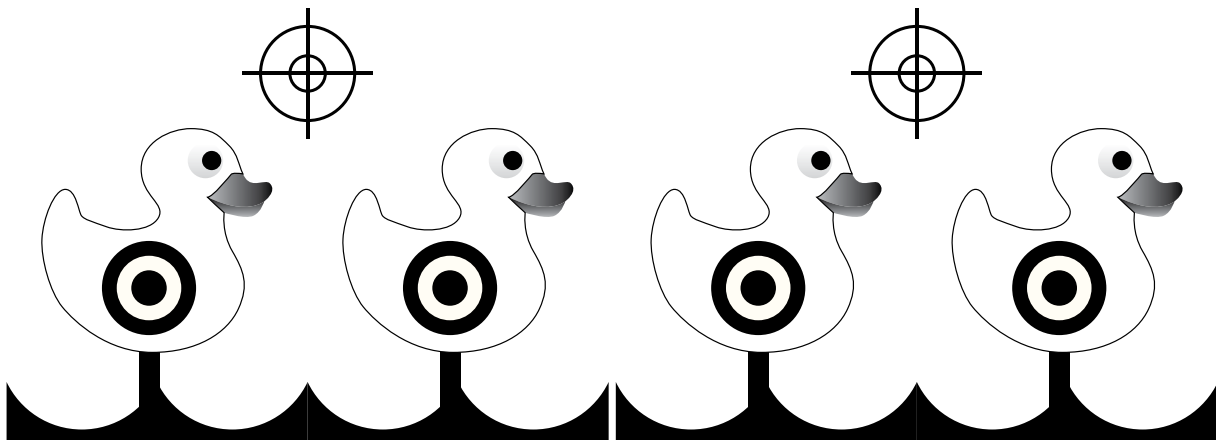
<sup>a</sup> 3 million taxpayers x \$200k x 10% average tax rate + 7 million taxpayers x \$100k x 5% average tax rate = \$95 billion

<sup>b</sup> 1 million taxpayers x \$200k x 10% tax rate + 9 million taxpayers x \$100k x 5% tax rate = \$65 billion

<sup>c</sup> 3 million taxpayers x \$200k x 6.8% tax rate + 7 million taxpayers x \$100k x 6.8% tax rate = \$88.4 billion, rounded down in chart

<sup>d</sup> 1 million taxpayers x \$200k x 6.8% tax rate + 9 million taxpayers x \$100k x 6.8% tax rate = \$74.8 billion, rounded up in chart

<sup>e</sup> Exact figure is \$82.96 billion



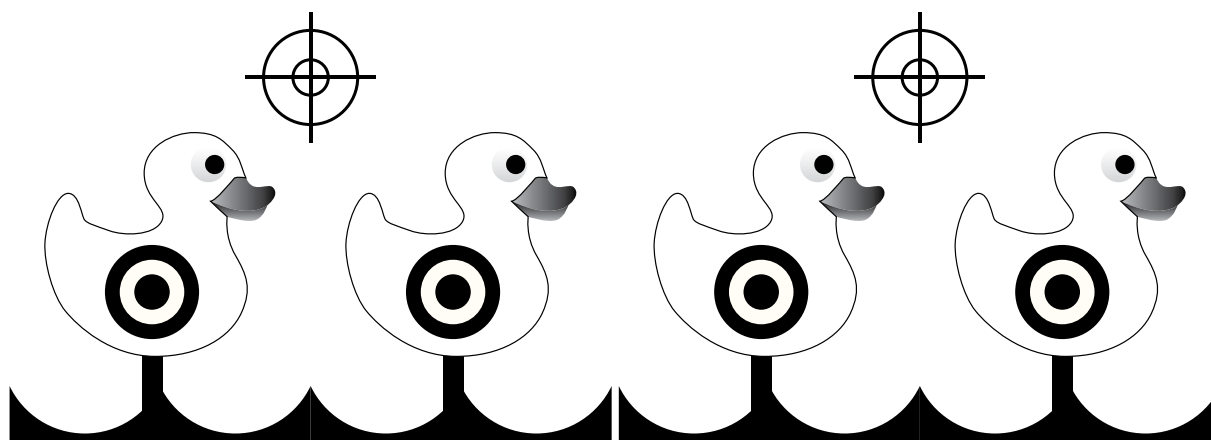
boom years, but only \$65 billion during recession years. This is a huge swing in revenues, far more pronounced than the change in the underlying tax base. In contrast, with a flat-rate tax of 6.8 percent on all income levels, the state legislature receives roughly \$88 billion during boom years, and roughly \$75 billion during recession years. (To repeat: The numbers in Table 4 make the point about revenue stability. The actual flat rate of the PRI plan is 3 percent, not 6.8 percent.)

22

Over the five-year period, both approaches yield the same average revenue of \$83 billion per year. The advantage of the flat tax, however, is that this equivalent long-run revenue stream is more consistently divided among the five years; the drop in revenues from boom to recession is only \$13 billion for the flat tax, in contrast to the enormous \$30 billion crash in revenues under the progressive system. In a sense, under the flat tax the legislature moves \$7 billion from each of the three good years in order to have \$10 billion in extra money during the two bad years.

Policy makers should not underestimate the importance of this difference between a progressive and a flat tax. During periods of prosperity, legislators will be tempted to increase spending programs commensurately with the surge in tax receipts, and have done so consistently in California. The more even distribution of those receipts—over good and bad years—under the flat tax provides a built-in measure of fiscal discipline. Rather than trusting that legislators (and ultimately the voters) will responsibly put aside tens of billions of dollars for a rainy day, the flat tax does this automatically. Obviously, even under a flat tax, revenues will be higher during periods of growth than in bad years. Yet these differences are much less pronounced than under a progressive tax system.

Before leaving this section, we should make two additional points concerning the hypothetical demonstration in Table 4. First, the reduced volatility in tax receipts illustrated with these numbers relies solely on eliminating the exaggeration caused by graduated tax brackets. These hypothetical numbers do not reflect any of the increased incentives to earn income that would surely materialize under a flat-tax system. In other words, in Table 4, we have assumed that the underlying economy performs the same, regardless of whether there is a 10-percent rate on the highest earners, or whether there is a 6.8-percent rate. As we know, this assumption is very conservative and omits one of the key benefits of a flat tax.<sup>14</sup>



The second interesting point is that the equivalent, i.e., revenue-neutral flat-tax rate came nowhere near splitting the difference between the two rates under the progressive system. In other words, one might have supposed that a flat-rate tax of 7.5 percent would be necessary to replace the 10-percent/5-percent progressive system, at least if we do not consider the incentive effects.

But as Table 4 demonstrates, this reasonable belief is wrong. Depending on the distribution of taxpayers among the various income brackets, and in particular depending on how that distribution changes from good years to bad, the equivalent flat-tax rate need not be the arithmetic average of the original rates for the graduated income brackets. More to the point, it is not true that a reduction in rates for the top earners needs to be offset by an equal increase in the lowest rates. With the hypothetical numbers used in Table 4, for example, a 3.2-point cut in the higher rate required only a 1.8-point hike in the lower rate.<sup>15</sup>

## Three: The Benefits of a Flat Tax in Practice

Besides spurring economic growth, which in turn boosted total tax receipts despite the lower rates, the three episodes demonstrate that sharp reductions in the top income-tax rate lead to a greater share of total taxes paid by the highest income earners.

**T**he previous section explained the theoretical advantages of a flat tax. This section uses real-world examples, drawn from the United States and around the world, to show the benefits of the flat tax in action.

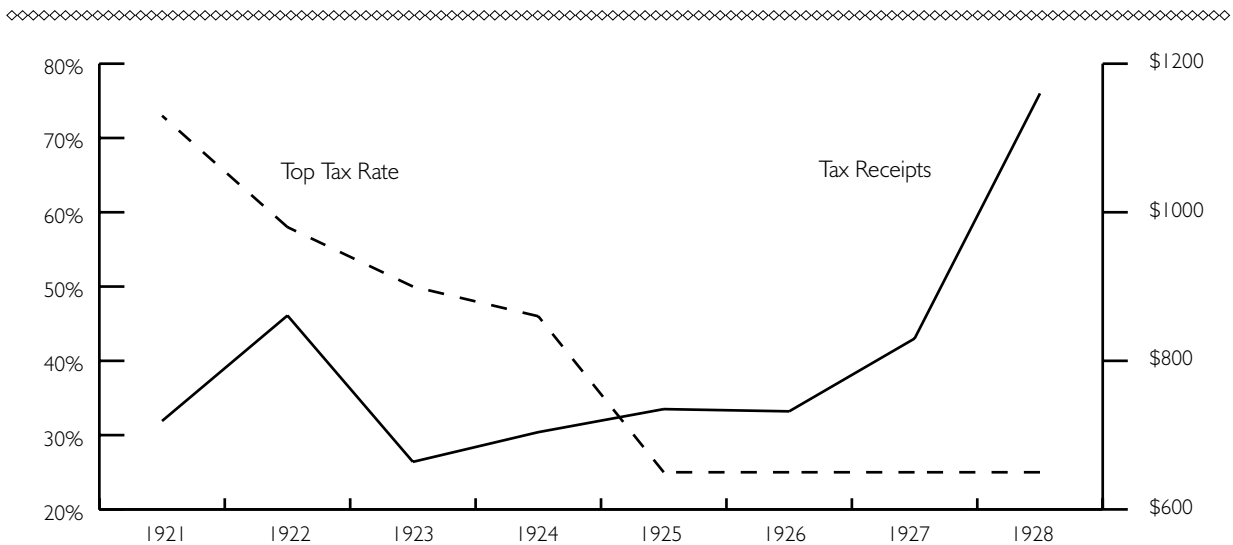
## The United States Experience

To help fund the Civil War, the United States introduced its first income tax at the federal level as part of the Revenue Act of 1861, which imposed a flat rate of 3 percent on all incomes above \$800. This particular tax was rescinded in 1872, and ultimately, in 1895, a Supreme Court ruling (requiring apportionment among the states on taxes on income derived from property) made federal income-tax collection impractical without constitutional amendment. The Sixteenth Amendment allowed the imposition of the modern federal income tax in 1913, and it had seven brackets at its inception.<sup>16</sup> Unfortunately, the United States has never since then enjoyed a flat income tax on the federal level, which makes it difficult to test the claimed theoretical advantages of Section II. Even so, there are three major episodes of twentieth-century tax reform in the direction of a flat tax, in which marginal rates were slashed. These episodes are the Harding-Coolidge tax cut, the Kennedy tax cut, and the Reagan tax cut. As Figures 5-7 show, in each episode, large cuts in the top federal income-tax rate helped produce large increases in total tax receipts collected. The supply-side incentives of reductions in the tax rate are well supported in U.S. history.

Besides spurring economic growth, which in turn boosted total tax receipts despite the lower rates, the three episodes demonstrate that sharp reductions in the top income-tax rate lead to a greater share of total taxes paid by the highest income earners. This may seem paradoxical, but in fact it makes perfect economic sense.

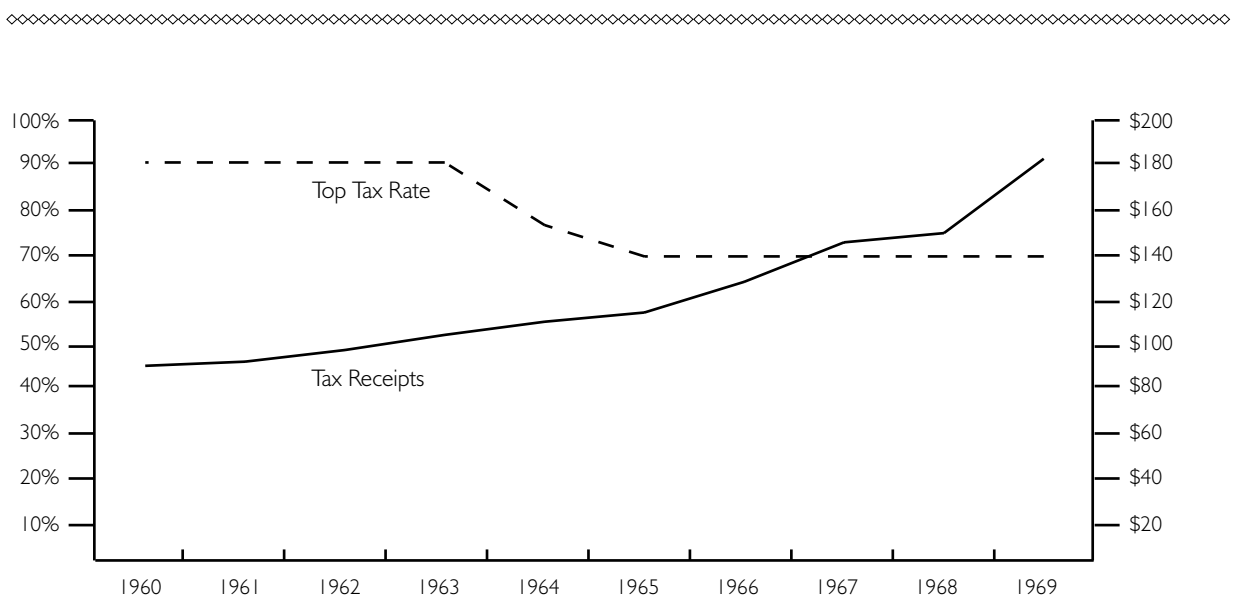
By unleashing the economy's most productive individuals, and by removing the incentive to shield or misreport income, tax-rate cuts cause the biggest increase in income at the top. Although often disparaged as further proof of "tax giveaways to the rich," the rise in upper incomes is partly the outcome of class mobility and simple arithmetic: If previously middle-class individuals start new businesses and become multimillionaires, their success will show up as a gain for "the top 1 percent" rather than for the middle class. In any event, Figures 8 and 9 show just how dramatically the total tax burden is shifted to the richest taxpayers following cuts in the tax rate:

**Figure 5**  
Tax Rates and Revenues during the 1920s  
(top marginal income-tax rate vs. \$ millions total federal income-tax receipts)



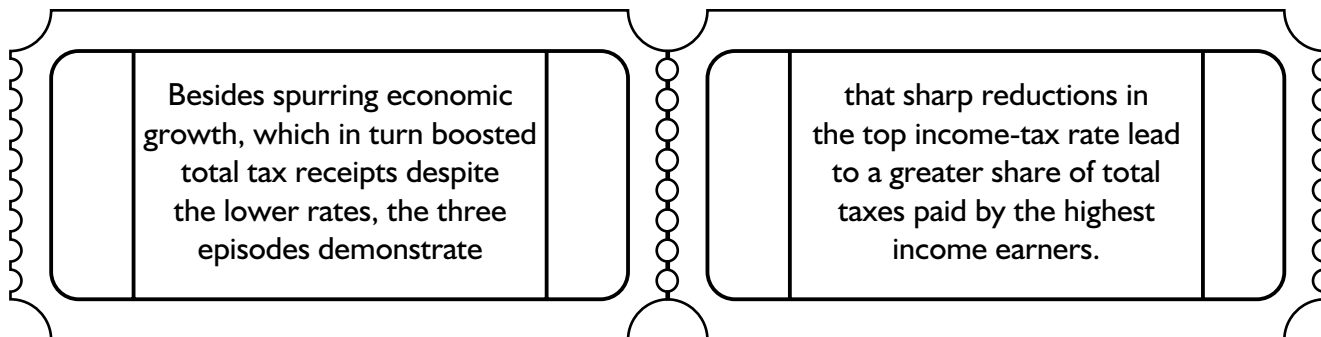
Sources: The Tax Foundation, Joint Economic Committee

**Figure 6**  
Tax Rates and Revenues during the 1960s  
(top marginal income-tax rate vs. \$ billions total federal income-tax receipts)



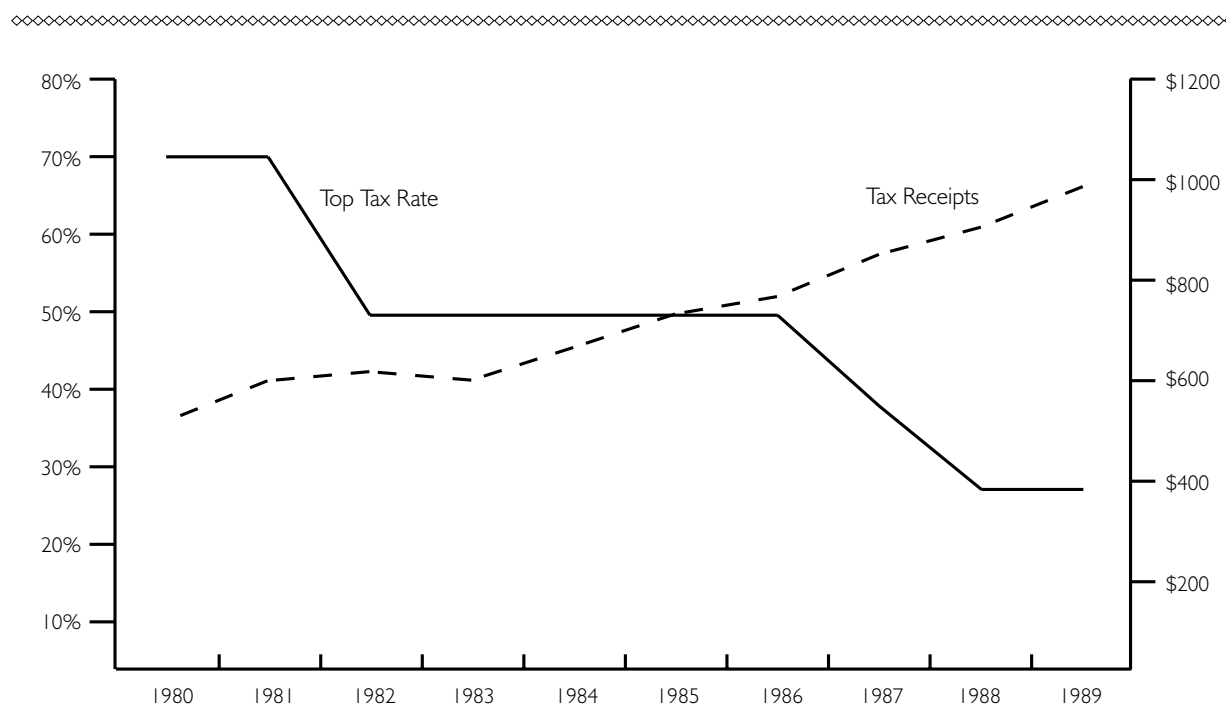
Sources: The Tax Foundation, U.S. Census Bureau





**Figure 7**

**Tax Rates and Revenues during the 1980s**  
(top marginal income-tax rate vs. \$ billions total federal income-tax receipts)

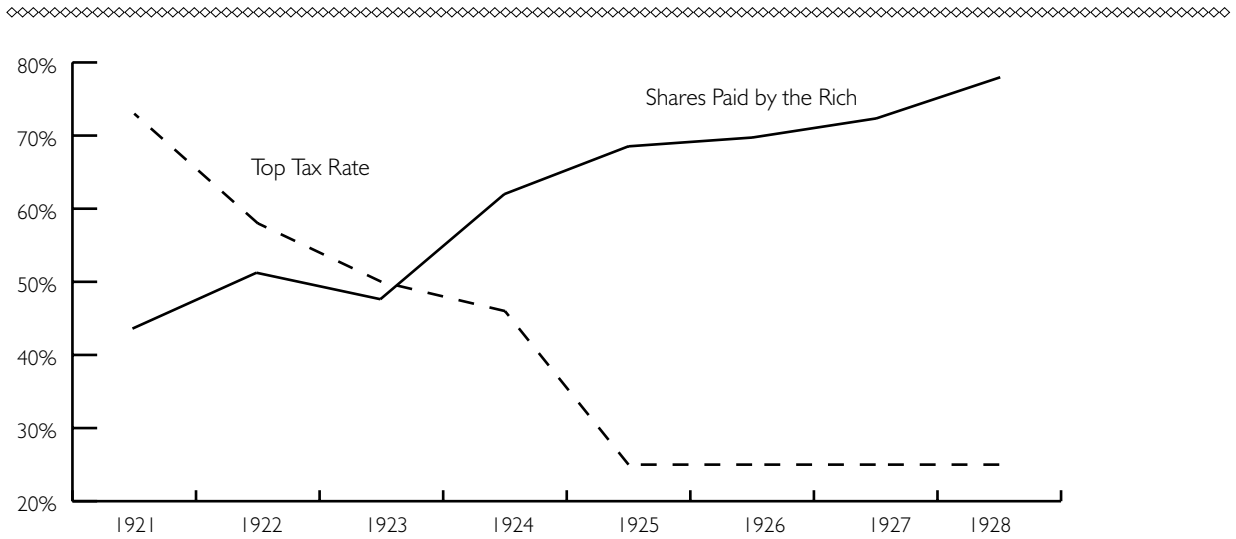


Sources: The Tax Foundation, U.S. Census Bureau

A similar story could be told of the Reagan years. For example, in 1981 the top 1 percent of income earners paid 18 percent of all income taxes. By 1988, the top 1 percent was paying 28 percent of all income taxes, despite (or, as we are suggesting, because of) the large rate reductions during the 1980s.<sup>17</sup>

## Figure 8

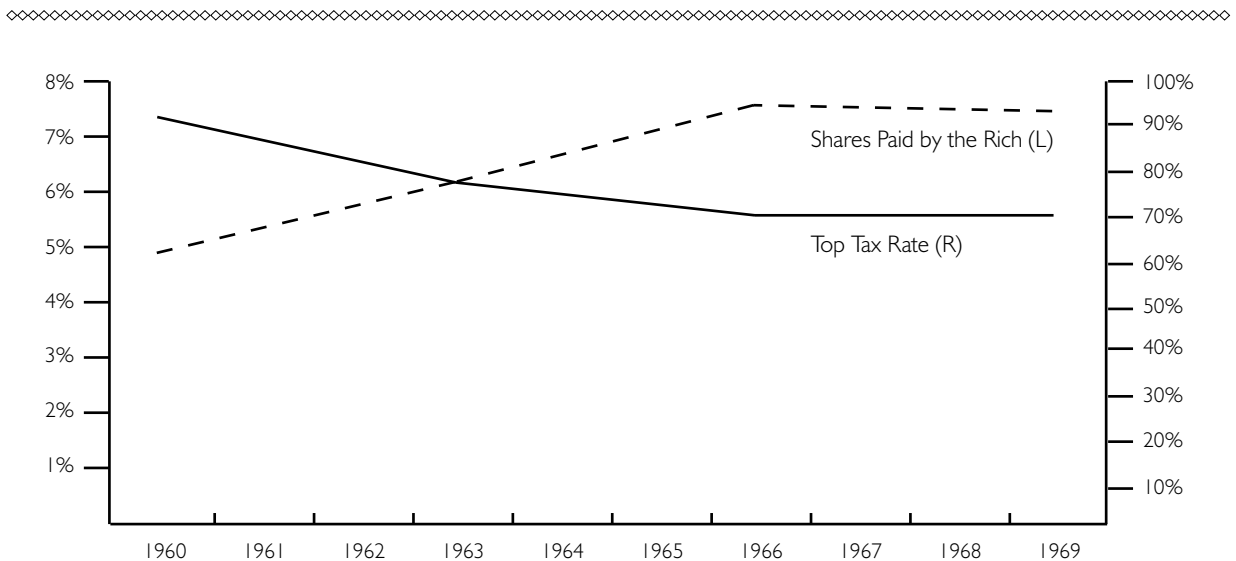
Tax Rates versus Taxes Paid by the Rich during the 1920s (top marginal income tax rate vs. percentage of taxes paid by those earning net incomes above \$50,000 historical)



Sources: The Tax Foundation, Joint Economic Committee

## Figure 9

Tax Rates versus Taxes Paid by the Rich during the 1960s (top marginal income tax rate vs. percentage of taxes paid by those with AGI above \$100,000 historical)



Source: The Tax Foundation, Joint Economic Committee

## Flat-Tax Success Around the World

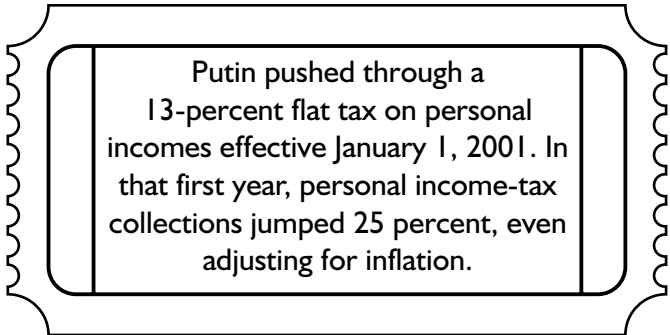
Although the United States has not had a flat income tax since its modern incarnation in 1913, many countries around the world have implemented a flat tax, and with much success. Albania, Bulgaria, Estonia, Georgia, Guernsey, Iceland, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Mauritius, Mongolia, Montenegro, Romania, Russia, Serbia, Slovakia, and the Ukraine<sup>18</sup> all have some form of a flat tax, and the concept is being seriously considered in Canada, China, Croatia, Germany, and Spain. As the momentum builds, tax competition among governments propels others to follow.<sup>19</sup>

Consider the case of Russia. When President Vladimir Putin took office in 2000, he faced a horrendous tax system rife with evasion and corruption. In July of that year, Putin pushed through a 13-percent flat tax on personal incomes, to be effective January 1, 2001. In that first year, personal income-tax collections jumped 25 percent, even adjusting for inflation. In the following year, the feat was almost reproduced, with real revenues increasing by almost an additional 25 percent. By the end of 2004, income-tax revenues had more than doubled since the imposition of the flat tax four years earlier.<sup>20</sup>

Estonia provides another example. In 1994, it replaced its multi-rate system with a flat tax of 26 percent (and a personal exemption of roughly \$1,000 per year). In the five years preceding the reform, Estonia's economy had contracted. In the eight years after the switch to a flat tax, Estonia enjoyed average economic growth of 5.2 percent per year.<sup>21</sup>

Slovakia started with a horribly complicated code—replete with five tax brackets ranging from 10 percent to 38 percent, 90 different exemptions, an additional 27 items that carried their own particular tax rates, etc. In October 2003, the confusion was reined in through the setting of a single rate of 19 percent for the corporate income tax, personal income tax, and value-added tax. In the first year after the reform, tax collections increased by 36 percent. International automakers signed agreements to relocate manufacturing plants to the country, causing the *New York Times* to dub Slovakia the “Detroit of Europe.”<sup>22</sup>

As these examples demonstrate, flat-tax reform is not just a theoretical curiosity but something that actually works. Countries around the world have successfully implemented flat-tax systems that reduce the burden on their citizens while increasing revenues to the government. California can enjoy this success too—if only it has the will to reform.



Putin pushed through a 13-percent flat tax on personal incomes effective January 1, 2001. In that first year, personal income-tax collections jumped 25 percent, even adjusting for inflation.

## Four: A Primer on Income Tax Theory

When it comes to taxing income, the starting point is net income. This is the flow of consumption purchases that people can make in the present, without impairing their ability to buy things in the future.

**T**he final section of this paper will show how a simple 3-percent flat tax on personal and net corporate income can raise the same revenues currently yielded by the progressive personal and corporate taxes and the estate, inheritance, and gift taxes. But before we go through the calculations that led to our figure of 3 percent, it will be helpful to explain the philosophy of income taxation. The following primer is intended to illustrate and resolve some of the thorny practical issues that arise when it comes to actually implementing an income tax.

The following discussion starts at a very basic level, and then becomes progressively more complex. The casual reader can safely move on to Section V whenever he has “had enough.” The issues discussed, however, are crucial to successful, real-world tax reform. Policy makers need at least to understand the consequences of various attributes of a tax system, whether or not they agree with the recommendations suggested below.

## **The Starting Point: Net Income**

When it comes to taxing income, the starting point is net income. This is the flow of consumption purchases that people can make in the present, without impairing their ability to buy things in the future. If someone owns an apple tree that requires no care, then every season its harvest of apples is net income to the owner. Selling (or eating) the apples doesn’t impair the ability of the tree to produce more apples in the following year. By the same token, a worker “owns” his body, which is capable of producing services that can be sold on the market. The money received for these services is net income, because by selling them today, the worker (under normal circumstances) does not impair his ability to produce labor services in the future.

The basic idea of an income tax, then, is for the government to siphon off a portion of this net income, to divert it from the private owner’s pocket and into state coffers. As long as the taxation is applied to net income, the government enhances its own consumption at the expense of potential consumption on the part of the citizen. Thus the owner of the tree must surrender a portion of her apple crop every year to the government, and the worker must surrender a portion of his “crop” of labor services. In a market economy, citizens enjoy the net income from ownership

of productive assets (whether an apple tree or a pair of skilled hands). To fund its activities, the government splits this stream of income so that a portion flows to the state while the remainder flows to the citizen-owners of the productive resources.

## Net Income in a Business Enterprise

Things are much trickier when it comes to a business enterprise that creates new assets or goods from those that already exist. Suppose Eddie the entrepreneur starts with \$1,000 of his own savings. He spends \$100 on apples, \$280 on caramel, and \$20 on wooden sticks. Then he spends the remaining \$600 hiring workers to assemble caramel apples and hawk them at a county fair. When all of the materials are gone and the workers have completed their shifts, Eddie is left with, say, \$1,200 that customers spent on the caramel apples. How, if at all, should he be taxed?

Because we are taxing net income—not wealth—it is clear that Eddie should be taxed only on the \$200 that he earned over and above his business expenses. After all, he needs to collect \$1,000 just to break even and to be able to repeat the process again at the next county fair. This exclusion of his business expenses—i.e., giving the entrepreneur the ability to deduct his wage and material costs—also avoids double taxation. For the apple tree’s owner, the \$100 Eddie spent buying her apples is part of her net income, and she is being taxed on it. Therefore, it would be inappropriate to tax Eddie on that \$100 as well. Similarly, \$280 of Eddie’s revenue went to a different entrepreneur, the one who bought the ingredients and labor necessary to make caramel, and it will be appropriately taxed in that arena. Therefore, both for consistency and to avoid double (or triple, etc.) taxation, Eddie should not be taxed on the full \$1,200 he received in revenues. He should be taxed only on the profit he received, i.e., his revenues minus business expenses.

## Dealing with Durable Assets

The next complication concerns durable (or fixed) assets, i.e., investment expenditures on items that last for more than one cycle of production. Returning to our story of Eddie the entrepreneur, suppose we make the tale more realistic. In addition to the \$400 on materials and the \$600 on labor, Eddie now also spends \$200 buying a heating unit to keep the caramel gooey. At the end of the fair, he once again has received \$1,200 from customers. But now his total amount of capital invested in the business has gone up to \$1,200. Does that mean his net income is zero, and that he shouldn’t be taxed? To answer this question requires a return to basics.

Our flat-tax plan will allow businesses only to deduct periodic depreciation of durable assets, rather than fully write them off at the time of purchase.

Recall that the definition of net income refers to spending that one could make without changing the original capacity to earn future income. In our revised story, Eddie started with \$1,200 of his own savings, and spent it all on materials, labor, and a heating unit. After the county fair, he was left with his original \$1,200, plus a slightly used heating unit. The cycle of business operations thus puts him in a better position to earn income in the future. At the next fair, for example, Eddie will have to shell out only \$1,000 in order to reap \$1,200 in revenue, because he can still use the same heating unit. At this point, there are two ways to proceed.

One plausible approach would say that Eddie has zero net income in the first year (when he buys the heating unit), and then \$200 in net income in every subsequent year for the life of the heating unit. He would pay no income tax in the first year, but he would be taxed on the \$200 in each of the subsequent years. In other words, we could allow the entrepreneur fully to expense (or write off) equipment costs as they are incurred.<sup>23</sup>

Another plausible approach would allow the entrepreneur to deduct the periodic depreciation, rather than the full purchase price, of fixed assets. For example, if the heating unit could serve perfectly well for four county fairs, but then had to be thrown out as junk, the annual depreciation of the unit would be (roughly)<sup>24</sup> \$50 per year. Eddie would then be taxed on net income of (roughly) \$150 every year, regardless of whether a new heating unit had been purchased in that particular year.

In this proposal, we adopt the second approach; that is, our flat-tax plan will allow businesses only to deduct periodic depreciation of durable assets, rather than fully write them off at the time of purchase. There are several reasons for our preference.

Revenues to the state will be more stable under our preferred approach. In our hypothetical example above, over a four-year period the state's tax base on the entrepreneur would be \$0, \$200, \$200, \$200 with full expensing, while it would be (approximately) \$150, \$150, \$150, \$150 with a depreciation deduction. This is a serious concern if a state implements flat-tax reform, because the enhanced incentives for investment could cause a serious shortfall for the treasury in the first year of the switch, as businesses engage in massive capital expenditures. More generally, if businesses can deduct only the depreciation on assets, legislators would have more time to react to unintentional consequences of tax reform. For example, it would take much longer for individuals to carry out a scheme of tax evasion or outright fraud, whereby one firm (perhaps operating offshore or suffering a huge loss) sold assets at an inflated price to another firm so the purchaser could reduce its tax liability.

Besides the pragmatic reasons, in this study we prefer the depreciation approach because it is also more logically consistent when one is taxing income (rather than consumption or business value-added).<sup>25</sup> For example, suppose Eddie decides not to buy the heating unit, but rather to rent it every year from a popular store, Heaters R Us. If the rental price for use during one county fair is \$50, then our entrepreneur would deduct this as an expense comparable to his

wage payments or the expenditures on caramel. In this scenario, his net income from the operation would clearly be \$150. Therefore, simple consistency would seem to require that if he buys the heating unit outright and “rents” it from himself, then his net income from the business of caramel apple production shouldn’t be altered. The degree of profitability of that enterprise (at this level of analysis) isn’t affected by the identity of the owner of the heating unit.

Another advantage of the depreciation approach is that it more accurately reflects the time value of money. To put it succinctly, the full-expensing method understates net income, because it ignores compound interest. In the heating unit scenario, Eddie starts with \$1,200 of his own money. The question is, out of the \$1,200 that he receives from his customers in revenues every year, how much can he spend, say, at the racetrack, so that when the heating unit finally dies and must be thrown out, Eddie is left with his original \$1,200?

If all he wants to do is engage in one four-year period of production, Eddie can spend \$200 at the racetrack in each of the first three years, using the remaining \$1,000 each year to buy materials and hire workers for the following year. Then, in the fourth year, he can’t spend anything at the track, because the \$1,200 in revenues replenishes his initial savings. Thus, on this analysis, his net income stream was \$200, \$200, \$200, \$0. But as we’ve seen above, the full-expensing method taxes the entrepreneur as if his income stream were \$0, \$200, \$200, \$200. As any finance student knows, the first income stream has a higher present value because of interest.

As the above example demonstrates, when taxing income it is actually incorrect (at least from a theoretical perspective) to allow full write-offs of capital expenditures, because such an approach does not accurately measure net income. Proponents of full expensing rightfully point to the higher incentives for savings and investment under their approach; what they are doing is taxing consumption rather than income. It is true that a consumption tax offers less distortion of the saving/consumption decision than an income tax does. However, there are also drawbacks to a consumption tax. As we have already pointed out, switching from the current income approach to a tax on consumption might involve a huge drop in revenues, if the consumption tax rate is not calibrated to the actual amount of investment that occurs under the new system. This might discredit the tax reform in its infancy, since opponents would have predicted huge deficits.

Another consideration is that voters and taxpayers understand what an income tax is, and they find it intuitively fair; people and businesses owe a higher tax bill when they have more income. But under a consumption tax—or what is the same thing, an “income” tax that allows businesses to fully expense their investments—there could be outcomes that strike many as absurd. For example, a very profitable business that invests in new equipment could actually pay zero taxes, while a firm that goes out of business and sells off its assets in order to satisfy its creditors might have a high tax bill, despite its large loss for the year.



There are pros and cons to a flat consumption tax versus a flat income tax. In this study we are proposing a flat income tax, and consequently we do not allow full expensing of capital investments. Meanwhile, we are ready to alter our story yet again.

## Dealing with Capital Gains and Losses

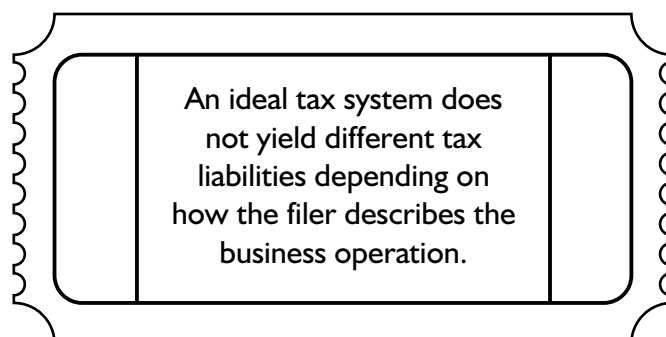
Suppose that, as before, Eddie starts out with \$1,200 of his savings. As before, he spends \$400 on materials, \$600 on labor, and \$200 on a heating unit. After the first county fair, he is left with \$1,200 from customers and a one-year-old heating unit. Yet now, what if he decides to sell the heating unit—for \$120, let’s say—and retire to Florida? What should be the tax treatment in this scenario?

As always, we need to calculate the net income from the operation. Eddie took his initial \$1,200 and ultimately turned it into \$1,320 (the \$1,200 in revenues from customers plus the \$120 from selling the one-year-old heating unit). His net income is therefore \$120, and that is the amount that should be subject to taxation. Note that in this scenario, when he decides to retire after the first year, his net income is lower than the (roughly) \$150 subject to taxation in the first year when he stays in business. This roughly \$30 difference reflects the fact that the one-year-old heating unit is worth more in Eddie’s caramel apple business than its value to another enterprise.

The rule holds in the opposite case, too, where (for some reason) Eddie is able to get a higher price for his heating unit. For example, suppose that after the first county fair, a road crew accidentally shatters a natural-gas pipeline. Consequently, some of the restaurants in the area scramble for electric powered heating units, even one-year-old used ones. Eddie sells his unit for \$500, believing that conditions will return to normal by the next county fair. Therefore, he has turned his initial \$1,200 into \$1,700, so his taxable net income is clearly \$500.

This scenario shows the importance of a single flat rate on all types of net income. If the rate on net business income is the same as the rate on capital gains, then it doesn’t really matter how the \$500 gain is broken down. If we like, we can say that Eddie earned a \$200 profit from turning resources into caramel apples, while he enjoyed a \$300 capital gain on the heating unit.

What if the capital gains tax rate is lower than the tax rate applied to normal business income—as is the case currently in the federal tax code? Then Eddie would rightly quibble with the above breakdown. He could quite reasonably point out that the \$200 net income from the caramel apple business is an overstatement; after all, had he



kept his heating unit and depreciated it according to the treatment we described earlier, then he would have been taxed on a net income of only (roughly) \$150. What has happened in this latest scenario, Eddie would point out, is that his capital gain is higher than originally estimated. He bought a new heating unit for \$200, and then sold a used unit for \$500. Since a new unit is more valuable than a used one, the capital gain is surely more than \$300. Therefore, Eddie could conclude in his letter to the state treasury that his overall gain of \$500—from his initial \$1,200 to his subsequent \$1,700—represents something like a \$150 gain from caramel apple production and a \$350 capital gain from speculation in heating units.

And what would happen in the opposite case, where capital gains were taxed at a higher rate than normal business income? Here too, Eddie could make a plausible claim to reduce his liability. He could argue that far from being a “capital gain,” the sale of the heating unit should be treated as part of his normal revenues. This is because, Eddie could argue, he is in the business of producing caramel apples and “previously enjoyed heating units.” The primary ingredients for these products are labor, apples, caramel, wooden sticks, and brand-new heating units. After using his trademark processes, Eddie had his finished products, namely caramel apples and used heating units, which he then sold to customers (in this particular year) for a total of \$1,700. Deducting his expenses for materials of \$1,200, he has a net business income of \$500 that should be taxed at the lower rate. There is nothing left to be counted as an alleged “capital gain.”

Although this particular scenario is fanciful, we stress that this type of ambiguity will arise in the real world if incomes are taxed at different rates depending on how the situation is framed—and it is precisely this ambiguity that keeps many tax attorneys employed. (For example, in 2007 there was a major controversy over the appropriate tax treatment of a hedge fund’s “carried interest.”) Under a flat tax with one rate on all types of income, and in which the depreciation on durable (yet retained) assets is deductible, the various viewpoints all yield the same result. Although at first seemingly complicated, the framework is actually quite simple. There is not even a categorical distinction between expenses for materials (such as apples and caramel) and expenses for durable equipment (such as the heating unit). These assets are actually treated in the same fashion; it is just that the materials are fully depreciated after one use, and so their full purchase price ends up being deducted.

To repeat, an ideal tax system does not yield different tax liabilities depending on how the filer describes the business operation. In the latest scenario, if Eddie wants to treat the new heating unit as a “material input” and the used heating unit as a “finished good” for his customer the restaurant owner, this unorthodox framing will not change his tax liability. In this approach, he would report total receipts of \$1,700 from sales to fairgoers and the restaurant. Out of that, he would deduct \$1,200 for his wages and material expenses, where the latter include the \$200 spent on the new heating unit. Therefore, his net taxable income is \$500, as we know it should be. Although it seems that we have abandoned our devotion to the rule of deducting only depreciation—rather than allowing full write-offs of investments in equipment—this appearance is deceiving, because in this contrived example the entrepreneur sells the durable asset after only

one period of use. The next section will illustrate the depreciation rule more clearly, when the durable asset is held for more than one year.

## Handling Sales of Durable Assets after Several Years of Use

Suppose now that Eddie chooses to retire after the second county fair. In the beginning, he starts with \$1,200 of his own savings, and spends it all on materials, labor, and a new heating unit. After the first fair, he has \$1,200 from sales to customers, and a one-year-old heating unit. When filing his taxes for this year, he claims the \$1,200 in revenues, deducts the \$1,000 in wages and material costs, and also deducts (roughly)<sup>26</sup> \$50 in depreciation on the heating unit, for a taxable net income of \$150.

After the second fair, Eddie finds himself with \$1,200 in revenues and a two-year-old heating unit. Because the children at the event were particularly snotty brats this time, he decides to sell his heating unit (for \$80 on eBay) and move to Florida. When filling out his taxes, he again claims his \$1,200 in sales, and deducts the \$1,000 spent on wages and materials as well as the \$50 in depreciation on the unit. But in addition, this year he also claims a \$20 capital loss on the heating unit, because it was valued (for accounting purposes) at \$100 after the second year—it had gone through two rounds of depreciation by that time. Yet since he sold it for only \$80 (rather than its \$100 “basis,” as it was valued by his accountant on his books), he suffered a \$20 loss in capital value. For the year as a whole, then, Eddie would claim a net income of \$130 (\$1,200 in gross revenues minus a total of \$1,070 in deductions). Notice that in this more orthodox treatment, Eddie does not count the \$80 from the sale of the heating unit as part of his business receipts, just as he did not deduct the initial \$200 purchase price as a business expense.

37

## Handling Interest and Dividends

Naturally, we can tweak the story yet again to make it more complicated, in order to understand the basis for implementing a coherent tax system. Up until now, we have assumed that Eddie started his business with funds that he had saved himself. But what if he borrowed the initial \$1,200 from his friend Larry at 5 percent interest?

As always, we compute Eddie’s net income by asking how much he could consume out of his gross proceeds, without impairing his future production. Since Eddie starts out with nothing, the question reduces to: How much can Eddie consume each year, while keeping up

If we are convinced that interest expenses should be deductible, and interest income taxable, then it naturally follows that dividend payments should be deductible while dividend income should be taxable.

with his interest payments and then being able to return the \$1,200 loan after the heating unit is scrapped?

If we, as before, treat the depreciation on the machine as \$50 per year, then Eddie's net income is \$90 per year. Out of his \$1,200 in gross revenues, he deducts \$1,000 in materials, \$50 in depreciation, and \$60 in interest payments to Larry. To check that this is correct, consider this: Going into the fourth county fair, Eddie has accumulated three years' worth of \$50 depreciation allowances, i.e., \$150 (under his mattress, let's say). After the fourth use, the heating unit is junk, and Eddie has \$1,200 from his sales of caramel apples, for a total of \$1,350 in his possession. Out of this, he makes the final interest payment of \$60 to Larry, and also returns the principal of \$1,200. Eddie is left with \$90 in net income in the last year, to spend as he pleases.

It is obvious that interest expenses should be tax deductible, just like wage payments or material costs. In a sense, Eddie has "rented" the use of a capital sum from Larry, at a price of \$60 per year. Just as it would clearly be a deductible business expense if Eddie had to rent a pressure washer to clean caramel off the pavement after the fair, by the same token, it is a deductible expense if Eddie needs to rent money in order to run his business.

By symmetry, Larry the lender would report the \$60 interest payments as net income when filing his taxes. After all, he starts with \$1,200 of his own money, and can consume the \$60 yearly payments without reducing the market value of this asset; he receives his \$1,200 back in perfectly good condition after four years. The market value of his \$1,200 at that time is still \$1,200.<sup>27</sup>

If we are convinced that interest expenses should be deductible, and interest income taxable, then it naturally follows that dividend payments should be deductible while dividend income should be taxable. In terms of calculating net income, there is no essential economic difference between Larry lending Eddie the initial \$1,200 and Eddie selling Larry \$1,200 in stock during the IPO for his caramel apple corporation. If the legislature—as is typical today—treats corporate interest payments differently from corporate dividend payments, then this introduces an arbitrary incentive into the economy for corporations to issue debt rather than equity. In a simple story such as ours featuring Eddie and Larry, this arbitrary incentive would be innocuous; the two would simply deal with each other in the cheapest way without affecting the production of caramel apples. In the real world, however, there are (perhaps subtle) reasons that companies issue debt versus equity. When the legislature arbitrarily places one method at a disadvantage, it reduces the total wealth of society and shrinks the total pie of (pre-tax) income.

## A Note on Complexity and Tax Evasion

We have reached the end of our discussion of ideal tax theory. Throughout, we have assumed that the goal of an income tax should be to capture a stated percentage of an individual's net income. This simple requirement becomes complicated only because the calculation of net income is itself

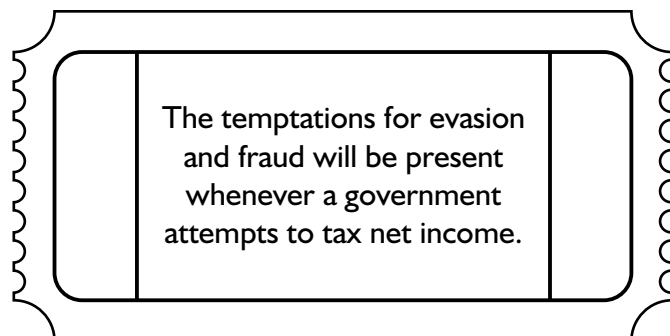
problematic in real-world circumstances. Fortunately, the necessity for keeping track of wage payments, asset depreciation, dividend disbursements, capital gains or losses, etc., is not purely for tax compliance; any business enterprise needs to make such calculations to determine if it is profitable. For example, a successful Christian businessman is not burdened with compliance costs by his church's request for a 10-percent tithe; presumably, the businessman already calculates his net income in order to determine if, say, the family can afford a trip to Paris in the summer. And there is no issue of whether his calculations will be "honest," since the whole plan is voluntary.

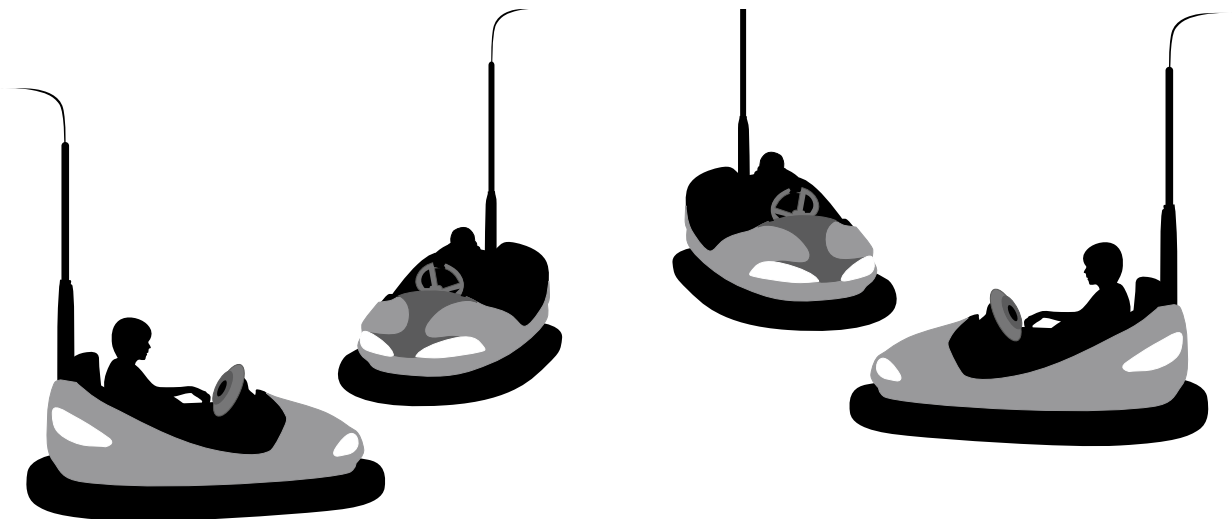
Of course, most taxpayers do not view the legislature as worthy of worship. And although federal and state tax codes in the United States rely on "voluntary" compliance, they are ultimately enforced through penalties. This adversarial relationship leads to tax evasion or outright fraud. One of the benefits of a simple, flat tax is that it reduces the incentives and ability to engage in such schemes, but the problem remains. Because of this inescapable conflict, in some cases the legislature may have to choose between enforcement and simplicity.

For example, a corporation might create a shell company to which it sells (on paper) all of its durable equipment at a huge "loss," and then turn around and rent the equipment from the shell company at very low prices. The end result of this scheme would be to shift taxable income into the future, raising the present value of the business and reducing the value of its tax payments to the government. To crack down on the grossest of such abuses, the legislature may have to amend the tax code, inserting somewhat arbitrary rules on capital losses and depreciation schedules. Such amendments will cause the tax code in practice to deviate from the ideal system described in this section.

We should stress that the temptations for evasion and fraud will be present whenever a government attempts to tax net income. This is the source of the conflict, and the shifting of durable assets is a mere symptom. For example, if a doctor and a lawyer each had the other as a client, they could agree to charge each other \$1 annually for their services, thus reducing the taxable income each reported to the government. If such abuse became rampant, the government might consider issuing rules for "appropriate" prices that various professionals could charge their clients. To repeat, a flat tax will not entirely eliminate such problems, but its simpler structure and lower marginal rate should at least provide a great improvement over the current system.

Finally, we note that a flat tax would still be incredibly simple for personal filers, to the extent that they are passive own-





ers of assets that produce streams of income. (In contrast, businesses combine inputs to create new assets or goods.) Personal filers would report any income from wages, interest, dividends, rental property, etc., and be taxed accordingly. Unfortunately, here too complications arise because, in some respects, the typical household often behaves as a business enterprise.

A dual flat-tax system—where personal filers report their income and nothing else, while businesses report net income as described above...provides simplicity for the typical individual taxpayer and coherence for the business taxpayer.

For example, even if a young couple both have salaried jobs and don't consider themselves a "business," they might still apply for a mortgage in order to buy a house. Should the interest payments on their mortgage be tax deductible? If they sell the house at a huge profit in three years, should they be taxed on the capital gain? What if the wife spends \$20,000 in tuition acquiring the skills for a job that is ultimately outsourced to India—should she be able to claim a loss in her "human capital" when filing? And if the gasoline used by an airline is a deductible expense, why isn't the monthly grocery budget a deductible expense for the household? After all, workers need fuel just as planes do.

There is no definitive answer to these questions. Pushed to the extreme, economic theory could certainly offer a judgment on the "correct" way to calculate net income in various situations. Yet this doesn't mean that a tax system ought to follow such strictures, because of the onerous costs of compliance. This proposal recommends a two-tiered system, one for personal filers and one for business entities. The personal form would be the famous postcard, where the individual would list his income from various sources. There would be no deductions, exemptions, or credits. The individual filer couldn't deduct mortgage interest, but by the same token, the individual filer wouldn't be taxed on capital gains from selling a house. The individual couldn't deduct tuition, meat purchases, or business suits as deductible expenses, but by the same token, he wouldn't have to bother saving receipts all year.

In practice, the line between “personal household” and “business” will be fuzzy. Here too the legislature will have to strike a balance between simplicity and accuracy. For example, according to the simplified postcard filing described above, if a couple sold their residence (for a profit) because of a job relocation, they would not be taxed on the capital gain. Yet what if the couple annually bought a second house, in order to renovate it and flip it the following year? What if the couple bought a new house every three months—turning over four houses per year—and paid hundreds of thousands of dollars to contractors to renovate their investments? Clearly at some point, this “personal household” would have to be considered a business and taxed accordingly. This paper does not take a position on where the line should be drawn, but simply notes that it will have to be drawn somewhere.

Even though it will lead to disputes on the borderline, a dual flat-tax system—where personal filers report their income and nothing else, while businesses report net income as described above—is our preferred approach. It provides simplicity for the typical individual taxpayer and coherence for the business taxpayer.

We are quite confident that with a flat rate of 3 percent on personal income and net business income, the California legislature would raise more revenue than it does with the current overly complicated, unfair, and inefficient tax code.



**T**he PRI flat-tax plan for California entirely eliminates the alternative minimum tax, as well as the estate, inheritance, and gift taxes. All personal and net corporate income would be taxed at a flat rate of 3 percent. Corporations would claim only legitimate business expenses as deductions, though dividend payments would be deductible to avoid double taxation. Individuals would have the choice of filing as a business enterprise—and thus keeping track of depreciation, capital gains, etc.—or they could simply report their gross income on a form the size of a postcard, and literally be done with their taxes in minutes.

43

Section IV explained the philosophy guiding the structure of the PRI flat-tax plan. In the following subsection, we explain the derivation of the revenue-neutral 3-percent flat rate.

## **Calculating the Static, Revenue-Neutral Flat Rate**

In discussions of proposed tax reforms, a typical benchmark for rate comparisons is to assume that the economic pie is unaltered by the tax system. In this subsection, we will look back at historical data on California's tax revenues and income statistics, in order to assess the exact flat rate that would have been needed to generate the same revenues as the graduated and complex tax system that was actually in place.

The static comparison is an extremely conservative approach, because, in practice, the switch to a flat tax will spur economic growth, as discussed earlier. In other words, had California adopted the PRI plan in 2001, the taxable income base would have been much larger in subsequent years than it was in historical fact. That means the PRI flat tax would have yielded more and more revenues over time, relative to the actual revenues flowing to the state. Therefore, the 3-percent flat rate derived below is actually higher than what would be needed to maintain revenue neutrality. The static comparison, however, is the one adopted here because of its conservatism. Economists do not agree on the magnitude of supply-side effects, i.e., of the ability of tax cuts to “pay for themselves” through economic growth. To avoid erring on the side of optimism, then, we propose a 3-percent flat rate, knowing that it is higher than necessary.

Relying on data from the California Franchise Tax Board's archives of annual reports, we can list the components of gross personal and corporate income for the last five years of available data. The corporate figure is worldwide income, so we multiply by a fraction to obtain an estimate of gross corporate income that is taxable by the state. (Specifically we take each year's "total state net income after apportionment" and divide by "net income after state adjustments.") We also multiply the currently allowed (worldwide) corporate deductions by the state scaling factor and then again by 25 percent, since much of these will fall away under a simple flat tax. (In 2005 over one-third of all corporate deductions were nebulously classified as "Other" by the FTB.) After these adjustments, we derive the total PRI flat-tax income base for each year.

**Table 5**  
**Calculating the PRI Flat Tax Income Base, 2001-2005**  
 (each year's nominal dollars, in millions)

	Taxable Year (millions \$)				
	2001	2002	2003	2004	2005
<b>Personal Income:</b>					
Wages and Salaries	552,731	545,083	556,484	592,051	625,842
Interest	24,418	18,573	16,886	16,315	22,359
Dividends	14,669	12,167	12,601	16,275	20,713
Pensions and Annuities	35,154	37,597	38,481	39,980	42,262
Net Business Income	37,010	37,582	39,130	40,910	47,668
Net Sale of Capital Assets	49,107	33,348	45,763	75,456	112,431
Net Rent and Royalty Income	6,505	6,246	6,429	5,857	4,491
Net Partnership and S Corp. Income	32,419	33,566	36,912	45,024	55,994
Net Estate and Trust Income	2,103	2,356	2,521	2,732	3,154
Net Farm Income	(1,402)	(1,169)	(837)	(891)	(949)
Net Other Income	24,383	25,805	26,014	27,840	30,547
<b>Total Personal Income</b>	<b>777,097</b>	<b>751,154</b>	<b>780,384</b>	<b>861,550</b>	<b>964,513</b>
<b>Gross Corporate Receipts</b>	<b>31,617,672</b>	<b>36,297,918</b>	<b>41,927,563</b>	<b>44,227,308</b>	<b>37,306,906</b>
Less Cost of Goods Sold	27,908,428	32,495,388	37,319,695	37,810,156	32,724,440
<b>Gross Profit</b>	<b>3,709,244</b>	<b>3,802,530</b>	<b>4,607,868</b>	<b>6,417,152</b>	<b>4,582,466</b>
Other Income (Capital Gains, etc.)	2,234,476	2,045,054	2,225,214	2,333,901	3,164,954
<b>Total Gross Corporate Income</b>	<b>5,943,720</b>	<b>5,847,584</b>	<b>6,833,082</b>	<b>8,751,053</b>	<b>7,747,420</b>
<b>Est. Taxable Fraction of Gross Income</b>	<b>9.0%</b>	<b>12.7%</b>	<b>8.2%</b>	<b>11.2%</b>	<b>12.3%</b>
<b>Est. CA Taxable Gross Corporate Income</b>	<b>537,344</b>	<b>742,243</b>	<b>561,859</b>	<b>978,966</b>	<b>952,465</b>
Less Est. PRI Allowed Deductions	126,431	175,622	125,698	218,038	194,647
Less Dividend Payments (PRI plan)	14,669	12,167	12,601	16,275	20,713
<b>Est. CA Taxable Net Corporate Income</b>	<b>396,245</b>	<b>554,454</b>	<b>423,560</b>	<b>744,654</b>	<b>737,106</b>
<b>PRI FLAT TAX INCOME BASE</b>	<b>1,173,342</b>	<b>1,305,608</b>	<b>1,203,944</b>	<b>1,606,204</b>	<b>1,701,619</b>

Source: California Franchise Tax Board

From the California Legislative Analyst's Office, we then obtained the historical revenues raised by the taxes we wish to abolish or reform. It is then a simple calculation to determine the PRI flat-tax rate that would have yielded equivalent revenues in each year, again making no assumptions about supply-side growth from the lower tax rates.

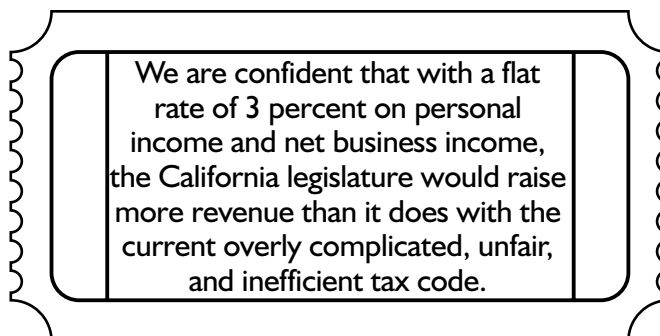
**Table 6**  
**Historical Revenues and PRI Flat-Tax Rate Derivation**  
**(each year's nominal dollars)**

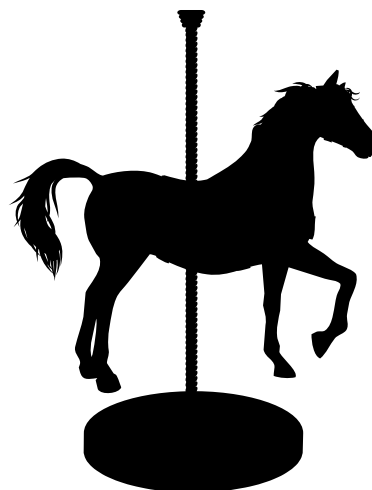
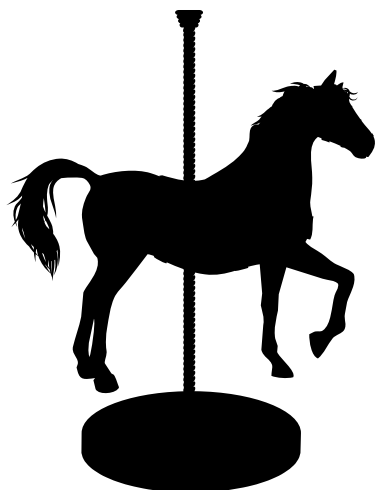
CA Fiscal Year (millions \$)					
	2001-02	2002-03	2003-04	2004-05	2005-06
Actual Corporate Tax Revenue	5,333	6,804	7,019	8,670	10,316
Actual Income Tax Revenue	33,047	32,710	36,399	42,738	49,901
Actual Estate, Inheritance, and Gift Tax	916	647	398	213	4
Total Target Revenues	39,295	40,161	43,816	51,621	60,221
PRI Flat Tax Income Base	1,173,342	1,305,608	1,203,944	1,606,204	1,701,619
Annual Static PRI Flat Tax Rate	3.35%	3.08%	3.64%	3.21%	3.54%
Five-Year Average Target Revenue	47,023				
Five-Year Average PRI Tax Base	1,398,143				
Static PRI Flat Tax Rate	3.36%				

Source: California Legislative Analyst's Office

Over the most recent five-year period for which data are available, a PRI flat tax of 3.36 percent levied on personal and net corporate income would have yielded, on average, the same revenues as the actual cornucopia of corporate, income, estate, inheritance, and gift taxes. To reiterate, this calculation completely ignores all the advantages of the flat tax, and conservatively assumes that the underlying tax base would have been unaffected by the choice of tax system.

In light of the dynamic effects of higher investment, influx of new workers and businesses, and reduced compliance costs, the PRI plan has rounded Table 6's exact revenue-neutral rate of 3.36 percent down to the simpler 3 percent. We are quite confident that with a flat rate of 3 percent on personal income and net business income, the





California legislature would raise more revenue than it does with the current overly complicated, unfair, and inefficient tax code.

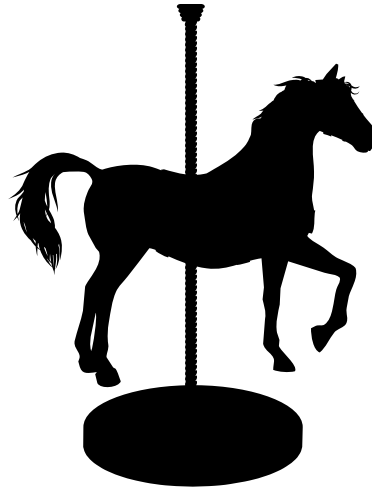
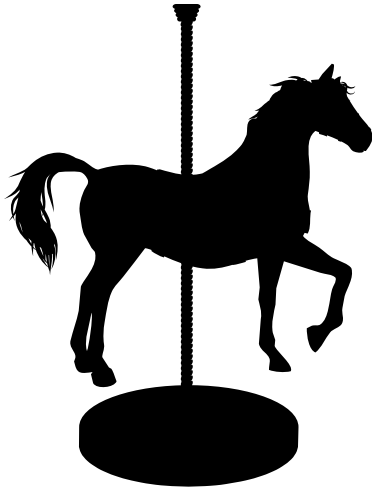
## Dynamic Estimates

Although our conservative approach relies on static analyses, more and more economists are endorsing dynamic estimates for revenue and economic growth. This approach incorporates the undeniable impact that tax incentives have on economic activity within a state. Indeed, in 1994, Governor Pete Wilson signed into law a mandate requiring the Department of Finance and the Legislative Analyst's Office to conduct dynamic revenue assessments when projecting future tax revenues. The goal was to avoid overestimating the increased revenues from tax-rate hikes. But the mandate expired in 2000, and was not renewed; California has since reverted to static forecasts of state revenue.<sup>28</sup>

Although most economists agree that cuts in tax rates do not lead to a proportional loss in tax revenues—i.e., they acknowledge there is truth to the Laffer Curve—they disagree on the magnitude of such supply-side effects. A fairly uncontroversial study conducted by N. Gregory Mankiw and Matthew Weinzierl in 2004 concluded: “In the long run, about 17 percent of a cut in labor taxes is recouped through higher economic growth. The comparable figure for a cut in capital taxes is about 50 percent.”<sup>29</sup>

Unfortunately, it is difficult to translate such statements into a projection for the PRI flat-tax plan because, strictly speaking, the PRI plan does not “cut taxes.” The reductions in upper-income tax rates are offset by eliminating loopholes; the entire plan is revenue-neutral by design. Having said that, the PRI plan was also designed to raise tax revenues with as little distortion to the economy as possible. By reducing marginal tax rates on additional income earned, the PRI plan operates much like the tax cut studied by Mankiw and Weinzierl.

The PRI plan would clearly lead to explosive growth in state tax receipts.



To give a flavor of the possible growth in revenues, consider that in tax year 2005, California taxpayers with adjusted gross incomes above \$1 million had a total AGI of more than \$172 billion. With the rate reduction from 10.3 percent to a flat rate of 3 percent, the PRI plan would involve a static “tax cut” of more than \$12.5 billion just on these individuals alone. If we take the low estimate that 17 percent of this “cut” will be recouped through an expansion of the tax base, that translates into more than an additional \$2 billion per year that the state would collect in personal-income-tax receipts, just from those Californians earning more than \$1 million per year. The PRI plan would clearly lead to explosive growth in state tax receipts.

This bold proposal, however, is sure to meet with uncertainty and objections, and to those we now turn.

The benefits of conversion to a flat-tax system are not primarily in the form of reduced tax bills. Rather, the primary benefits are enhanced economic growth, lower compliance costs, and a more stable revenue stream for the legislature throughout the ups and downs of the business cycle.

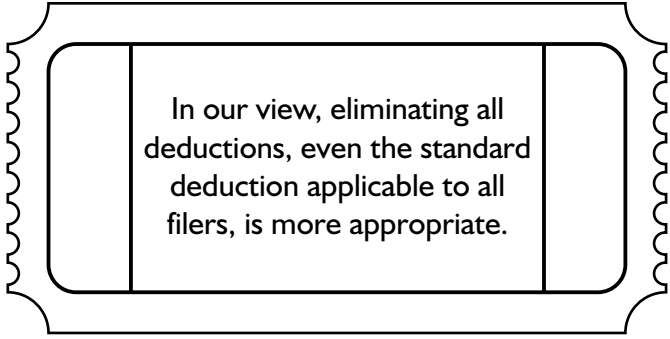
## What about a standard deduction or personal exemption to help the poor?

**U**nlike some proposals, the flat tax recommended in this study does not include a so-called standard deduction or personal exemption, whereby every filer is allowed to reduce his or her gross income by a standard amount. In the view of some, the standard deduction allows a switch to the flat tax without imposing too great a burden on the poor.

Some proponents of a flat tax, such as Alvin Rabushka and Niels Veldhuis, go so far as to provide a table demonstrating that a combination of a flat tax with a generous standard deduction retains progressivity in the tax code.<sup>30</sup> For example, with a flat rate of 10 percent and a standard deduction of \$10,000, someone who makes \$20,000 per year will end up paying \$1,000 in taxes, which represents an effective tax rate of only 5 percent. On the other hand, under this system someone who makes \$100,000 per year will pay \$9,000 in taxes, which represents an effective tax rate of 9 percent. Thus the rich pay a higher effective tax rate, even though all taxable income is subject to the same flat rate.

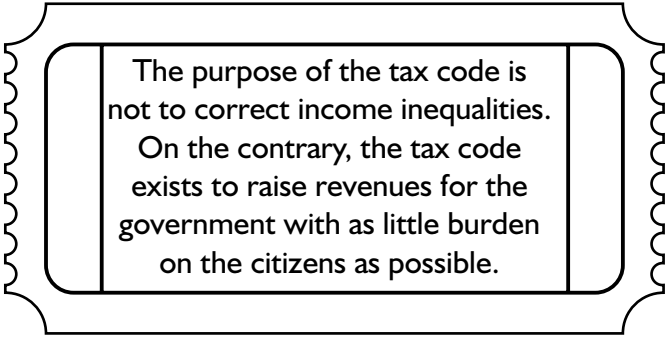
In our view, eliminating all deductions, even the standard deduction applicable to all filers, is more appropriate. First, the very spirit of flat-tax reform is to eliminate complications and to have a straightforward tax code that applies the same rate to all incomes, period. Indeed, the plan recommended by Rabushka and Veldhuis isn't really a "flat tax" at all, but a progressive system with two tax brackets—the lower taxed at 0 percent, the higher taxed at the "flat" rate. Of course, there are issues of fairness, but by the same token, people justify the current progressive codes by appeal to their "fairness."

The same arguments for imposing a single flat rate on incomes above the standard deduction show the advantages of a consistent application to incomes below this arbitrary threshold. For example, if a tax plan includes a standard



In our view, eliminating all deductions, even the standard deduction applicable to all filers, is more appropriate.

deduction, the tax base is necessarily smaller, meaning that the revenue-neutral flat rate must be that much higher; this reduces the economic-growth advantage from switching to a flat tax. In addition, the standard deduction can cause perverse incentives, just as other arbitrary exceptions in the tax code do. For example, it may distort the entrepreneur's choice between labor and capital equipment, because each additional worker enjoys a range of tax-free income, whereas each additional machine does not.



The purpose of the tax code is not to correct income inequalities. On the contrary, the tax code exists to raise revenues for the government with as little burden on the citizens as possible.

The issue is not a choice between labor and capital; rather the issue is how best to allocate workers and equipment among different sectors. The higher the standard deduction in the income-tax code, the more distorted this allocation becomes.

50

There is another, pragmatic argument for eliminating all deductions. If all taxpayers are subjected to the same effective tax rate, it will be much harder to pass anti-growth tax hikes in the future. In contrast, if the legislature is allowed to increase the standard deduction while ramping up the “flat” tax rate, many lower-income citizens may approve of the measure, thinking that it is largely a tax hike on “the rich.” This is precisely what a flat tax is supposed to avoid; its pro-growth benefits are amplified when businesspeople and high-income earners are confident that the system will remain in place for years. If all income is taxed at the same rate, it is that much harder for politicians to engage in class warfare and, in the process, discourage economic activity in the state.

The purpose of the tax code is not to correct income inequalities. On the contrary, the tax code exists to raise revenues for the government with as little burden on the citizens as possible. After all, sales taxes and other fees, such as road tolls, are not calibrated to the income of the payer, and the results would be absurd if they were. If citizens wish to help poorer individuals, they can approve of programs on the spending side. When the legislature wishes to build a road, it raises tax monies and pays the workers accordingly—it doesn't create a special loophole in the tax code for those who work on roads for the state. By the same token, if the government wishes to ease the impact of its activities on poorer citizens, it should address these concerns directly with spending programs, not by tinkering with the tax code.

## **Will I lose my mortgage interest deduction, child tax credit, etc.?**

The short answer is yes. The longer answer: There is no way to flatten out the tax code without eliminating someone's favorite loophole. Of course certain deductions and credits have widespread support; that is why they entered the tax code in the first place. But precisely because of dozens, if



not hundreds, of these perfectly understandable provisions, the tax system has become unwieldy, raising the costs of compliance. And worse, the thicket of loopholes simply means that the government hikes marginal tax rates on the shrinking tax base in order to achieve its revenue objectives.

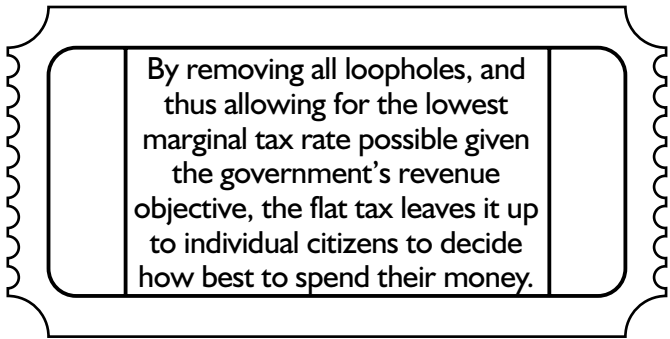
By removing all loopholes, and thus allowing for the lowest marginal tax rate possible given the government's revenue objective, the flat tax leaves it up to individual citizens to decide how best to spend their money. For example, if the vast majority of citizens believe in the importance of philanthropy, it is counterproductive for those citizens to codify such near-unanimous support with a tax deduction on charitable donations. Doing so simply reduces the tax base and increases the percentage the government must take from the taxable income of each citizen to keep revenues constant. More resources aren't available for charity because of the deduction; in fact, the opposite happens because the higher marginal tax rates discourage income generation in the first place. If the vast majority of citizens believe in the importance of philanthropy, those citizens do not need to elect politicians to turn around and motivate them to donate.

The only sensible argument for favored tax provisions is that the majority wants to give incentives to a minority of citizens to engage in behavior that they otherwise would not consider. For example, if the government raises tax rates while creating a deduction for charitable giving, a particular individual who voted against the change may end up donating more to his favorite charity than he would have under a flat tax. In effect, the move away from a flat tax has raised tax rates on all non-charitable uses of one's income. This may seem desirable to many people in the case of charity (or the purchase of an electric car, etc.), but it reflects pure social engineering. Some would argue that it is more consistent with a truly democratic society to keep the tax code neutral, rather than use it to encourage people to spend their money in ways that the majority finds more appropriate.

Naturally, our discussion of deductions applies only at the state level. Under the PRI plan, California taxpayers would obviously still claim these deductions when filing their federal taxes.

## Will my tax bill go up or down?

This question can be answered only by considering one's current tax liability and comparing it to the outcome under the PRI plan. Under the static revenue-neutral assumption, if some taxpayers end up owing less to the government, then it follows by the laws of arithmetic that other taxpayers must owe more. No tax reform can promise lower tax bills for everyone and static revenue for the government, unless we factor in the beneficial effects on

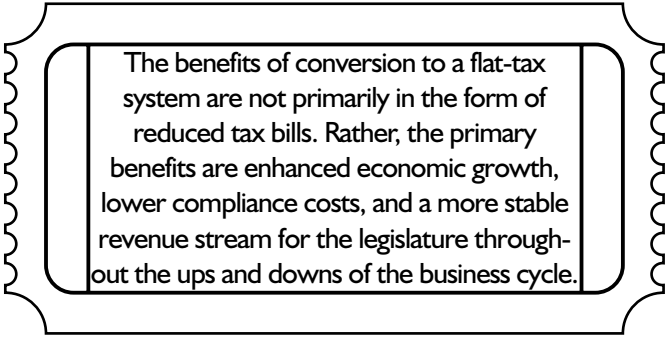


By removing all loopholes, and thus allowing for the lowest marginal tax rate possible given the government's revenue objective, the flat tax leaves it up to individual citizens to decide how best to spend their money.

economic growth from the tax reform, which will be many. Although each case must be examined with its unique circumstances, we can offer some general predictions.

If we switch to a flat rate of 3 percent, the biggest winners in the short run in terms of their tax liabilities would be those in the middle to upper tax brackets who take advantage of few deductions,

while the biggest losers—in terms of tax liabilities—would be those with large incomes that had been shielded from taxes through numerous loopholes. Though we may hope such extreme cases will be rare, one can imagine, say, a blind single mother with a full-time job that pays \$40,000 per year, who owns a home with a new mortgage, has several children, and regularly donates much of her income to charities. Proponents of any flat-tax reform should candidly admit that, if the government insists on static revenue neutrality, the tax bills of people such as this may increase. If the public so desires, perhaps a temporary assistance program—administered through the spending side, not through the tax code—could be established during the first few years after the transition to the flat tax.



The benefits of conversion to a flat-tax system are not primarily in the form of reduced tax bills. Rather, the primary benefits are enhanced economic growth, lower compliance costs, and a more stable revenue stream for the legislature throughout the ups and downs of the business cycle.

Although it is important to discuss honestly such undesirable effects, we must stress that the benefits of conversion to a flat-tax system are not primarily in the form of reduced tax bills. Rather, the primary benefits are enhanced economic growth, lower compliance costs, and a more stable revenue stream for the legislature throughout the ups and downs of the business cycle. Even for those taxpayers who would see an increase in their tax liability in the immediate aftermath of a switch, they would still gain from an improved economy, ease of filing taxes, and the avoidance of state financial crises such as the one California is currently experiencing.

Once a flat tax is in place, California's revenues would grow more quickly than would have been the case under the status quo. This would allow the legislature to lower the flat-tax rate and ease the burden on all taxpayers. In the long run, virtually everyone would be better off under a flat tax than under the present convoluted and inefficient system.

### **Isn't a flat tax a handout to the rich?**

As the above subsection conceded, it is an unfortunate implication of the design of a flat tax that switching to it may allow particular upper-income households to enjoy a reduction in their total tax liability, while a particular working-class household (which owns a home, has children, etc.) may end up with a larger tax bill. We should stress that this isn't necessarily the typical outcome. After all, many of the loopholes in the current tax code were designed for special interests, and

certainly the rich can afford tax attorneys to shelter their income as much as possible; these wealthy households could very well pay more, because the loss of their tax shelters more than offsets the gain from moving to a lower marginal tax rate. The specific impact of the flat tax, especially in the first year of its implementation, will depend on the circumstances of each filer.

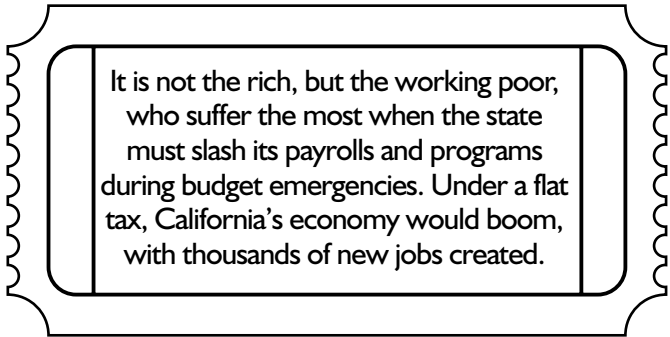
We remind the reader, however, that the purpose of flat-tax reform is to provide the legislature with a smoother flow of desired revenues in a way that distorts the economy as little as possible. It is not the rich, but the poor, who suffer the most from stagnant economic growth. It is not the rich, but the working poor, who suffer the most when the state must slash its payrolls and programs during budget emergencies. Under a flat tax, California's economy would boom, with thousands of new jobs created. The state's finances would be on much surer footing, reducing the traumatic episodes of massive, unexpected layoffs and pay cuts, such as California's most vulnerable residents are currently facing because of the revenue rollercoaster.

Finally, as Section III's historical analyses showed, flat-tax reform will shift a larger share of the state's revenue burden onto its richer citizens. That is to say, the switch to a flat tax will cause a higher percentage of revenue to come from the richest taxpayers.

## Doesn't the PRI plan tax savings twice?

As mentioned earlier, some flat-tax proposals allow full expensing of investment expenditures, and do not tax income received from bonds or stock. The proponents of such an approach might consider the PRI plan—which taxes all forms of net income, including dividends and interest payments—as a form of double taxation. In this view, the individual is first taxed when he gets his paycheck, and then is taxed again if he spends this money on a bond or share of stock.

This criticism of the PRI plan is misguided. It is not true that invested income is double-taxed, because future tax payments are made only on the new net income generated from an investment. For example, if an individual receives \$50,000 in wages, he pays the 3-percent flat tax on it. If he then takes \$1,000 of what remains and buys a bond yielding 5-percent interest per annum, he will pay 3 percent in income tax on the annual payments of \$50. But this isn't double taxing the original \$1,000 in income. Furthermore, at any time the individual can sell his bond and use the proceeds to buy stereo equipment.<sup>31</sup> Under the PRI plan, the sale of the bond does not constitute net income and thus is not taxable; this is the flip side to the fact that the initial purchase of the bond was not tax deductible. The PRI plan taxes net income appropriately, and so does not unfairly double-tax the same income.



It is not the rich, but the working poor, who suffer the most when the state must slash its payrolls and programs during budget emergencies. Under a flat tax, California's economy would boom, with thousands of new jobs created.

## What is comprehensive versus targeted tax reform?

Many proponents of flat-tax reform claim that if the legislature is serious about fixing the tax code, it needs to clean the Augean stables and rebuild the tax code from scratch. The benefits from reforming just a portion of the tax code, such reformers claim, are greatly diluted if the rest of the monstrosity is permitted to survive.

We agree that a comprehensive restructuring of California's tax code—using a statewide flat income tax to replace every other tax, including the sales tax and local property taxes—would be superior from the perspective of compliance and the elimination of distortions caused by loopholes. Some of these more radical proposals have been around for decades, yet state legislatures have not adopted them. There are many reasons for this reluctance.

First, of course, there are tremendous political difficulties. After all, the current tax code was not created randomly; each specific provision was intended to benefit some group. Second, as a proposal becomes more sweeping, its ultimate consequences become harder to predict. The impact of the PRI flat-tax plan on specific households or companies is much easier to measure, compared to some rival proposals.

Although its focus on personal and corporate income taxes ignores the irrationality embedded in other parts of the California state and local tax codes, the PRI plan nonetheless will greatly streamline and improve collection of more than half of California's revenues. The governor's budget estimates that in fiscal year 2008-09, the personal income tax will account for 44.7 percent of total revenues and transfers, and the corporate tax will account for an additional 9.2 percent.<sup>32</sup> And these percentages have been growing: from 1969 through 1998, the share of California's annual state tax revenues that came from personal income taxes increased 22 percent.<sup>33</sup> Moreover, the PRI plan directly addresses the rollercoaster revenue stream in California. Between 1968 and 1998, state income-tax revenue has been 23 percent more volatile than sales-tax revenue.<sup>34</sup>

By keeping the PRI plan as an income tax, rather than a consumption or value-added tax as other proposals suggest, we make our reform more understandable to the average taxpayer and voter. Rather than holding out for the knockout punch to an unwieldy, unfair, and inefficient tax code, the PRI plan provides a moderate revision of the existing system, with fairly predictable impacts on various taxpayers. Even so, the advantages of the PRI plan are tremendous.

## If we get a flat tax, how do we keep it?

Ultimately, the desires of the people will determine the long-term success or failure of tax reform. If the majority demands a flat, low-tax system, it will get it, and if it demands a graduated, loophole-ridden system, it will get that instead. Yet, even though the majority ultimately gets the tax system it desires, there are institutional frameworks more conducive to the former outcome. For

example, we have explained that the exclusion of a standard deduction and personal exemption is correct in terms of economics (because it allows a lower marginal rate) and in terms of politics. When all taxpayers are subjected to the same rules—where everyone pays the same marginal and effective tax rate—there is much less scope for class warfare.

Beyond this, it would be wise to embed the flat-tax plan in the California state constitution to make it more difficult to modify or abolish. Under the PRI proposal, as is the case today, a two-thirds majority of the legislature would be able to adjust the flat rate. But if the flat-tax structure itself were embedded in the state constitution, it would be much harder to depart from the framework by introducing new tax brackets and loopholes. We hope the present study adds to the momentum for this vital reform.

## About the Author and the Project Director

## Author

**ROBERT P. MURPHY** is senior fellow in Business and Economic Studies with the Pacific Research Institute (PRI) in San Francisco. He earned his Ph.D. in economics from New York University in 2003. After teaching for three years at Hillsdale College, Murphy joined Laffer Associates, where he worked with Arthur Laffer on research papers and portfolio management. He is the author of *The Politically Incorrect Guide to Capitalism* (Regnery, 2007), and has written more than 100 articles for the layperson on free-market economics. Murphy is also an economist with the Institute for Energy Research, where he specializes in energy taxation and the economics of climate change.

## Project Director

**LAWRENCE J. MCQUILLAN** is director of Business and Economic Studies and senior fellow in Political Economy at PRI. *Human Events* describes him as a “distinguished conservative leader” in public policy.

Since joining PRI in 2001, Dr. McQuillan has specialized in tax, budget, regulation, and legal-reform issues. He is coauthor of *Jackpot Justice: The True Cost of America’s Tort System* and the *U.S. Tort Liability Index*—these books have reached a combined audience of more than 77 million people. He is also coauthor of the *U.S. Economic Freedom Index: 2004 Report*, published in association with *Forbes*, which ranks the 50 states according to how friendly or unfriendly their governments’ policies are toward free enterprise and consumer choice.

McQuillan speaks regularly to civic and policy groups across the country and on the national news media. His television appearances include NBC news, CNBC, and CNNfn. YouTube hosts some of his interviews. He is a frequent guest on nationally syndicated radio talk shows including the *Ron Insana Show*, *Roger Hedgcock Show*, and *Jerry Doyle Show*. He counsels governors, legislators, and advocacy groups across the country; provides legislative testimony; and was a member of Governor Arnold Schwarzenegger’s task force on a constitutional spending limit for California.

McQuillan has published more than 125 articles in such outlets as the *Wall Street Journal*, *USA Today*, *Forbes*, *Investor's Business Daily*, *National Review*, *Los Angeles Times*, *New York Post*, *San Francisco Chronicle*, *Washington Times*, and *the Weekly Standard*. He has written on such topics as tax and spending limits, lawsuit abuse, pensions, workers' compensation, and economic freedom. His recent writings include "Ambulance Chasers Bad for Our Health," "Make a Bad Mortgage: Take the Hit," and "Live Free or Move."

McQuillan created the quarterly *California Golden Fleece Awards*, exposing fraud and abuse in California government. Cited in *The Nation* and the *Los Angeles Times*, these awards led to the overhaul of the California Victim Compensation Program and helped reform California's workers' compensation system in 2003 and 2004.

From 1998 until 2001, McQuillan was a research fellow at the Hoover Institution, Stanford University, where he specialized in international economics. He edited the book *The International Monetary Fund Financial Medic to the World?* (translated into Japanese) and wrote the study *The Case against the International Monetary Fund*, which Nobel laureate Milton Friedman reviewed as "excellent."

From 1993 until 1997, McQuillan was the founding publisher and contributing editor of *Economic Issues*, a national subscription newsletter based in Chapel Hill, North Carolina, that reviewed economic journal articles relevant to current public-policy issues.

While in graduate school at George Mason University in Fairfax, Virginia, where he earned a Ph.D. in economics, McQuillan was a research assistant for Nobel laureate James M. Buchanan and received the H. B. Earhart Fellowship for research excellence. Trinity University in San Antonio, Texas, awarded him a B.A. in economics and business administration.



# Endnotes

- <sup>1</sup> Daniel Mitchell, "The Historical Lessons of Lower Tax Rates," Background #1086, The Heritage Foundation, July 19, 1996, available at <http://www.heritage.org/Research/Taxes/BG1086.cfm>.
- <sup>2</sup> Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1982.
- <sup>3</sup> The original call for a flat tax was Robert Hall and Alvin Rabushka's *Wall Street Journal* op-ed, "A Proposal to Simplify Our Tax System," which appeared on December 10, 1981. In 1985 they wrote a book on the subject, *The Flat Tax*, which was revised in 1995 and has recently been released again (Hoover Institution Press, 2007). For similar examples of flat-tax proposals see Arthur Laffer, "Will Gray Davis Survive?" Laffer Associates (2003); Steve Forbes, *Flat Tax Revolution: Using a Postcard to Abolish the IRS* (Washington D.C.: Regnery, 2005); and Alvin Rabushka and Niels Veldhuis, "A Flat Tax for Canada," The Fraser Institute (2008), available at [http://www.fraserinstitute.org/COMMERCE.WEB/publication\\_details.aspx?pubID=5124](http://www.fraserinstitute.org/COMMERCE.WEB/publication_details.aspx?pubID=5124).
- <sup>4</sup> Lawrence J. McQuillan, "Terminating Fiscal Conservatism," *National Review Online*, February 22, 2008.
- <sup>5</sup> Figure 2 is reproduced from Arthur B. Laffer and Jeffrey Thomson, "Housing Downturn Not Felt Equally by All," Laffer Associates, September 10, 2007, p. 9.
- <sup>6</sup> This effect of graduated tax rates will be demonstrated more fully in Section II.
- <sup>7</sup> This effect is studied in Lawrence J. McQuillan, Ying Huang, and Robert E. McCormick, *U.S. Economic Freedom Index: 2004 Report* (San Francisco: Pacific Research Institute, 2004).
- <sup>8</sup> Figure 4 is based on data from Laffer and Thomson, "Housing Downturn Not Felt Equally by All," p. 7.
- <sup>9</sup> See Scott A. Hodge, J. Scott Moody, and Wendy P. Warcholik, "The Rising Cost of Complying with the Federal Income Tax," *Tax Foundation Special Report No. 138* (January 2006), available at <http://www.taxfoundation.org/research/show/1962.html>.
- <sup>10</sup> Quoted in Forbes, *Flat Tax Revolution*, p. 45.
- <sup>11</sup> Franchise Tax Board, *Annual Report 2006*, p. 18. Available at: <http://www.ftb.ca.gov/aboutftb/annrpt/2006/2006AR.pdf>
- <sup>12</sup> The abolition of the millionaires' surcharge of 1 percent (Proposition 63) would require a vote of the people. The present paper deals primarily with an ideal goal for tax reform, without focusing on the specific mechanics of how best to implement it.
- <sup>13</sup> In order to keep the numbers in the chart simple, we have used average tax rates. In other words, taxpayers earning \$200,000 pay the 10-percent rate on all of their income, not just on the income above the \$100,000 threshold.
- <sup>14</sup> In this section, we have also ignored the benefits of the lower compliance costs under a flat tax, also discussed earlier. The reason for this omission, again, is to isolate conceptually the various ways in which a flat tax is superior to a progressive system filled with loopholes.

- <sup>15</sup> In percentage terms, on the other hand, the top bracket received a 32-percent reduction, while the lower bracket suffered a 36-percent hike.
- <sup>16</sup> A detailed history of the structure of the modern federal income-tax code is available at <http://taxfoundation.org/research/show/151.html>.
- <sup>17</sup> See Peter B. Sperry, "The Real Reagan Economic Record: Responsible and Successful Fiscal Policy," Heritage Foundation Backgrounder #1414, March 1, 2001, available at <http://www.heritage.org/Research/Taxes/BG1414.cfm>.
- <sup>18</sup> This full list is drawn from the Wikipedia entry on "flat tax," though Forbes discusses a subset of this more recent list in *Flat Tax Revolution*.
- <sup>19</sup> See Daniel Mitchell's recently released "The Global Flat Tax Revolution: Lessons for Policy Makers," The Center for Freedom and Prosperity Foundation, February 29, 2008, available at <http://www.freedomandprosperity.org/press/p02-29-08/p02-29-08.shtml>.
- <sup>20</sup> Forbes, *Flat Tax Revolution*, p. 93.
- <sup>21</sup> *Ibid.*, pp. 96–97.
- <sup>22</sup> *Ibid.*, pp. 101–102.
- <sup>23</sup> This is the approach favored by Hall and Rabushka in *The Flat Tax*, as well as Forbes in *Flat Tax Revolution*.
- <sup>24</sup> The figure is not exactly \$50 because of the time value of money. This subtle point will be addressed later in the text.
- <sup>25</sup> What we say here is applicable to a corporate income tax. Other economists have proposed flat business value-added taxes or consumption taxes. In these proposals, it is appropriate for businesses to write off their purchases of durable assets fully in the first year.
- <sup>26</sup> To avoid tedium, for the rest of this section we will omit further uses of "roughly." Keep in mind that the figures are not exact, however, because of the time value of money.
- <sup>27</sup> The purist could point out that in real terms, Larry's \$1,200 might be worth less because of price inflation. Such a complication lies outside the scope of this primer, but strictly speaking, a theoretically ideal tax system would account for changes in purchasing power when valuing durable assets over time.
- <sup>28</sup> Lawrence J. McQuillan and Matthew C. Piccolo, "California's Outdated Method of Budgeting Needs a Retooling," *San Francisco Examiner*, October 29, 2007, available at [http://liberty.pacificresearch.org/publications/id.3401/pub\\_detail.asp](http://liberty.pacificresearch.org/publications/id.3401/pub_detail.asp).
- <sup>29</sup> N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," National Bureau of Economic Research, NBER Working Paper No. 11000, December 2004.
- <sup>30</sup> Rabushka and Veldhuis, "A Flat Tax for Canada," pp. 152–153, The Fraser Institute (2008).
- <sup>31</sup> If a business sells a bond, it is liable for additional taxes only if interest rates had fallen since the initial purchase, leading to a capital gain. But the individual is not taxed on capital gains because of the simple filing for individuals under the PRI plan.
- <sup>32</sup> Governor's Budget Summary, January 10, 2008, p. 16.

<sup>33</sup> W. Mark Crain, *Volatile States: Institutions, Policy, and the Performance of American State Economies* (Ann Arbor, Mich.: University of Michigan Press, 2003), p. 53.

<sup>34</sup> *Ibid.*, p. 76.

# PRAISE FOR ENDING THE REVENUE ROLLERCOASTER

A 3% flat tax would trigger the biggest boom in California since the Gold Rush!

**Steve Forbes**

President and Chief Executive Officer of Forbes  
and Editor-in-Chief of *Forbes* magazine

Robert Murphy's study provides an excellent explanation of how a flat tax would increase growth in California and stabilize state finances. If California policy makers want to halt the exodus of entrepreneurs and investors to low-tax states, they should pay close attention.

**Daniel J. Mitchell**

Senior Fellow  
Cato Institute

Robert Murphy has laid out a fascinating proposal for tax reform in California, a state that desperately needs fresh ideas. While the details of the PRI plan differ from recommendations I have made in the past, those details are relatively unimportant in the grand scheme of things. We agree that California will only avoid its recurrent budget crises if it stops chasing away its most productive citizens with arguably the highest tax rates and regulatory burdens in the nation, and the most volatile revenue streams of any state in the nation. By adopting a neutral flat tax, the legislature will experience a smoother flow of revenues through economic booms and busts, which will make it much easier to avoid chronic deficits. Robert Murphy should be congratulated for putting together a fine monograph.

**Arthur B. Laffer, Ph.D.**

Founder and Chairman,  
Laffer Associates and Member of President Reagan's  
Economic Policy Advisory Board

V2