"A new approach to federal budgeting and a flatter progressive tax system"

AUTHORS	Janet E. Mosebach Michael Mosebach

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Janet E. Mosebach (USA), Michael Mosebach (USA)

A new approach to federal budgeting and a flatter progressive tax system

Abstract

There is little argument that governments need money to accomplish their goals. However, questions about how much money is enough and how equitable the current U.S. income tax system are under discussion. Recent economic events and the downgrading of U.S.'s credit rating on government-issued debt have drawn renewed attention to tax reform, the federal budget, and the level of U.S. national debt. The authors posit that changes in the way the federal budget is developed are key to stopping the trend of annual budget deficits and bringing down the national debt, as well as providing a basis for meaningful income tax reform. Using publicly available data disseminated by the Office of Management and Budget and the Congressional Budget Office, this study develops a flatter income tax system based on Gross Domestic Product (GDP) that provides the federal government with a predictable level of receipts each year and taxpayers with a simplified tax system with reduced tax rates.

Introduction

Recent events have drawn renewed attention to the federal budget and the level of national debt in the United States, which stood at over $16.6 trillion as of February 25, 2013[1]. Nationally, these events include the downgrading of the U.S.'s AAA credit rating on government-issued debt by Standard & Poor's in August 2011, the failure of the special bipartisan joint Congressional committee on debt reduction (commonly referred to as the 'super committee') to reach a deficit reduction compromise in November 2011, the recent 'fiscal cliff' negotiations in late 2012, the sequester that took effect on March 1, 2013, and what seems to be a never ending stream of financial crises going forward. Internationally, the current economic climate in Europe has concerned markets in the U.S. and Europe, leading many to ask how much debt is too much debt, and Japan's recent reduction in its corporate tax rate has left the United States with the highest marginal corporate tax rate in the world.

Long-term debt issues, concern over the continuing trend of annual U.S. budget deficits, and expiration of the Bush-era tax cuts have also renewed the debate about tax reform of various types, giving rise to discussions about a flat tax, a balanced budget amendment, or both. Election year politics has often been a forum to discuss these types of reforms and the most recent election cycle was no exception. It appears that most lawmakers are now in agreement that changes must be made in the tax code. However, as the recent fiscal cliff negotiations have shown, it is difficult to get lawmakers to agree on the specifics.

The notion of a flat tax is not new and has been suggested many times by lawmakers and others. There are two ways to implement a flat tax. The first is to have taxpayers pay a flat rate of tax, say 20 percent. The second is to institute a federal budget where the government receives a flat amount of income tax revenue each year, say 20 percent of U.S. Gross Domestic Product (GDP). Either of these flat tax regimes must, of course, be accompanied by some enforceable limitation on federal spending.

The current federal tax system purports to collect taxes to support the government but with a $16.6 trillion national debt the government is either not collecting enough tax, is spending too much, or both. Our intent is not to enter into the less spending versus more tax revenue debate. Our goal is to suggest a different approach to federal budgeting and develop a reasonable tax system that provides the federal government with a predictable level of receipts, ties federal outlays to receipts, and provides taxpayers with a simplified tax system. We approach this issue by examining how to provide government with the funds necessary to carry out its designated functions, without declaring what those functions are or should be, or making judgments about the various social agendas behind current or proposed budgeted outlays.

We suggest that a change in the way the annual federal budgeted receipts are formulated is the key to halting continual annual budget deficits, bringing down the national debt in a reasonable amount of time, and producing a flatter progressive tax system that provides sufficient tax revenue at relatively low tax rates for taxpayers. We posit that federal receipts should be based on the earnings of the economy as a whole and our proxy for the economy as a whole is GDP. Using this method, federal receipts and outlays are both based on GDP, thereby capping federal spending in the process. We also suggest using

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[1] This figure includes both debt held by the public (approximately $11.7 trillion) and intragovernmental holdings (approximately $4.9 trillion) as reported by the U.S. Treasury Department on February 25, 2013. Daily national debt amounts can be accessed online at http://www.treasury direct.gov/NP/BPDLogin?application=np.

gross earnings as the tax base in order to simplify the tax system for all taxpayers. This system addresses two main concerns: first, it returns the tax system to first principles; collecting tax revenue to support the functions of government. Second, taxpayers would be able to identify with the system. For instance, if a taxpayer earns $50,000, they must pay a percentage of those earnings in tax. At that point, the taxpayer can make a reasonable approximation of their cash flows for the coming year. Our method mirrors this on a national scale.

Relying on information from the Office of Management and Budget (OMB), we compile federal budget data from 1947 to 2016 to show that we have already an approximately flat tax system using the second definition of a flat tax noted above. Then, using data from the Congressional Budget Office (CBO), we develop a flatter progressive tax system that provides the federal government with a predictable level of receipts each year, and taxpayers with a simplified tax system and reduced tax rates.

1. Flat tax

The idea of, and argument for, a flat tax rate is not new. The Revenue Act of 1861 imposed a 3 percent flat tax on personal income to finance the Civil War which was repealed ten years later after the war ended[1]. The ratification of the Sixteenth Amendment to the Constitution in 1913 was the birth of our current income tax regime. The income tax code has changed thousands of times since then but it still remains basically the same progressive tax based on gross income less certain legislated deductions and credits.

In the 1960s, economist Milton Friedman proposed a flat tax rate on all individuals based on total income with limited deductions (Friedman, 1962 and 1984). In December 1981, the Wall Street Journal published an editorial by Robert Hall and Alvin Rabushka from the Hoover Institution entitled "A Proposal to Simplify our Tax System" in which they proposed a 19 percent flat tax on individuals and businesses (Hall and Rabushka, 1981). Their 1983 book on the same topic provided additional details on the operationalization of their proposal where taxpayers were allowed no deductions or credits except a generous personal or family allowance based on the taxpayer's circumstances, and filed their tax return on a postcard (Hall and Rabushka, 1983). Their proposal sought to broaden the tax base as much as possible, keep the tax rate as low as possible, and still provide the federal government with the same tax revenue as the existing tax system at the time. By including a family allowance that exempted a certain amount of income from tax, they actually created a tax system that was not truly flat but a system where the effective tax rate increased as a smaller amount of income was exempted from tax.

The Tax Reform Act of 1986[2] reduced the number of tax brackets for individuals from more than 10 to two, and compressed tax rates by raising the lowest rate and lowering the highest rate but interest in a true flat tax waned. Then, in the 1990s, while campaigning to be the democrat's presidential nominee, California Governor Jerry Brown proposed a flat tax of 13 percent tax on all personal (with limited deductions) and business income, and the elimination of the social security tax. In 1995, House Majority Leader Richard Armey (Texas) and Senator Richard Shelby (Alabama), both republicans, proposed a 17 percent flat tax on individuals, while House Minority Leader Richard Gephardt (Missouri; democrat) and Senator Arlen Specter (Pennsylvania; republican at the time) each introduced flat tax proposals of their own.

In 1996, Steve Forbes became one of the most visible proponents of a flat tax when he introduced his version during his campaign for the Republican presidential nomination calling for a 17 percent flat tax with limited deductions for all individual taxpayers and the elimination of all tax on interest, dividend, and capital gain income. Later that same year, The National Commission on Economic Growth and Tax Reform, chaired by former representative Jack Kemp (New York; republican) proposed a single, low flat rate tax but declined to specify a rate, and Senator Phil Gramm (Texas; Republication) proposed a 16 percent flat tax that preserved many of the deductions allowed under the current individual income tax system and taxed investment income. In the recent republican presidential primary campaign, almost all of the candidates supported some form a flat tax: Herman Cain proposed his '9-9-9' plan; Texas Governor Rick Perry proposed an optional 20 percent flat tax rate where individuals could file their annual return on a postcard; Jon Huntsman said he favored a "flatter, fairer, simpler tax code"; and Newt Gingrich said he would support a flat tax of, at most, 15 percent. With all of this interest from politicians and lawmakers it is interesting to note that a flat tax proposal has never come to the floor of the U.S. House of Representatives or Senate for a vote.

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[1] In 1894, Congress enacted a 2 percent flat tax that was found to be unconstitutional because Congress, at the time, did not have the power to impose a direct tax without apportioning it by the population of each state.

[2] Tax Reform Act of 1986, commonly cited as TRA86, was enacted on October 22, 1986 (P.L. 99-514).

With all the talk about a flat tax and the implied simplification of a flat tax system, one might think a majority of U.S. taxpayers would be in favor of such a system. However, a November 9, 2011, Wall Street Journal op-ed piece (Brady and Frisby, 2011) suggests that "Flat tax proponents face an uphill battle." They cite two polls that show more people oppose switching from our current tax system to a flat tax than support it. The two polls, one commissioned by Brady and Frisby themselves, and one by Rasmussen Reports, asked respondents if they wanted to change from the current tax system to a flat tax system at a 19 percent or 17 percent rate, respectively. The authors speculate people that are worse off prefer to maintain our current progressive tax structure where taxpayers earning more are taxed more. It does not appear the polls inquired as to a respondent's current tax rate, therefore, it is not only plausible but reasonable that self-interest drove the results and respondents were simply making their decision by comparing the proposed flat tax rate to their current rate. It is interesting to note that while respondents did not favor a flat tax, 61 percent of the Rasmussen respondents did favor getting rid of the current income tax code and replacing it with a simpler tax code.

While lawmakers in the United States have been debating the pros and cons of a flat tax system, other countries have been taking action. Since 1994, over 20 countries, mostly in Eastern and Central Europe, have instituted a flat tax. Keen, Kim and Varsano (2007) examined the impact of flat tax regimes in a variety of countries. They note that these systems vary widely and empirical evidence is limited, making even the simplest generalizations about the impact of a flat tax suspect or questionable. Their ambiguous results concerning increases in tax revenue generation and compliance rates, among others, lead them to question the sustainability of the flat tax, and speculate some flat tax adopters might move away from a flat tax in the future. However, within months of the release of the Keen, Kim and Varsano 2006 International Monetary Fund working paper (which resulted in the 2007 published paper), several additional countries enacted a flat tax.

Mitchell (2008) points out that most of the new flat tax adopters between 1994 and 2008 were former Soviet Republics emerging from communism and trying for the first time to compete with other Western European countries for capital. This geographic concentration caused some to wonder if a flat tax could be successfully implemented in larger, more mature, and more prosperous economies. As larger countries (Russia in 2001, Romania in 2005) and more mature economies (Iceland in 2007) started adopting a flat tax, Mitchell noted the feasibility of

such a tax regime became more accepted. In addition, threats to the flat tax in Russia and Slovakia were defeated, leaving the flat tax in place. Mitchell attributes this shift to a flat tax to globalization and the pressure it puts on politicians to lower taxes to attract jobs and capital from other countries.

Not all countries are completely happy with their switch to a flat tax. In 2012, the Socialist party in Bulgaria, which instituted a 10 percent flat tax in 2008, began discussing the possibility of scrapping the flat tax and returning to a more progressive system that taxes high-income earners at a higher rate than other taxpayers. In November 2012, the Czech Republic modified their 15 percent flat tax system to include a new 22 percent rate on incomes over a certain level beginning in 2013. In December 2012, as part of an austerity package, Slovakia's parliament voted to modify their flat tax system by increasing their 19 percent flat tax to 23 percent for corporations and 25 percent for individuals earning over a certain monthly amount starting in 2013 with a five percent surcharge for certain government officials (Liptakova, 2012).

As for current flat tax rates around the world, other than those noted above, they tend to be below 20 percent, with the exception of Iceland. Some countries with rates over 20 percent have reduced them to rates closer to or below 20 percent (Estonia and Lithuania). Hall and Rabuska (1983) proposed a flat tax rate of 19 percent because it made their proposal revenue neutral. However, they also felt 20 percent was a political and psychological barrier they did not want to cross because politicians might be able to make a few small changes and increase the rate into the mid or high 20s, while breaking the 20 percent threshold itself would be more arduous.

2. Federal budget based on historical receipts

If taxpayers want tax laws that are simpler to apply, a flat tax rate seems to fit the bill. However, as noted above, taxpayers do not overwhelming support switching to a flat tax rate system in the United States. Whatever the reason (fear of being taxed at a higher rate; someone else not paying a high enough rate; an unwillingness to make such a drastic change to the income tax system; etc.), it appears if we want a flat tax, we need a different system that would simplify the tax code, have a relatively low tax rate, and assure that sufficient government revenue was generated.

A review of historical federal budget data indicates that annual federal receipts, as a percent of GDP, are relatively stable over time. If we consider a second, alternative definition of a flat tax, we already have a flat tax in place. Not a flat income tax rate but a system where the government rece-

ives a flat amount of tax revenue each year based on a stable percentage of GDP. Table 1 presents annual federal budget information from 1947 to 2016. This federal budget information, available from the White House OMB, actually goes back in time much farther but we concentrate our analysis on the years after the world wars and the great depression[1]. The reason for widespread concern over annual federal deficits and the level of federal debt is evident in this table. Since 1947, there are only twelve years where the federal budget resulted in a surplus.

Table 1. Summary of federal receipts, outlays, surpluses (deficits), and GDP: 1947 to 2016
(in millions of dollars except GDP which is in billions of dollars)

Fiscal year[a]	Total receipts	Total outlays	Surplus or deficit	GDP	Receipts as a % of GDP	Five-year average receipts	Outlays as a % of GDP	Five-year average outlays
1947	38,514	34,496	4,018	233.2	16.52%		14.79%	
1948	41,560	29,764	11,796	256.6	16.20%		11.60%	
1949	39,415	38,835	580	271.3	14.53%		14.31%	
1950	39,443	42,562	(3,119)	273.1	14.44%		15.58%	
1951	51,616	45,514	6,102	320.2	16.12%	15.56%	14.21%	14.10%
1952	66,167	67,686	(1,519)	348.7	18.98%	16.05%	19.41%	15.02%
1953	69,608	76,101	(6,493)	372.5	18.69%	16.55%	20.43%	16.79%
1954	69,701	70,855	(1,154)	377.0	18.49%	17.34%	18.79%	17.68%
1955	65,451	68,444	(2,993)	395.9	16.53%	17.76%	17.29%	18.03%
1956	74,587	70,640	3,947	427.0	17.47%	18.03%	16.54%	18.49%
1957	79,990	76,578	3,412	450.9	17.74%	17.78%	16.98%	18.01%
1958	79,636	82,405	(2,769)	460.0	17.31%	17.51%	17.91%	17.50%
1959	79,249	92,098	(12,849)	490.2	16.17%	17.04%	18.79%	17.50%
1960	92,492	92,191	301	518.9	17.82%	17.30%	17.77%	17.60%
1961	94,388	97,723	(3,335)	529.9	17.81%	17.37%	18.44%	17.98%
1962	99,676	106,821	(7,146)	567.8	17.55%	17.33%	18.81%	18.34%
1963	106,560	111,316	(4,756)	599.2	17.78%	17.43%	18.58%	18.48%
1964	112,613	118,528	(5,915)	641.5	17.55%	17.70%	18.48%	18.42%
1965	116,817	118,228	(1,411)	687.5	16.99%	17.54%	17.20%	18.30%
1966	130,835	134,532	(3,698)	755.8	17.31%	17.44%	17.80%	18.17%
1967	148,822	157,464	(8,643)	810.0	18.37%	17.60%	19.44%	18.30%
1968	152,973	178,134	(25,161)	868.4	17.62%	17.57%	20.51%	18.69%
1969	186,882	183,640	3,242	948.1	19.71%	18.00%	19.37%	18.86%
1970	192,807	195,649	(2,842)	1,012.7	19.04%	18.41%	19.32%	19.29%
1971	187,139	210,172	(23,033)	1,080.0	17.33%	18.41%	19.46%	19.62%
1972	207,309	230,681	(23,373)	1,176.5	17.62%	18.26%	19.61%	19.65%
1973	230,799	245,707	(14,908)	1,310.6	17.61%	18.26%	18.75%	19.30%
1974	263,224	269,359	(6,135)	1,438.5	18.30%	17.98%	18.72%	19.17%
1975	279,090	332,332	(53,242)	1,560.2	17.89%	17.75%	21.30%	19.57%
1976	298,060	371,792	(73,732)	1,738.1	17.15%	17.71%	21.39%	19.95%
1977	355,559	409,218	(53,659)	1,973.5	18.02%	17.79%	20.74%	20.18%
1978	399,561	458,746	(59,185)	2,217.5	18.02%	17.88%	20.69%	20.57%
1979	463,302	504,028	(40,726)	2,501.4	18.52%	17.92%	20.15%	20.85%
1980	517,112	590,941	(73,830)	2,724.2	18.98%	18.14%	21.69%	20.93%
1981	599,272	678,241	(78,968)	3,057.0	19.60%	18.63%	22.19%	21.09%
1982	617,766	745,743	(127,977)	3,223.7	19.16%	18.86%	23.13%	21.57%
1983	600,562	808,364	(207,802)	3,440.7	17.45%	18.74%	23.49%	22.13%
1984	666,438	851,805	(185,367)	3,844.4	17.34%	18.51%	22.16%	22.53%
1985	734,037	946,344	(212,308)	4,146.3	17.70%	18.25%	22.82%	22.76%
1986	769,155	990,382	(221,227)	4,403.9	17.47%	17.82%	22.49%	22.82%
1987	854,288	1,004,017	(149,730)	4,651.4	18.37%	17.67%	21.59%	22.51%
1988	909,238	1,064,416	(155,178)	5,008.5	18.15%	17.81%	21.25%	22.06%

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[1] While the OMB produces federal budget information each year, you can only access the current 2013 budget directly on their website. For all past budgets, the OMB website automatically redirects you to the U.S. Government Printing Office (GPO). The 2012 federal budget information used in this paper is accessible at: http://www.gpo.gov/fdsys/browse/collection.action;jsessionid=PjJrP1PZzQtwmMQMYH12Xhhwc148Pw0dK1RgDkv3f Y49rjFfLPGJ!359172709!2097165231?collectionCode=BUDGET&browsePath=Fiscal+Year+2012&isCollapsed=false&leafLevelBrowse=false&is DocumentResults=true&ycord=0.

Table 1 (cont.). Summary of federal receipts, outlays, surpluses (deficits), and GDP: 1947 to 2016
(in millions of dollars except GDP which is in billions of dollars)

Fiscal year[a]	Total receipts	Total outlays	Surplus or deficit	GDP	Receipts as a % of GDP	Five-year average receipts	Outlays as a % of GDP	Five-year average outlays
1989	991,105	1,143,744	(152,639)	5,399.5	18.36%	18.01%	21.18%	21.87%
1990	1,031,958	1,252,994	(221,036)	5,734.5	18.00%	18.07%	21.85%	21.67%
1991	1,054,988	1,324,226	(269,238)	5,930.5	17.79%	18.13%	22.33%	21.64%
1992	1,091,208	1,381,529	(290,321)	6,242.0	17.48%	17.96%	22.13%	21.75%
1993	1,154,335	1,409,386	(255,051)	6,587.3	17.52%	17.83%	21.40%	21.78%
1994	1,258,566	1,461,753	(203,186)	6,976.6	18.04%	17.77%	20.95%	21.73%
1995	1,351,790	1,515,742	(163,952)	7,341.1	18.41%	17.85%	20.65%	21.49%
1996	1,453,053	1,560,484	(107,431)	7,718.3	18.83%	18.06%	20.22%	21.07%
1997	1,579,232	1,601,116	(21,884)	8,211.7	19.23%	18.41%	19.50%	20.54%
1998	1,721,728	1,652,458	69,270	8,663.0	19.87%	18.88%	19.07%	20.08%
1999	1,827,452	1,701,842	125,610	9,208.4	19.85%	19.24%	18.48%	19.58%
2000	2,025,191	1,788,950	236,241	9,821.0	20.62%	19.68%	18.22%	19.10%
2001	1,991,082	1,862,846	128,236	10,225.3	19.47%	19.81%	18.22%	18.70%
2002	1,853,136	2,010,894	(157,758)	10,543.9	17.58%	19.48%	19.07%	18.61%
2003	1,782,314	2,159,899	(377,585)	10,979.8	16.23%	18.75%	19.67%	18.73%
2004	1,880,114	2,292,841	(412,727)	11,685.6	16.09%	18.00%	19.62%	18.96%
2005	2,153,611	2,471,957	(318,346)	12,445.7	17.30%	17.33%	19.86%	19.29%
2006	2,406,869	2,655,050	(248,181)	13,224.9	18.20%	17.08%	20.08%	19.66%
2007	2,567,985	2,728,686	(160,701)	13,891.8	18.49%	17.26%	19.64%	19.77%
2008	2,523,991	2,982,544	(458,553)	14,394.1	17.53%	17.52%	20.72%	19.98%
2009	2,104,989	3,517,677	(1,412,688)	14,097.5	14.93%	17.29%	24.95%	21.05%
2010	2,162,724	3,456,213	(1,293,489)	14,508.2	14.91%	16.81%	23.82%	21.84%
2011 estimate	2,173,700	3,818,819	(1,645,119)	15,079.6	14.41%	16.05%	25.32%	22.89%
2012 estimate	2,627,449	3,728,686	(1,101,237)	15,812.5	16.62%	15.68%	23.58%	23.68%
2013 estimate	3,003,345	3,770,876	(767,531)	16,752.4	17.93%	15.76%	22.51%	24.04%
2014 estimate	3,332,588	3,977,141	(644,553)	17,782.2	18.74%	16.52%	22.37%	23.52%
2015 estimate	3,583,043	4,189,773	(606,730)	18,804.1	19.05%	17.35%	22.28%	23.21%
2016 estimate	3,819,103	4,467,806	(648,703)	19,790.5	19.30%	18.33%	22.58%	22.66%
Average percentages								
All years shown					17.75%	17.77%	19.92%	20.03%
All years shown excluding estimated years					17.75%	17.88%	19.62%	19.70%
Pre-Bush/Obama years (1947-2000)					17.88%	17.87%	19.44%	19.70%
Bush/Obama years excluding estimated years (2001-2010)					17.07%	17.93%	20.57%	19.66%
Bush/Obama years including estimated years (2001-2016)					17.30%	17.44%	21.52%	21.04%
Estimated years (2011-2016)					17.68%	16.62%	23.11%	23.33%
Standard deviation (all years)					1.97%	1.96%	5.51%	6.06%
Mean + 1 standard deviation					19.71%	19.72%	25.43%	26.08%
Mean - 1 standard deviation					15.78%	15.81%	14.41%	13.97%

Note: [a]The federal fiscal year begins on October 1 and ends on the subsequent September 30. It is designated by the year in which it ends. Prior to 1977, the federal fiscal years began on July 1 and ended on June 30. In calendar year 1976, the July-September period was a separate accounting period, known as the transition quarter (TQ), to bridge the period required to shift to the new fiscal year. For purposes of this study, the TQ is excluded.

The receipts, outlays, and GDP are used to compute the percentages of GDP and average percentage changes. An examination of total receipts and outlays as percentages of GDP reveals receipts as a percentage of GDP average approximately 18 percent over the period shown, 1947 to 2016. This would suggest that GDP is a reasonable basis for predicting receipts because receipts as a percentage of GDP have changed little, on average, since 1947. This holds true whether we examine annual or five-year rolling average percentage. There are also very

few periods where the percentage of receipts (outlays) is more than one standard deviation away from the average. During the Bush/Obama years, 2000 to the present (both with and without the estimates for 2011 to 2016), receipts as a percentage of GDP are slightly but not significantly lower. The five-year average receipts as a percentage of GDP has also been dropping since 2002 and is estimated to be significantly lower than the overall average until 2016.

The overall average outlays as a percentage of GDP is approximately 20 percent versus the 18 percent

for total receipts, resulting in deficits in most years. The OMB is projecting significantly higher outlays as a percentage of GDP, an average of 23.11 percent, over the estimated period of 2011 to 2016. The five-year averages of outlays as a percentage of GDP tend to be either lower or higher than average for decades at a time. For instance, from 1951 to 1976, the five-year averages are all lower than the overall average. From 1977 to 1998, they are all higher but then flip to lower than the overall average again from 1999 to 2008. In 2009, the five-year average jumps above 21 percent and is estimated to remain at even higher levels until 2016, reaching as high as 24.04 percent in 2013. Overall the data indicate that while outlays (spending) as a percentage of GDP move up or down for several decades at a time, receipts tend to remain relatively constant, and predictable, at approximately 18 percent of GDP. Therefore, it appears we already have a flat tax in the U.S. as far as collections.

As shown in Table 1, the annual federal budget typically results in a deficit. Many have suggested we need a balanced budget amendment to the Constitution to avoid these annual deficits and the growth in the federal debt. While that seems unlikely to happen in the near future, Congress did enact pay-as-you-go budget rules in 2010 that require all new spending to be offset by spending cuts elsewhere, revenue increases, or a combination of the two[1]. Based on the OMB projections for 2011 through 2016, it does not appear the budget is being balanced as a result of these rules.

Because receipts are relatively constant as a percentage of GDP, and GDP is relatively easy to predict (the Wall Street Journal, among others, does annual surveys of economists' predictions of GDP), constructing the receipts side of the annual federal budget should, on average, be accurate if receipts are based on GDP. We use a five-year rolling average change in GDP, as opposed to a simple percentage change from the prior year, to smooth any extraordinary changes, thus, allowing for better budgeting. The five-year rolling average change in GDP is multiplied by the actual total receipts in the prior year to estimate the budgeted receipts for the next budget year. In order to reduce annual budget deficits, we also use the budgeted annual receipts resulting from this computation as the maximum budgeted outlays for the same year, resulting in a balanced budget[2]. The five-year rolling average change in GDP, budgeted receipts, and resulting maximum budgeted outlays for all available years are shown in Table 2.

Table 2. Computation of federal budgeted receipts and outlays based on the five-year rolling average change in GDP (in millions of dollars except GDP which is in billions of dollars)

Fiscal year	GDP (in billions)	Change in GDP from prior year	Five-year rolling average change in GDP	Actual total receipts	Budgeted receipts and outlays	Actual receipts over (under) budgeted receipts	Actual total outlays	Actual outlays (over) under budgeted outlays
1947	233.2							
1948	256.6	10.03%						
1949	271.3	5.73%						
1950	273.1	0.66%						
1951	320.2	17.25%						
1952	348.7	8.90%	8.51%	66,167				
1953	372.5	6.83%	7.87%	69,608				
1954	377.0	1.21%	6.97%	69,701	77,908	(8,207)	70,855	7,053
1955	395.9	5.01%	7.84%	65,451	80,995	(15,544)	68,444	12,551
1956	427.0	7.86%	5.96%	74,587	79,756	(5,169)	70,640	9,116
1957	450.9	5.60%	5.30%	79,990	76,116	3,874	76,578	(462)
1958	460.0	2.02%	4.34%	79,636	83,743	(4,107)	82,405	1,338
1959	490.2	6.57%	5.41%	79,249	88,694	(9,445)	92,098	(3,404)
1960	518.9	5.85%	5.58%	92,492	86,698	5,794	92,191	(5,493)
1961	529.9	2.12%	4.43%	94,388	88,056	6,332	97,723	(9,667)
1962	567.8	7.15%	4.74%	99,676	103,102	(3,426)	106,821	(3,719)
1963	599.2	5.53%	5.44%	106,560	102,936	3,624	111,316	(8,380)

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[1] Commonly known as the PAYGO rules, they provide Congress with the ability to make exceptions for certain emergency spending items, and to vote to waive application of the PAYGO rule to certain legislation. President Obama also signed a PAYGO law (P.L. 111-139) on February 12, 2010, which requires the OMB to keep track of new spending and determine if all new spending was paid for each year. If not, an automatic across-the-board spending cut is triggered. This law also provides a number of exceptions for spending identified by Congress as emergency in nature. The PAYGO law is separate and apart from Congress' PAYGO rules. It should be noted that pay-as-you-go rules have existed in the past in various forms and contributed to the budget surpluses seen in the late 1990s.

[2] Of course, if budgeted annual receipts are not sufficient to sustain the current level of outlays (spending), cuts in outlays will be necessary. As noted earlier, we leave the decisions as to which outlays might have to be reduced or eliminated to others.

Table 2 (cont.). Computation of federal budgeted receipts and outlays based on the five-year rolling average change in GDP (in millions of dollars except GDP which is in billions of dollars)

Fiscal year	GDP (in billions)	Change in GDP from prior year	Five-year rolling average change in GDP	Actual total receipts	Budgeted receipts and outlays	Actual receipts over (under) budgeted receipts	Actual total outlays	Actual outlays (over) under budgeted outlays
1964	641.5	7.06%	5.54%	112,613	109,349	3,264	118,528	(9,179)
1965	687.5	7.17%	5.81%	116,817	118,469	(1,652)	118,228	241
1966	755.8	9.93%	7.37%	130,835	125,436	5,399	134,532	(9,096)
1967	810.0	7.17%	7.37%	148,822	130,785	18,037	157,464	(26,679)
1968	868.4	7.21%	7.71%	152,973	150,831	2,142	178,134	(27,303)
1969	948.1	9.18%	8.13%	186,882	171,567	15,315	183,640	(12,073)
1970	1,012.7	6.81%	8.06%	192,807	177,471	15,336	195,649	(18,178)
1971	1,080.0	6.65%	7.40%	187,139	218,504	(31,365)	210,172	8,332
1972	1,176.5	8.94%	7.76%	207,309	225,140	(17,831)	230,681	(5,541)
1973	1,310.6	11.40%	8.60%	230,799	215,860	14,939	245,707	(29,847)
1974	1,438.5	9.76%	8.71%	263,224	240,732	22,492	269,359	(28,627)
1975	1,560.2	8.46%	9.04%	279,090	272,203	6,887	332,332	(60,129)
1976	1,738.1	11.40%	9.99%	298,060	311,075	(13,015)	371,792	(60,717)
1977	1,973.5	13.54%	10.91%	355,559	331,830	23,729	409,218	(77,388)
1978	2,217.5	12.36%	11.10%	399,561	360,587	38,974	458,746	(98,159)
1979	2,501.4	12.80%	11.71%	463,302	437,374	25,928	504,028	(66,654)
1980	2,724.2	8.91%	11.80%	517,112	493,187	23,925	590,941	(97,754)
1981	3,057.0	12.22%	11.97%	599,272	578,160	21,112	678,241	(100,081)
1982	3,223.7	5.45%	10.35%	617,766	646,351	(28,585)	745,743	(99,392)
1983	3,440.7	6.73%	9.22%	600,562	751,324	(150,762)	808,364	(57,040)
1984	3,844.4	11.73%	9.01%	666,438	752,261	(85,823)	851,805	(99,544)
1985	4,146.3	7.85%	8.80%	734,037	716,411	17,626	946,344	(229,933)
1986	4,403.9	6.21%	7.59%	769,155	791,940	(22,785)	990,382	(198,442)
1987	4,651.4	5.62%	7.63%	854,288	868,912	(14,624)	1,004,017	(135,105)
1988	5,008.5	7.68%	7.82%	909,238	890,344	18,894	1,064,416	(174,072)
1989	5,399.5	7.81%	7.03%	991,105	989,626	1,479	1,143,744	(154,118)
1990	5,734.5	6.20%	6.70%	1,031,958	1,057,003	(25,045)	1,252,994	(195,991)
1991	5,930.5	3.42%	6.15%	1,054,988	1,135,352	(80,364)	1,324,226	(188,874)
1992	6,242.0	5.25%	6.07%	1,091,208	1,174,873	(83,665)	1,381,529	(206,656)
1993	6,587.3	5.53%	5.64%	1,154,335	1,188,742	(34,407)	1,409,386	(220,644)
1994	6,976.6	5.91%	5.26%	1,258,566	1,227,701	30,865	1,461,753	(234,052)
1995	7,341.1	5.22%	5.07%	1,351,790	1,288,216	63,574	1,515,742	(227,526)
1996	7,718.3	5.14%	5.41%	1,453,053	1,394,449	58,604	1,560,484	(166,035)
1997	8,211.7	6.39%	5.64%	1,579,232	1,492,336	86,896	1,601,116	(108,780)
1998	8,663.0	5.50%	5.63%	1,721,728	1,614,526	107,202	1,652,458	(37,932)
1999	9,208.4	6.30%	5.71%	1,827,452	1,762,393	65,059	1,701,842	60,551
2000	9,821.0	6.65%	6.00%	2,025,191	1,921,052	104,139	1,788,950	132,102
2001	10,225.3	4.12%	5.79%	1,991,082	2,042,105	(51,023)	1,862,846	179,259
2002	10,543.9	3.12%	5.14%	1,853,136	2,275,505	(422,369)	2,010,894	264,611
2003	10,979.8	4.13%	4.86%	1,782,314	2,228,324	(446,010)	2,159,899	68,425
2004	11,685.6	6.43%	4.89%	1,880,114	2,048,534	(168,420)	2,292,841	(244,307)
2005	12,445.7	6.50%	4.86%	2,153,611	1,959,765	193,846	2,471,957	(512,192)
2006	13,224.9	6.26%	5.29%	2,406,869	2,068,485	338,384	2,655,050	(586,565)
2007	13,891.8	5.04%	5.67%	2,567,985	2,368,029	199,956	2,728,686	(360,657)
2008	14,394.1	3.62%	5.57%	2,523,991	2,668,251	(144,260)	2,982,544	(314,293)
2009	14,097.5	-2.06%	3.87%	2,104,989	2,867,450	(762,461)	3,517,677	(650,227)
2010	14,508.2	2.91%	3.15%	2,162,724	2,812,994	(650,270)	3,456,213	(643,219)
2011 estimate	15,079.6	3.94%	2.69%	2,173,700	2,271,068	(97,368)	3,818,819	(1,547,751)
2012 estimate	15,812.5	4.86%	2.65%	2,627,449	2,301,122	326,327	3,728,686	(1,427,564)
2013 estimate	16,752.4	5.94%	3.12%	3,003,345	2,292,218	711,127	3,770,876	(1,478,658)
2014 estimate	17,782.2	6.15%	4.76%	3,332,588	2,768,549	564,039	3,977,141	(1,208,592)

Table 2 (cont.). Computation of federal budgeted receipts and outlays based on the five-year rolling average change in GDP (in millions of dollars except GDP which is in billions of dollars)

Fiscal year	GDP (in billions)	Change in GDP from prior year	Five-year rolling average change in GDP	Actual total receipts	Budgeted receipts and outlays	Actual receipts over (under) budgeted receipts	Actual total outlays	Actual outlays (over) under budgeted outlays
2015 estimate	18,804.1	5.75%	5.33%	3,583,043	3,193,677	389,366	4,189,773	(996,096)
2016 estimate	19,790.5	5.25%	5.59%	3,819,103	3,657,401	161,702	4,467,806	(810,405)
Totals								
All years shown						318,186		(13,529,613)
All years shown excluding estimated years						(1,737,007)		(6,060,547)
Pre-Bush/Obama years (1954-2000)						175,620		(3,393,484)
Bush/Obama years excluding estimated years (2001-2010)						(1,912,627)		(2,667,063)
Bush/Obama years including estimated years (2001-2016)						142,566		(10,136,129)
Estimated years (2011-2016)						2,055,193		(7,469,066)

The annual federal budget prepared by OMB is released in February each year by the President and is for the upcoming fiscal year that begins on October 1 of that year. For example, OMB uses data from the fiscal year ended September 30, 1998, to prepare the 2000 budget that will be released by the President in February 1999. This budget covers the fiscal year beginning on October 1, 1999 and ending on September 30, 2000. Due to the timing of the budget process, OMB must use actual data from two years prior to the budget year to prepare the budget.

To control for this delay, we use a compounded five-year rolling average change in GDP. For example, continuing with our 2000 budget year example, the five-year rolling average change in GDP at the end of the 1998 fiscal year is 5.63 percent. To compute the 2000 budgeted receipts we compound this average change in GDP by raising 1.0563 (1 plus the average change in GDP for 1998) to the power of two to approximate the same information as of the end of fiscal year 2000. The result is then multiplied by the actual receipts from the 1998 fiscal year of $1,721,728 (in millions), resulting in budgeted receipts and, therefore, maximum budgeted outlays for 2000 of $1,921,052 (in millions)[1].

3. Flatter progressive tax system

Setting maximum outlays equal to budgeted receipts will lead to a balanced federal budget, on average. However, there is still the issue of determining an income tax rate that will result in sufficient receipts to fund these outlays. One of the issues with past flat tax proposals was the proposed tax rate was perceived to be too high by many. In order to develop a lower tax rate, we propose changing the tax base to gross income. This will eliminate the need for thousands of pages of tax law and regulations dealing with deduction limits and eligibility requirements, and allow the overall tax rate to be lower. We also propose eliminating tax credits for the same reason. This will bring the income tax code back to first principles, i.e., collecting tax revenue to fund the government, simplify the income tax code, and eliminate various tax provisions aimed at influencing behavior.

To develop our flatter progressive tax system, we use data from two publicly available sources. In addition to the GDP data previously mentioned (available from OMB), we use historical average pretax household income and share of total federal tax liability by household income quintiles available from the Congressional Budget Office (CBO). The highest quintile is also partitioned to show the top 10 percent, 5 percent, and 1 percent of all households. A CBO report issued in June 2010 provides this data for 1979 through 2007, along with the number of households in each household income quintile by year[2]. According to OMB historical federal budget data, the portion of total federal receipts representing individual and corporate income tax collections from 1979 to 2007 averaged 45.7 percent and 10.2 percent, respectively[3].

To start, we compute a flat amount of tax per household, regardless of household income level; simply total budgeted receipts divided by number of households in the U.S. Using this system, each household in the U.S. would pay $9,267 a year in federal taxes as shown in Table 3. This is a true flat tax. The problem is, as a percentage of household income, the lowest quintile of households pays 50.36 percent of their pretax income in federal taxes while the top 1 percent of households pays 0.49 percent. It is easy to see why this is an untenable and unreasonable method to impose income tax and we simply compute it as a point of reference.

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[1] As a matter of national security, exceptions could be made in the case of a declared war.

[2] This report, *Average Federal Taxes By Income Group*, dated June 1, 2010, can be accessed electronically at CBO's website at http://www.cbo.gov/publication/42870. This data was extended to 2009 by a report entitled *The Distribution of Household Income and Federal Taxes, 2008 and 2009*, dated July 10, 2012, which can be accessed electronically at CBO's website at http://www.cbo.gov/publication/43373. Due to the dramatic economic downturn in 2008 and 2009, using household data from this period would bias our computations.

[3] The remaining federal receipts come from employment taxes (35.3 percent), excise taxes (4.1 percent), and other (4.6 percent).

Table 3. Computation of each household's share of tax

Budgeted receipts for 2007 (from Table 2)					$ 2,368,029,000,000			
Average % paid by individuals per OMB (average for 1979-2007)					45.7%			
Portion of budgeted receipts paid by individuals					$ 1,083,087,470,897			
Number of households in 2007 per CBO					116,880,000			
Tax per household for 2007					$ 9,267			
Average pretax household income groups								
	Lowest quintile	Second quintile	Middle quintile	Fourth quintile	Highest quintile[a]	Top 10%	Top 5%	Top 1%
Tax per household for 2007 (from above)	$ 9,267	$ 9,267	$ 9,267	$ 9,267	$ 9,267	$ 9,267	$ 9,267	$ 9,267
2007 average before-tax household income (2007 dollars) per CBO	$ 18,400	$ 42,500	$64,500	$ 94,100	$ 134,000[b]	$ 394,500	$ 611,200	$ 1,873,000
Tax liability as a % of household income	50.36%	21.80%	14.37%	9.85%	6.92%	2.35%	1.52%	0.49%

Notes: [a]The Top 10/5/1% have been removed from this quintile, leaving just the 81st-90th percentile. [b]Cannot adjust the 2007 figures to exclude the top 10/5/1%; could only do this to other data because they are percents and this one is dollars. In 2009 CBO report, these figures were presented without the top 10/5/1% numbers but only in 2009 dollars. We took the 2007 amount for the 81st-90th percentiles, which was in 2009 dollars, and adjusted it back to 2007 dollars.

Next we compute each household's tax liability using CBO data for number of households and each household's historical share of total federal tax liabilities per quintile along with our previous computation of budgeted federal receipts for 2007 in Table 4. This results in a tax liability where each household's share of the budgeted receipts necessary to fund the federal government is based on each household income quintile's historic share of federal tax liabilities. Dividing this dollar amount by the average pretax household income per quintile produces a tax rate for each quintile. For example, the average household in the lowest quintile would pay $638, representing 3.47 percent of their pretax income, while households in the top 1 percent would pay $203,079, representing 10.84 percent of their pretax income. We then use this simple household tax liability to construct a more reasonable and flatter progressive tax rate.

One goal of our computation of federal budgeted receipts (and, therefore, outlays) based on GDP is to insure the federal government receives sufficient revenue. Our other goals are to simplify the tax system and keep the tax rate fairly low. However, after reviewing the amount of tax paid as a percentage of household income necessary to generate sufficient federal receipts, it seems doubtful that one flat rate for all households will accomplish these goals. Households in the lowest quintile would pay a much larger percentage of their income in tax than most policymakers would support.

In order to develop a flat tax rate system that is fair (however you interpret the word 'fair'), but still easy to apply, it must allow for a slightly progressive structure. Testing a number of options lead us to settle on a system where households pay 3 percent, 6 percent, 9 percent and 12 percent, for the households with income in the lowest, second, middle and fourth, and highest household quintiles,

respectively, and the tax base starting at one dollar of gross income. While not truly a flat tax rate, it is almost flat and still easy to apply. During some years, this flatter progressive tax system generates more than the budgeted receipts required to fund the government, so the excess would be used to pay down the national debt. In years where no surplus is generated, the resulting deficit, through borrowing, would increase the national debt. After the national debt was reduced or eliminated, the tax rate could be adjusted to allow for a completely balanced budget or continue for a term of years to create a reserve for times of national emergency.

As will be noted below, the portion of total federal receipts representing individual and corporate income tax collections from 1979 to 2007 averaged 45.7 percent and 10.2 percent, respectively. Using the same methodology we used for individuals, we suggest a true flat tax rate for corporations assuming they are taxed on all revenue as shown on their audited financial statements, eliminating the need for tax deductions and credits. Financial information for all corporations listed in Compstat for 2007 is presented in Table 5. There are a total of 14,141 corporations with total sales of $39.5 trillion and federal tax expense of $245.2 billion. We assume a 1 percent flat tax rate because the tax base is so much larger than taxable income as it is currently computed. While this may seem low, it is reasonable because corporations pass the cost of federal taxes on to consumers via higher prices for goods and services. As a result, individuals pay both individual income tax and the majority of corporate taxes. A 1 percent flat tax on corporations results in tax receipts of $394.6 billion based on our 2007 scenario. This amount is significantly lower than the amount that would be collected because it only includes corporations listed in Compustat and not all corporate entities.

Table 4. Computation of flatter progressive tax rates by household income quintiles

	Totals	Average pretax household income groups							
		Lowest quintile	Second quintile	Middle quintile	Fourth quintile	Highest quintile[a]	Top 10%	Top 5%	Top 1%
Share of federal tax liabilities per OMB (average for 1979-2007)		1.45%	5.80%	11.20%	18.75%	14.80%	10.90%	15.20%	21.75%
Portion of budgeted receipts paid by individuals (as computed in Table 3)	1,083,087,470,897								
Portion of those budgeted receipts per quintile		15,704,768,328	62,819,073,312	121,305,796,740	203,078,900,793	160,296,945,693	118,056,534,328	164,629,295,576	235,571,524,920
Number of households in 2007 (rounded)		24,634,000	22,220,000	22,856,000	22,978,000	11,735,000	6,007,000	4,772,000	1,160,000
Portion of budgeted receipts per household		683	2,827	5,307	8,838	13,660	19,653	34,499	203,079
2007 average before-tax household income (2007 dollars) per CBO		18,400	42,500	64,500	94,100	134,000[b]	394,500	611,200	1,873,000
Tax liability as a % of household income		3.47%	6.65%	8.23%	9.39%	10.19%	4.98%	5.64%	10.84%
Progressive flat tax rate		3.00%	6.00%	9.00%	9.00%	12.00%	12.00%	12.00%	12.00%
Tax per household using progressive flat tax rate		552	2,550	5,805	8,469	16,080	47,340	73,344	224,760
Number of households in 2007 (rounded)		24,634,000	22,220,000	22,856,000	22,978,000	11,735,000	6,007,000	4,772,000	1,160,000
Total tax revenue per quintile	1,481,328,078,000	13,597,968,000	56,661,000,000	132,679,080,000	194,600,682,000	188,698,800,000	284,371,380,000	349,997,568,000	260,721,600,000

Notes: [a]The Top 10/5/1% have been removed from this quintile, leaving just the 81st-90th percentile. [b]Cannot adjust the 2007 figures to exclude the top 10/5/1%; could only do this to other data because they are percents and this one is dollars. In 2009 CBO report, these figures were presented without the top 10/5/1% numbers but only in 2009 dollars. We took the 2007 amount for the 81st-90th percentiles, which was in 2009 dollars, and adjusted it back to 2007 dollars.

Table 5. Computation of corporate share of tax

Budgeted receipts for 2007 (from Table 2)	$ 2,368,029,000,000				
Average % paid by corporations per OMB (average for 1979-2007)	10.2%				
Portion of budgeted receipts paid by corporations	$ 242,600,488,241				
Computation of flat tax paid by corporations					
Number of observations	Total sales	Total net income	Total assets	Total federal tax	Flat tax rate
14,141	$ 39,464,524,050,000	$ 2,813,215,732,000	$ 124,451,270,400,000	$ 245,231,677,000	1.0% $ 394,645,240,500

Notes: Of the 14,141 firms listed in Compustat only 5,469 had federal tax information. Total federal tax is from the tax footnote-federal (Compustat name txfed).

Table 6 compares the flat tax collections from individuals (Table 4) and corporations (Table 5) with the budgeted receipts computed in Table 2. Using our flatter progressive tax proposal with 2007 GDP, number of households, and household and corporate income data, there would be $550.3 billion in excess federal receipts in 2007. Since outlays are set equal to budgeted receipts, any excess receipts could not be spent but would, in-stead, be used to reduce the national debt. If no national debt exists, excess receipts are used to reduce the budgeted receipts for the next budget year or to fund a reserve to be used in cases of national emergency. When the national debt is eliminated or reduced to a level with which poli-cymakers are comfortable, the flat tax rate could be adjusted downward so that a balanced budget would result.

Table 6. Comparison of computed tax collections to budgeted receipts (2007)

	Individual (Table 4)	Corporate (Table 5)	Total
Progressive flat tax collections	$ 1,481,328,078,000	$ 394,645,240,500	$ 1,875,973,318,500
Budgeted receipts	$ 1,083,087,470,897	$ 242,600,488,241	$ 1,325,687,959,138
Excess collections	$ 398,240,607,103	$ 152,044,752,259	$ 550,285,359,362

While the basis of this flat tax proposal is devel-oped using historical averages of GDP, household income, share of total federal tax liabilities per household, etc., those averages are then applied to 2007 data. Although this is a potential limitation of our computations, it is reasonable to assume that the historical averages will smooth the impact of any short-term changes in overall economic conditions and provide a sound tax system over the long term.

Conclusion

There is little argument that the U.S. government, like each of us, needs money to accomplish its de-sired goals[1]. The question is, as it always has been, how much does the federal government actually need? Most taxpayers generally have no problem paying taxes. The issue, and what taxpayers seem in search of, is a taxing system that is equitable, straightforward and relatively easy to apply, and provides government with enough, but not too much, revenue. Governments around the world, struggling with these same issues, are reforming their tax systems with many of them instituting true flat tax systems or tiered system with a higher rate for high-income taxpayers.

Our recommendation is twofold. First, the federal budget system is changed so receipts and outlays are based on a five-year historical rolling average change in GDP. Second, individuals and corpora-tions are taxed on gross earnings using a flatter progressive tax system. For individuals this is gross income with no deductions or credits. For corporations, this is gross revenues and gains from their audited financial statements (or other books and records if no financial audit is performed). This means all households and corporations have 'skin in the game' which is an indicator of an equitable system. In essence, the federal govern-ment collects receipts based on the nation's GDP and taxpayers are taxed according to their own gross production.

While this budget process keeps federal government growth in line with overall economic growth, it also accentuates the fact that "it's the economy, stupid" (a phrase made popular during the 1992 presidential campaign) was not such a bad warning. Any growth in the federal budget will be driven by growth in the overall economy and, likewise, any shrinkage in the overall economy will drive a reduction in the size of the federal government. Unlike the current federal budgeting system, which relies heavily on the amount of spending contained in prior budgets, this new system looks at revenue (receipts), keeps feder-al spending in check by restricting it to the amount of revenue, and provides taxpayers with a much simpler tax system.

Our proposal focuses on determining the amount of revenue the government collects and restricts spend-ing to the same amount. This built-in overall spend-ing limit serves to balance the budget on average. Although outside the scope of this paper, another approach to the federal budget and national debt would be to concentrate on the spending side, per-haps instituting a zero baseline budgeting system. However, given the size of the U.S. government, the feasibility of such a system is unclear.

Legislative action is required to affect the changes we propose, which, given the current U.S. political climate, seems unlikely to occur in near future. There is currently bipartisan support on the issue of tax reform but it is unclear if there is enough com-mon ground for lawmakers to agree on how to reform the tax system. By focusing on the federal budget process and then a tax system that eliminates all deductions and credits, the influence of special interest groups and lobbyists could be mitigated to a point where lawmakers are motivated to act sooner as opposed to later.

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[1] We leave it to others to determine the goals of the federal government.

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