What is the flat tax?

While any tax system with flat rates could be called a flat tax, the name "flat tax" is usually reserved for a system developed by Robert Hall and Alvin Rabushka in a 1985 book. Their flat tax is really a two-part VAT, with all value added except wages taxed at the business level and wages taxed at the individual level at the same flat rate, but with an exemption related to family size.

The Hall-Rabushka flat tax would replace the current income tax system with a consumption tax. Their system is a two-part value-added tax (VAT). All value added, except wages, which would be deductible, would be taxed at the business level. Wages would be taxed at the individual level, with an exemption based on family size. All taxable wages and all business nonwage value added would face the same flat rate. In Hall and Rabushka's original proposal, that rate would be 19 percent (1985).

In short, the flat tax is a consumption tax, even though it looks like a wage tax to households and a variant of a VAT to most businesses. Therefore, other than the exemptions, the economic effects of the flat tax are essentially the same as those of a VAT or a sales tax.

The flat tax can be split into two parts: the business tax and the individual tax. Firms would be responsible for paying taxes (at a flat rate) on sales after they have deducted wages, pensions, material costs, and capital investments. Individuals would be responsible for paying taxes (again, at a flat rate) on the wages that firms have deducted, but only on wages in excess of an exemption level.

WORK CITED AND FURTHER READING

Aaron, Henry J., and William G. Gale. 1996. *Economic Effect of Fundamental Tax Reform.* Washington, DC: Brookings Institution Press.

Gale, William G. 2005. "Flat Tax." In *Encyclopedia of Taxation and Tax Policy*, 2nd ed., edited by Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (149–51). Washington, DC: Urban Institute Press.

Hall, Robert E., and Alvin Rabushka. 1985. *The Flat Tax.* Stanford, CA: Hoover Institution Press.