

# POLICY REPORT

DEBATE ON THE  
FLAT-RATE TAX

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## Banking Regulation and Economic Change

By Catherine England

Six months ago, a survey of news stories on banks and savings and loan associations (S&Ls) would have indicated considerable concern about the general health of the industry. Oklahoma City's Penn Square National Bank had just failed, raising serious questions about the efficacy of federal regulatory oversight as well as the stability of the banking system itself. The failure of Penn Square highlighted the far-reaching interconnections among depository institutions. Two of the nation's top 10 banks as well as a number of savings and loan associations and credit unions were caught with uninsured funds in Penn Square.

Examining the newspaper articles dealing with banking and the financial services industry during the past few months, however, reveals a significant shift in emphasis. While the general economic health of the industry still gets some press, news stories today are most likely to consider the new systems and services that are being offered or the new rules under which banks may soon operate.

Several questions come to mind. Why has the shift in emphasis occurred? Have the problems which generated the earlier concern been resolved? What can we expect in the future? While it would be difficult to find complete answers to these questions, some important points are worth considering.

### The Shift in Emphasis

One explanation for this shift in attention lies in general economic conditions. Interest rates have fallen substantially since July. The prime rate (that interest

rate banks charge their best corporate customers) has fallen from above 16% six months ago to 11% today. In addition, the index of leading indicators was up strongly in December, indicating that a recovery may, at long last, be underway. Furthermore, the weakest banks and S&Ls have already failed or merged with stronger institutions. Thus, the health of the industry is not the cause for concern it was in July.

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**"The banks and thrifts have been unnecessarily, and perhaps permanently, weakened by government interference in the marketplace."**

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This is not to say there are no longer any problems. Clearly, many banks and savings and loans are in dire straits. In addition, the health of the banking industry generally lags slightly behind changes in the business cycle. A number of new and exciting changes are taking place for the depository institutions, however, and those are generating a considerable amount of interest.

The most dramatic change undoubtedly has been the lifting of ceilings on the interest that may be paid depositors. Beginning December 14, 1982, banks and S&Ls were allowed to offer whatever interest rate they chose on limited access (i.e., no more than six drafts per month) accounts with a minimum balance of \$2,500. On January 5, 1983 banks and S&Ls began offering noncor-

porate customers fully checkable (or "Super NOW") accounts with no government-imposed interest rate ceilings. Beyond the confusion these new accounts have caused, and the circus-like atmosphere created by banks and S&Ls trying to outbid one another and attract deposits, there is also a great deal of speculation about the impact the new accounts will have on the industry.

As of January 12, the money market accounts had attracted \$147 billion while the fully checkable accounts had total deposits of \$8.5 billion. Contrary to what many people expected, however, these funds have not been drawn primarily from the money market mutual funds (MMMFs). Deposits with the MMMFs have been reduced only about \$30 billion since the new accounts were introduced. The other \$125 billion now in the market accounts of the depository institutions has come primarily from checking and savings deposits the banks and thrift institutions already held.

One might wonder, then, what the banks and savings and loan associations have gained by the introduction of the new accounts. After all, their costs have been raised substantially through higher interest payments, without significant gains through increases in total deposits. The most important gain has been a reversal of the net outflow of funds that depository institutions had been experiencing. Given their new power to pay depositors a market rate of interest, the banks and thrift institutions can expect a more stable source of deposits as customers need no longer shift funds in search of a return above the inflation rate.

As important as the recent changes are, however, they still do not resolve many of the underlying structural defi-

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(Cont. on p. 3)

# Who's Responsible for the Growing Budget?

President Reagan projects the 1984 federal budget at \$848.5 billion. One year ago he had projected it at \$805.9 billion. Earlier he had projected \$772 billion. President Reagan's 1984 figure is now higher than the one projected by President Carter, who was assuming a higher rate of inflation. President Reagan's budget is some \$30 billion higher in real terms than President Carter had projected.

Clearly, federal spending has not been reduced. It has not even been leveled off. Projected 1984 spending is \$22 billion higher in real terms — and \$42.6 billion higher in nominal dollars — than was projected just a year ago.

The players in the budget game are now waging a heated battle over what part of the budget is responsible for this continuing and dangerous growth. Liberals generally insist that defense spending is to blame. Karen W. Arenson writes in the *New York Times* that defense spending amounts to 43% of the federal spending if Social Security and net interest payments are removed. (Of course, military spending would amount to 83% of the budget if all benefit payments, grants to states and localities, and interest were removed.)

Critics of the defense budget point out that it will amount to \$1.8 trillion in authorizations between 1984 and 1988. While nondefense spending will increase by 13% over four years, military spending will rise 50%. Defense spending (excluding personnel costs) will grow from 4.7% to 10% of the goods-producing sector of the economy. Defense is scheduled to grow from 5.5% of GNP in 1981 to 7.8% in 1988. Clearly, these critics say, responsibility for the continuing growth of federal spending and the deficit lies with the defense budget.

Conservatives and supporters of the defense budget refute these arguments. Columnist Pat Buchanan writes, "Even if Reagan gets all he asks in 1984, defense spending will account for only 29 percent of federal spending, far below the 44 percent of John F. Kennedy's time." Buchanan points out that just one domestic program — Social Security — has risen from \$11 billion in 1960 to \$174 billion in 1983. The largest government department is still — and by Reagan's figures will continue to be — Health and Human Services, not the Pentagon. Payments to individuals increased from \$30.4 billion in 1963 to \$391.9 billion in 1983. Despite the much-heralded cuts, President Reagan's budget proposes to increase federal outlays for the unemployed and low-income from \$78 billion in 1981 to \$92.7 billion in 1984, while expenditures for the elderly will rise from \$103.9

billion in 1978 to \$236.1 billion in 1984. Entitlements programs overall will increase from \$363.4 billion in 1984 to \$481.4 billion in 1988. Thus, it is out-of-control domestic spending that is responsible for massive budget increases.

We at *Policy Report* find that we frequently can't agree with either liberals or conservatives. This time, however, we are in agreement with both. Both military and domestic spending are responsible for our budget problems. In an economic sense, it doesn't really matter, of course. The taxpayer who can't make his own budget balance, the business shut out of the capital markets by government borrowing, the worker who lost his job because of the burden of the government on our economy, can't really tell what kind of spending caused their problems. All government spending extracts resources from the private sector.

In a different sense we may think the issue does matter. If we believe that the government is failing to meet its obligations in a particular area, we may favor spending more on that function — and then we are likely to blame the other spending programs for our overall budget problems. It seems clear to us, though, that a thorough re-evaluation of national needs would allow us to cut spending across the board, from entitlements to the military.

Actually, we shouldn't be surprised that despite temporary ups and downs, government spending continues to grow in all major areas. The political impetus for big government can more easily accommodate new spending programs than discriminate between them. Log-rolling on Capitol Hill more often takes the form of "I'll vote for your weapons program if you'll vote for my education bill" than "I'll vote against the jobs bill if you'll vote against the MX." This is why today's "bipartisan compromises" almost always mean "tax increases."

Conservatives who want lower domestic spending and much higher military spending have set a very difficult task for themselves. It is awkward to make the case that government is far too large and too expensive while simultaneously arguing for a half-trillion dollar increase in defense spending. They would find it easier to build an intellectual and political movement for smaller government across the board. If they fail to do that, we can expect government to continue to grow, and arguments over which part of the budget is growing faster will be largely diversionary. ■

## Banking Regulation (Cont. from p. 1)

ciencies in the system. The immediate problems may have been relieved, especially if a stronger economy is just around the corner, but that does not mean that there won't be other difficulties in the future. A brief examination of the crises faced by these institutions during the past couple of years perhaps will provide some lessons about what lies ahead.

### Interest Rate Ceilings

The primary problem was, as everyone is by now aware, the interest rate ceilings. With the high and rising inflation of the past few years, there was a demand for liquid assets that paid a market rate of interest. The banks and S&Ls were prevented from meeting this demand for new financial assets by government-imposed interest rate ceilings (which they had generally supported earlier). Once the money market mutual funds gained prominence, the banks and thrift institutions found they had no means of competing to hold the funds they were losing.

It took the government awhile (in particular the Depository Institutions De-regulation Committee, or DIDC) but they finally removed the restrictions on what could be paid depositors — at least those depositors with account balances of over \$2,500. In the meantime, however, the banks and S&Ls lost over \$250 billion to the money market mutual funds. These nonbank institutions will undoubtedly be reluctant to give these funds back. Thus, strong competition can be expected to develop between the traditional depository institutions and the nonbank holders of funds. While this competition will be good for consumers, the banks and thrifts have been unnecessarily, and perhaps permanently, weakened by government interference in the marketplace. Given the disaster caused by these regulations, one must hope that ceilings on deposits of under \$2,500 will soon be removed.

### Institution Specialization

The thrift institutions (i.e., savings and loan associations and mutual savings banks) were hit first and hardest

during the recent period of hardships. Much of the reason is the mismatch of assets and liabilities inherent in savings and loans and mutual savings banks. By law, the thrifts are required to place the lion's share of their loan portfolios in long-term mortgages while most of their deposits are essentially short term, available to depositors on demand. This created serious problems when the thrifts found themselves losing deposits and facing rising costs, but unable to adjust their loan portfolios accordingly. Because of the long-term nature of the vast majority of their loans, the average effective yield on mortgages held by S&Ls in 1980 was only 8.79% while the inflation rate was 12.4%. It is easy to understand why most thrift institutions found profits nonexistent and many depleted their equity.

It is time to accept that the housing industry no longer needs to be subsidized by forcing a specific group of financial institutions to provide mortgage funds. A more diversified portfolio would lead to a safer, more stable set of institutions. Furthermore, funds would continue to be available for mortgages. As one part of a generally diversified loan portfolio, mortgages can be very profitable. They are a relatively secure loan (people are more likely to make their mortgage payment than any other), and the new variable rate mortgages minimize risk. In addition, the expertise of the thrift institutions is largely in mortgage lending. They would almost certainly continue to put a large part of their portfolios in mortgages. Therefore, there is no longer any need (if there ever was) to continue to require thrift institutions to concentrate almost exclusively on home mortgages.

The problems with the loan portfolios of thrifts is only part of a larger problem, however. Since the 1930s, the various sorts of financial institutions have been pigeonholed. Each classification is viewed by the federal regulators as having a specific function, with no need to expand its services. Over the past few years, however, market forces have begun to blur the lines dividing various financial institutions. New en-

## In This Issue

Banking Regulation and Economic Change	1
Editorial: Who's Responsible for the Growing Budget?	2
Policy Forum: The Flat-Rate Tax	6
Policy Report Reviews: TV Coverage of the Oil Crises: How Well Was the Public Served?	10
American Economics Texts: A Free Market Critique	10
What the Anti-Federalists Were For	11
Agenda '83	11
"To be governed . . ."	12

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(Cont. on p. 4)

## Banking Regulation (Cont. from p. 3)

trants — particularly those from outside the industry like American Express, Sears, and Merrill Lynch, to name a few — have attempted to attract customers by offering a wide range of financial services. With the existence of these "financial supermarkets," why should consumers be forced to deal with several different institutions to take care of their financial needs? If financial institutions — particularly banks and S&Ls — are to better serve consumers in the future, the guidelines defining what sort of behavior is proper or acceptable for a particular type of financial institution ought to be loosened or eliminated. Removing restrictions on the kinds of businesses bank holding companies can buy, for example, would help increase the flexibility of depository institutions in offering new products. This will become increasingly important in a rapidly changing world.

### Interstate Banking

Restrictions on the geographic locations of banks and S&Ls also may create problems in the future. The McFadden Act of 1927 and the Douglas Amendment to the Bank Holding Company Act of 1956 restrict the movement of banks across state lines. Advances in telecommunications, coupled with the mobility of the average American, are making these prohibitions on interstate banking increasingly burdensome. As the non-traditional financial institutions gear up to make the funds of the average American available nationwide, banks and S&Ls stand to lose once again.

The belief that an "undue concentration of financial resources" would result from such a move simply has no basis in fact. Well-run unit banks have proven they can survive in states allowing statewide branching. In California, for example, more than one-third of the banks have survived as unit banks despite potential competition from Bank of America, the nation's largest bank. In New York State, the evidence is even stronger. Facing potential competition from at least five of the nation's top 10 banks, over 46% of New York banks continue to exist while operating one office.

The advantages of more liberal branching laws are many. Branch banking, where it exists, has increased the stability of the system during economic downturns. A wider geographic base leads to more diversified loan portfolios and a broader system of support if one office begins losing money.

Even more important, however, is the increase in competition that would result. The mere threat of new competition is often enough to ensure that existing banks give customers the best service possible. Many small upstate New York banks, upon hearing that a New York City bank was about to open a local branch, quickly offered free checking and expanded overdraft privileges along

**"Depository institutions are still too closely regulated to provide consumers with the best possible service and to adjust to changing economic conditions."**

with other new services. Recent news stories decrying the continuing practice by most banks of placing holds on out-of-state checks could become a thing of the past with increased competition.

Finally, interstate branching would obviously allow customers access to their funds over a broader geographic area. Supreme Court decisions of the 1960s made it clear that bank mergers were subject to the nation's antitrust laws, so the legal mechanism is in place to protect against "undue concentration of financial power."

Some progress in this area is being made. Recent legislative changes have given federal regulatory authorities increased power to approve mergers for failing institutions across state lines and across industries. Furthermore, some states are beginning to negotiate reciprocal agreements allowing branch-

ing across state lines. The federal government could do much to help facilitate such changes. An important issue continues to be the definition of a "bank." This question applies particularly to the increasingly widespread use of automatic teller machines (ATMs). Using a looser definition for "bank" would be one way of allowing extended use of ATMs and, thus, easier access to funds.

### Changes in Disclosure Rules

The failure of Penn Square drew attention to two other problems in particular. The first of these has to do with the information available about the financial health of depository institutions.

As noted earlier, a number of financial institutions were caught with uninsured funds in Penn Square when it failed. The fact that these banks, S&Ls, and credit unions were uninformed about the serious nature of Penn Square's problems raised questions about the secrecy surrounding the condition of depository institutions. Unlike other publicly held corporations with extensive disclosure requirements, much of the information concerning the health of a bank or S&L has traditionally been considered too sensitive to be made public.

The realization that the powers of depository institution regulators are limited has led to a re-examination of this general premise. While the threat of a run on an unsound bank sends shivers down many spines, the notion that market forces ought to have some role in disciplining excessively risky banks and S&Ls is gaining popularity. Large depositors (those with deposits exceeding the \$100,000 insured amount) have asked how they are to protect themselves from unwise lending practices without some information about those decisions.

As a result, the Securities and Exchange Commission has issued new disclosure guidelines. In October 1982, the SEC began requiring increased information about past-due foreign loans held by domestic banks. The Commission left the banks with a good deal of discretion, however, in deciding which countries

have liquidity problems, which could have a material impact on their ability to repay loans. Bankers naturally have fought the changes, but most observers feel that the market will demand fuller disclosure so that riskier banking practices can be subjected to much-needed market discipline. In the end, a safer, more stable system of financial institutions could result.

### Deposit Insurance

The decision by the Federal Deposit Insurance Corporation to pay the depositors of Penn Square rather than arranging a merger raised a second set of questions about FDICs in foreseeing and preventing failures. In particular, criticism was directed at the practice of charging a single flat rate percentage of total deposits as an insurance premium regardless of the relative risk of the institution. This policy, in effect, encourages the managers of depository institutions to take on more risk than they would otherwise. Riskier loans generally carry a higher interest and, hence, if paid back, can prove extremely profitable. Depositors are generally unconcerned about the risk of a particular loan portfolio because of the existence of federally-supplied deposit insurance. And taking on more risk in the financial services industry will not lead to an increase in insurance premiums (unlike almost every other field).

The Penn Square fiasco threw these weaknesses in the deposit insurance system into sharp relief. As a result, for the first time in the 50 years since it was established, federal regulators are admitting publicly that the current system of deposit insurance could stand a few changes. The most popular proposal has been the suggestion that the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) begin charging variable rate insurance premiums based on the category or classification of the bank or S&L.\* Bankers have argued, however, that it is not clear that regula-

\*When examined, depository institutions are assigned to one of five categories. Institutions with a rank of "one" are considered the soundest while those with a rank of "five" are in imminent danger of failure.

tors are able to adequately judge the state of a depository institution. As evidence, it has been noted that when Penn Square failed, it was ranked as a "three," that is, "troubled but not in immediate danger of failure."

It has been suggested that the private sector provide deposit insurance instead. Allowing private insurance companies to insure deposits has a number of important advantages. In the first place, competition among the various insurers for the business of depository institutions would guarantee that bank managers were able to obtain the best insurance deal — shopping around when they felt a specific insurer had failed to correctly assess the risk of their institution.

On the other hand, private insurers

**"FDIC premium policies encourage the managers of depository institutions to take on more risk."**

would have a strong incentive to monitor closely the banks and thrift institutions they insured — particularly if the depository institutions began to take on more risk. Thus, private insurers would be able to discourage excessive risk-taking before it reaches a critical stage through raising insurance premiums and increasing the frequency of examinations.

Finally, the regulation function could be totally turned over to these insurers. Who, after all, has a greater interest in the potential success of new products, the viability of new offices, or the maintenance of adequate capital and/or reserves to back deposits?

### Third-World Debt

An issue gaining increasing prominence in the news concerns the loans by domestic banks to various less developed countries. Countries like Mexico or Brazil might default on these loans, seri-

ously endangering a number of larger banks. The question is what the federal regulatory authorities should do in that event.

It is reasonable to argue that the banks exposed in this area made bad business decisions and that it is not the business of the federal government to provide bailouts for poor management. However, we should recognize that it was the incentives provided by a system with flat-rate insurance premiums, with usury laws in many states, with restrictions on domestic branch banking, and by a general earnings squeeze caused by a declining deposit base that led these banks to search for investments outside this country.

The issue is a complicated one, and it is not at all clear what sort of political decision will be made if the loans are defaulted. One of the primary lessons to learn from this predicament is that regulation can lead to serious, unpredictable problems. Under a free-market banking system with privately provided insurance the chances are slim that such a problem would have arisen.

### Conclusions

In spite of the enthusiasm over recent changes in the banking laws, there is much that remains to be done. Depository institutions are still too closely regulated to provide consumers with the best possible service. An important priority for those who understand the benefits to be gained through banking deregulation is continuing education of the public. Consumers of financial services must be made aware of how much they stand to gain in a freer market.

Finally, it is essential that Congress and the regulators be made to understand the long-range, largely unseen costs of extensive regulation. No one could have predicted the late 1970s period of stagflation 10 years ago. Similarly, no one can accurately predict the economic conditions that will exist at the end of this decade. To ensure that depository institutions are able to adjust and, hence, survive, deregulation must be pursued. The present system simply imposes too high a cost. ■

## The Flat-Rate Tax

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters, where distinguished analysts present their findings to an audience drawn from government, the public policy community, and the media. A recent Forum featured Alvin Rabushka, senior fellow at the Hoover Institution and co-author with Robert Hall of *Low Tax, Simple Tax, Flat Tax* (McGraw-Hill, 1983). Commenting on Rabushka's talk was Gina Despres, counsel to Sen. Bill Bradley (D-N.J.) and a chief author of the Bradley-Gephardt simplified tax plan.

**Alvin Rabushka:** I hope you've all received your 1982 tax kit form. At your option feel free to send in the Hall-Rabushka postcard forms in place of the 1040s, but I'm not going to represent you in court when the IRS calls you back and says they're not willing to accept those. But this year's 1040 form has about 50 pages of three-column, single-spaced instructions, about a dozen forms and requests for another 50 forms, and that's the tip of the iceberg. This is an enormously complicated system. It's not only too complex, it's too costly in the sense that it costs literally billions of dollars to do the record-keeping and the form filling out.

The third problem with the current tax system is that it's much too inefficient. And what simply happens here is that we try to tax income that comes from GNP, but about half of that leaks out by the time we get down to taxing it, so we end up with very high marginal rates trying to get enough revenue from a tax base that is in fact less than half of the Gross National Product.

The fourth problem with the tax system is that it's too perverse. Everyone in this room has at least one tax shelter and is thinking about two or three more. And since you're in the 50% bracket, you have to earn two dollars in income in order to have a dollar left over, whereas a dollar saved in taxes is worth a dollar.

The fifth problem is that the marginal

rates are much too high. Despite the 1981 Tax Act, we still face 50% marginal rates, which stand as a major disincentive to work, saving, and investment. And since under the present code we also double-tax corporate dividends, in fact for some forms of income the actual rate is between 70 and 75%.

Finally, and a problem of great interest today, our receipts are too low. By that I mean the deficit gets bigger and the government is effectively bankrupt.

Now, to replace the whole current code — and I mean literally the entire current income tax, both personal and corporate — we've drafted a plan which is largely built around four principles.

The first is that we want to tax all in-

### A Cato Institute Policy Forum

come once and only once, as close as possible to its source. The reason for taxing it at its source is that when income from businesses is transmitted to individuals it's either not reported or it's evaded or it leaks away from the tax base. The only way in fact to capture income for taxation is to tax it at the business source. At the same time we only want to tax it once. We want to stop double taxation.

Second, and absolutely crucial, is to tax all income at the same low rate. The third principle is that poor people should pay no income taxes. And the fourth principle is that any tax system should be simple enough to fit on postcard-size forms.

Let me elaborate on that third point for just one minute because I want to draw a distinction between graduated tax rates and a progressive tax system. It is possible to have a progressive tax system based upon a flat rate, and the vehicle for doing this is a personal allowance. If you grant a certain allowance

for a husband, a wife, and children, and then you begin to tax beyond that personal allowance at a constant rate, the marginal rate is constant throughout, but the share of your income you pay in taxes would rise as your overall income increases. It is *not* necessary to have graduate rates, surtaxes, and surcharges to have a progressive system.

Now let me very briefly try to look at the main points of the Hall-Rabushka Tax Plan. Let's start with the business tax form on the postcard that I've passed out. A business would simply report all of its receipts from the sale of goods and services and any used plant or equipment or land that it might sell. And from that we would subtract all of its investment spending, so at this step we are replacing and scrapping the current system of depreciation over time with a 100% business write-off in the first year — that is, expensing of all capital investment. The firm would also deduct all of its wages and salaries and the current costs for its production of goods and services, and that would leave taxable income. And if that was positive, the firm would pay 19% of that. And if it was negative, the business would carry forward 19% of its loss and earn interest to be counted against future tax liabilities.

Now if we move from the business tax to the compensation tax, progressivity enters into play. How does that work? The individual reports his cash or pension income. And then, depending on his family situation, he would take the relevant personal allowance. (We would index exemptions to the consumer price index to preserve their real value over time.) So the taxpayer would subtract the appropriate personal allowance from reported compensation. That's his taxable income. He would multiply by 19%. That's the tax owed. In most cases an employer would be able to adjust the amount of withholding, so when the year was over, one would either get a slight refund or pay a slight amount.

Progressivity enters into the system at the individual level because if, for example, a family of four earned \$10,000

they would be able to exempt \$7,700 from taxation. They would pay the 19% rate on the other \$2,300 and that would produce an average tax of 4.4%. And if you do the same calculations for higher levels of income, you would find the average tax rate rising until finally as you approached the six-figure level people are effectively paying 19%.

In our book we have taken the annual reports for Exxon, Apple Computer, and Old National Bank in Indiana and we have filled out the tax form for them. Exxon would pay much more taxes under our plan. Apple would pay much less, which I believe is precisely the kind of incentive system we want to have. In effect, what we've designed is a comprehensive Gross National Product-based tax, netting out all investment. And if you net out investment, in effect you tax consumption. To put it another way, we've got the equivalent of a uniform consumption tax which is progressive because we've granted a personal allowance to individuals.

Now, let me just try to summarize some effects of our plan. It is estimated that approximately \$10 billion — that's real money — goes into the recordkeeping, the commercial costs, and the preparation of tax forms, and the cost to the taxpayer through IRS for auditing and checking. A considerable part of this \$10 billion could be saved. Estimates by a variety of economists suggest that there is maybe \$50 billion of what we would call dead weight lost to the economy as a result of people making all kinds of decisions on the basis of tax consequences rather than productive consequences.

A crucial point of our plan, is that we go instantly to a top marginal rate of 19% from the current 50%. We do not tax capital gains on the transactions of financial assets. We don't tax the sale, for example, of gains on stock because stock represents the residual claims on a firm's profits. When those profits increase, the tax on those profits is higher. To tax the increase in the underlying value of the stock at the same time would amount to double taxation.

Finally, we've estimated that had our

plan been put into effect on January 1 of this year, we would — under an optimistic scenario — have a balanced budget at the start of 1986 or — under a pessimistic scenario — have a deficit substantially below what we now have. Even in the worst case, we get to a manageable deficit within three years.

Also, based on a number of studies of additional labor supply under a uniform flat-rate consumption tax, we've estimated that the impact on GNP could be



Alvin Rabushka

as much as 9% higher by 1990. And this would offset any undesirable redistribution effects in the short run by shifting the tax burden between groups.

The 19% rate is that rate which, when you net out investment and personal allowances, reproduces existing revenues in the current year, so in the initial year of transition we neither raise nor lower aggregate taxes.

Let me conclude on the shoals of polit-

ical realities which dash the hopes of all good men and women. I have been told by, among others, Sen. Bill Bradley, that the plan is unfair. We have been told by Sen. Russell Long that it's a giveaway to the rich. We've even been told by Sen. Bob Dole that the time is not yet right.

We are aware that the issue of fairness and redistribution is a serious one. We are aware that the builders think it would devastate an already depressed economy. The president of our university and others would doubtless worry over the reduction in charitable contributions. Those who serve the truly needy would worry about the fact that without a tax subsidy in giving, the poor and the museums would go without. In fact there are 400 such loopholes in the form of exemptions, credits, exclusions, and deductions. There are 110 tax preference items in the code outright. And needless to say, downtown Washington has one or more offices for every one of these groups who are going to be up here fighting when the bill comes out.

However, my optimism is that recent trends are not only not going to go away, they're going to get worse. The incidence of tax cheating will rise. The underground economy will grow. The last two laws have made the tax form more complex, not less. The budget deficit is getting bigger, not smaller. The marginal rates are not really falling on real incomes. And I think there's a growing sense that something is wrong and it needs to be fixed. Even if we're unable to do something that would be dramatically successful on the spending side of the budget, we can still accomplish a major and meaningful tax reform which has the desirable effects of lower rates, higher revenues, and great simplicity. The broad grassroots appeal will keep this issue alive. And I'm very optimistic that over the next two or three years we'll see this become a top item on the tax-writing agenda.

**Gina Despres:** Although Hall-Rabushka and the Bradley-Gephardt flat-rate tax are very different in certain important respects, the authors of both are united in opposition to the defects in the pres-

## Flat Tax (Cont. from p. 7)

ent system — complexity, administrative costs, inefficiency, high marginal rates, and perversity, particularly tax shelters. I'm very encouraged by the surge of interest in restructuring the tax system, and I like to interpret this surge of interest as an indication that whatever system we ultimately end up with, there is some agreement that we are no longer going to use the tax code as a vehicle for political favoritism and social engineering, which it has increasingly become over the last decade or so.

Hall-Rabushka does several other things that I think we ought to be quite clear about. First, as Al said, it is not an income tax. It is a tax on consumption. The reason is that in taxing income only once it leaves savings out of the tax base. In other words, it virtually eliminates taxes on corporate profits, capital gains, dividends, interests, and rents. This means that what's left in the tax base is wages, salaries, and fringe benefits, and any net business receipts that aren't reinvested. With the end to double taxation of dividends plus elimination of capital gains and the low flat rate on corporate and individual income, this plan substantially reduces the tax burden on capital. But because its authors would also maintain the yield of the current tax law, it follows that they would raise the tax burden on labor by an equally substantial amount.

Moreover, Hall and Rabushka propose to make taxable to employers the nonwage compensation they pay to employees. This includes social security contributions, health, life and unemployment insurance premiums, and worker's compensation. This will increase the cost of labor in a way that is tantamount to increasing the minimum wage, and it will probably discourage hiring. In the case of some low-paid workers, they might find themselves priced completely out of the market. At a time when unemployment is a major problem, I think that this is something that we ought to take quite seriously.

The implications of such a radical plan on the distribution of the tax burden are enormous. Hall-Rabushka would significantly lower the taxes of

those in the highest income classes and greatly increase the burden on lower and middle income taxpayers. Under Hall-Rabushka a single person with a \$15,000 income would pay about 14% more than under current law, as it will be effective in 1984. A four-person family with an income of \$25,000 would pay something around 40% more. A four-person family with an income of \$35,000 would pay over 20% more. A four-person family with an income of \$45,000 would pay 11% more. And on the other side, taxpayers whose incomes are between \$100,000 and \$200,000 would get about a 45% tax cut, and millionaires — literally those with incomes over a million dollars — would get over an 80% tax cut. Some people find this change in the distribution — whatever the compensating factors in terms of stimulating investment or whatever claims the authors want to make for it — very disturbing.

There is also nothing in the Hall-Rabushka plan to stop corporations from amassing large amounts of capital tax free. Indeed, any big corporation could borrow enough money for investment to wipe out their taxes year after year. This kind of growth would concentrate a disturbing amount of wealth and power in the corporate sector, a prospect that would be troubling to many Americans.

Now at the same time the plan could create hardship for certain businesses. It eliminates the tax deduction for interest. This would be particularly damaging to businesses that borrow to carry inventory, notwithstanding the offset from expensing. Similarly, prohibiting the deduction of any unused depreciation allowances after the plan's effective date could hurt firms that have recently made long-lived investments. For industries like the wholesale and retail trade which are labor intensive, borrow to carry inventory, and use long-lived capital, the combination of the tax on nonwage compensation, the repeal of the interest deduction, and the restriction of depreciation could be devastating.

I also think there's an important question as to whether the plan would raise

as much revenue as its authors claim. Since its low rate is one of its main attractions and since this rate would have to be raised if there is a revenue shortfall, this is an important consideration. One of the difficulties that I can see on the revenue side is that Hall-Rabushka appears to include in the tax base such ephemeral things as free services provided by banks and other financial institutions to consumers; free meals, clothing, and lodging provided by employers; and a variety of other fringes, all of which have proved very difficult to tax for both political and administrative reasons.

The authors also seem to be assuming that if you get the rate down to 19% all of the multi-billion dollar underground economy will be brought into the tax base. This seems to be an excessively optimistic assumption.

Hall and Rabushka have come up with a clever means of simplifying the tax system and eliminating the double taxation of dividends, but these advantages are bought at the cost of increasing the tax burden on middle-income taxpayers and lowering it on upper-income groups, so there is a trade-off between simplification and income redistribution. In addition, the plan lowers the tax on capital, but it increases it on labor. Whether these trade-offs are worthwhile is at bottom a political issue that seems bound to get even more attention in the coming months. Notwithstanding these criticisms and the implicit boost for Bradley-Gephardt, which is a progressive income tax, I do think it is important that this session is going on and that he and I are here talking about restructuring the tax code — both optimistic that this year and next year restructuring tax policy will have a fairly high place on the political agenda. That I think is real progress.

**Rabushka:** Hopefully, when I have persuaded Gina that we can deal with all her objections, then Sen. Bradley will be the first to co-sponsor Sen. DeConcini's bill that will be the Hall-Rabushka plan. I'm sure that we both agree that Bradley-Gephardt isn't really a flat tax plan, but is a

greatly compacted multi-bracket plan.

Let me deal with unfairness, which is a good argument. What is unfair about the unfairness argument is to take the example of the poor low-income widow who only clips coupons, because there are so few of her that that's not an interesting case. The interesting case is the question of the redistribution of the tax burden from the upper-income to the middle-income taxpayers. We have to be very clear at the outset that some rich people pay no taxes and that some middle-income people pay a lot. It all depends on how aggressive you are in rearing the shopping basket of shelters in the *Wall Street Journal*, but it's also

American people, at least the median voter, tolerate in the short run a temporary increase in his tax burden?" I think the answer to that is that in exchange for it he's going to get simplicity. In exchange for it, even at that middle-income level, we are going to get a reduction in marginal rates.

Also, I believe it's almost a unanimous consensus among most economists that we are going to get higher rates of capital formation and higher growth. And indeed, Gina argues that moving from an income tax to a consumption tax implies that we are going to tax labor income disproportionately more. The point is, the incentives that lead to the

growth, not from surfacing the underground economy.

Let me just conclude and say why I think our plan will help close the deficit. If you look at any forecast, what you see is that under existing tax law receipts as a share of GNP are falling. But outlays are not falling, so the gap is widening. What in effect we do is to freeze — stop from falling — the receipts as a share of GNP by a proportionate tax. That all by itself, in fact, has the effect of producing more revenue than the existing code.

According to a new CBO study, in 1961 87% of all Americans faced marginal tax rates of 21 to 22%, despite having a statutory system that ran from 20



Gina Despres responds to Alvin Rabushka at Cato Policy Forum.

fair to say that, let's face it, the upper-income do pay a lot today and the middle-income do pay less. And our critics are absolutely right. If Hall-Rabushka becomes law, retroactive to January 1 of this year, those between \$15,000 and \$30,000 will pay another 3 to 5% of their income in taxes and those earning over \$60,000 will pay less. This issue is so important and so obvious that we admit it in paragraph 3 of the book, and devote a whole appendix to calculating and demonstrating precisely the nature of the charges. And if the charges were absolutely devastating, we would have been blown out of the water.

And we have to ask, "Why should the

formation of capital that make labor more productive — and thus will tax it more — seem to be precisely the attractive incentives of such a tax. And as a result, I believe that a consumption-type tax, netting out all investment and saving, is precisely the right mix of incentives we want to make the economy more productive.

On the business of the underground economy — in the article and in our book we make no claims whatsoever for getting the barter, cash-and-carry economy to surface. What we don't want is to be tainted with the exaggerated claims of supply-siders. We argue that the supply-side effects come from higher

to 91%. The interesting point about this is we, in effect, operated a flat tax. By 1969 we were at the point where something like 35% of all people faced marginal rates beyond 22%. By 1979 the distribution of marginal rates very much began to look like statutory rates. And the reason for that was accelerating inflation pushed everybody up into rates that back in 1961 only the very rich paid. So we had in place a statutory rate system which in fact has become a steeply graduated real system, and as those rates have exploded in the last 15 years we've correspondingly had this declining fall in the savings rate, and a dismal performance overall.

# The Oil Crisis: TV Misses the Real Story

**TV Coverage of the Oil Crises: How Well Was the Public Served?**, edited by Leonard J. Theberge. *The Media Institute, Washington, D.C., 1982. 3-vol. set, 172 pp. \$12.95.*

These three short volumes review and comment on network news coverage of the 1973-1974 and 1978-1979 oil crises. Volume I analyzes the "quality" of the coverage, emphasizing the degree of economic sophistication evident in news stories and the historical background used. It contains data on sources, where the blame was laid for the oil shortage, and what solutions were discussed. Volume II offers a quantitative analysis of coverage during the two crises, comparing from one crisis to the next the categories discussed in Volume I. Volume III, "An Economist's Perspective," is an essay by Thomas W. Hazlett comparing the actual events with their coverage by the networks.

Where Volume II simply shows that the network reporters and editors learned virtually nothing from one crisis to the next, Volumes I and III are particularly revealing, offering insights into the formation of public opinion on a vital national issue, as well as indicating a need for journalists to become more educated in economics.

Volume I, based on an extensive computer-aided content analysis of 1,462 stories, reveals that government provided the most information (56%) and that nongovernment experts were the source of information only 2% of the time. In addition, only 15% of the solutions discussed dealt with the central issue of price controls; coercive non-market "solutions" received three times the coverage that market solutions received; and only 18% of the discussions identified government as a possible cause. Thus, network coverage failed to provide the public with "sufficient information to make an informed judgment . . . paid scant attention to the real debate, and in fact the central political and economic issue at stake: non-market solutions (rationing, regulation, price controls) vs. market solutions (deregula-

tion, decontrol)," and "demonstrated an over-reliance on government sources for information."

Whether the networks' failure to provide reliable information and analysis is inextricably linked with the medium itself is a question that is not seriously addressed. It is suggested that historical background and sophisticated analysis are difficult to present in what must be a visually appealing and fast-paced medium, leading to pessimistic conclusions for the reader.

Hazlett's essay provides an informative account of the oil crises, their causes and ultimate cure, and a rather pessimistic commentary on the media's coverage of such events. Hazlett concludes, "The ebb and flow of spontaneous social forces are just not as provocative as titil-

## Policy Report Reviews

ating characters who, as 'Big Oil' or OPEC, or Wasteful American Gas Guzzler, meanly conspired to create the oil crises. These stereotypes are portraits that grab and sell; one has yet to hear the promotional clip: 'Supply and Demand — Film at 11.' Yet the uncontested fact is that crucial public policies did not accomplish their goals because they ignored the consequences of market forces, and television news failed as well because it ignored this critical aspect of the story. This is the chagrining lesson to be learned from America's oil crises. The unsettling conclusion may be that, in essence, today's television news medium considers the subtle truth a bad story."

Perhaps deregulation of broadcasting will change matters. Let's hope so.

**American Economics Texts: A Free Market Critique**, edited by James B. Taylor. *Young America's Foundation, Reston, Virginia, 1982. 285 pp. \$4.50.*

This book is a useful guide to contemporary economics texts. Fourteen

texts are reviewed by a group of young pro-free market economists. The reviews are scholarly and temperate; an attempt is made to examine the strengths and weaknesses of each text and, when appropriate, to discuss the political/economic biases, omissions, or distortions that occasionally appear.

Taken as a whole, the collection serves as proof that political belief and economic science are more closely related than some economists might want to admit: Interventionist textbook authors (like Paul Samuelson, whose other works are praised by reviewer Alan Stockman) tend to stress "market failure" as the basis for government action, following their analysis with the non sequitur that the state "must" step in to correct things, at the same time ignoring completely any question of "government failure." Markets are made of fallible human beings; governments are not.

The books reviewed are Samuelson's well-known tome, Robert Heilbroner and Lester Thurow's *The Economic Problem*, James D. Gwartney and Richard Stroup's *Economics: Private and Public Choice*, Paul Wonnacott and Ronald Wonnacott's *Economics*, R. G. Lipsey and P. O. Steiner's *Economics*, Edwin G. Dolan's *Basic Economics*, Armen A. Alchian and William R. Allen's *University Economics*, Edwin Mansfield's *Economics: Principles, Problems, Decisions*, Paul Heyne's *The Economic Way of Thinking*, Milton Spencer's *Contemporary Economics*, Richard B. McKenzie and Gordon Tullock's *Modern Political Economy*, Campbell R. McConnell's *Economics*, and Roger Leroy Miller's *Economics Today*.

As is so often the case, the most widely used texts in a field tend to be 20 years or more out of date. Important developments in monetary theory, the theory of human capital, and very importantly, the economic analysis of government activity, are absent from most texts. Among the exceptions to this rule are the work of Gwartney and Stroup, McKenzie and Tullock, and Dolan, which are

reviewed by economists Roger Garrison of Auburn University, Dwight Lee of Virginia Polytechnic, and Manuel Johnson of the Department of Treasury. Each is highly recommended as an introductory text.

*American Economics Texts* will prove valuable to students beginning the study of economics. Important in their own right for their economic insights, the essays also provide a useful overview of the texts currently available on the market, direct the student to additional sources of information about the science of economics, and help to correct the many deficiencies students are likely to find in their assigned texts.

**What the Anti-Federalists Were For**, by Herbert J. Storing. *University of Chicago Press, 1982. 111 pp. \$4.95.*

Since for the last 200 years, public policy debate has often centered around the meaning of the American Constitution, it is refreshing to go back and examine the debate over the Constitution itself. The late Herbert J. Storing edited a seven-volume set of papers, *The Complete Anti-Federalist*, in order to meet such a need. This volume, *What the Anti-Federalists Were For*, is Storing's lengthy introduction to the seven-volume set, an introduction which the University of Chicago Press had the foresight to publish separately in paperback.

An examination of the Anti-Federalists has important public policy implications because it leads to questions as to whether the American Constitution was designed to limit state power. Nearly all of those who were interested in limiting the power of the federal government to protect the nation against external aggression were strong opponents of the Constitution on the grounds that it gave the federal government far too much power. Most of those who supported the Constitution did so because they felt it would allow for an activist central government. Such a contrast might suggest that many of our current problems are due not only to misinterpretation of the Constitution but also to the very structure of the document. Therefore, in many cases, reform may require far-

reaching constitutional changes.

Storing's book points out that the Anti-Federalists were not only critics of the Constitution, they also had a program of laissez-faire and non-intervention. *What the Anti-Federalists Were For* is highly recommended to all those interested in a broader perspective on current constitutional debates.

**Agenda '83**, edited by Richard N. Hall. *Heritage Foundation, Washington, D.C. 362 pp. \$6.95.*

Following on its earlier books of advice to the Reagan administration (*Mandate for Leadership*, *Agenda for Progress* and *The First Year*), the Heritage Foundation has issued its recommendations for the last two years of this presidential term. The subjects range from monetary policy to foreign affairs to the role of women in the administration.

Supply-siders Bruce Bartlett and Norman Ture, in separate essays, urge the administration to return to its original economic principles. Bartlett writes, "President Reagan's single greatest mistake was allowing his original tax package to become distorted beyond recognition." Ture calls for short-term reforms that would undo much of the mischief of the 1981 tax increase and long-term reforms such as elimination of the corporate tax, integration of the personal and corporate taxes, and a flat-rate income tax.

Heritage analyst Catherine England gives the administration mixed reviews for its performance in regulatory reform, even criticizing Mark Fowler, the deregulation-minded chairman of the Federal Communications Commission, for continuing regulation in too many areas. She calls for a move toward competition in telecommunications and the financial industry and urges abolition of the Consumer Product Safety Commission. Transportation economist Fred L. Smith, Jr., of the Council for a Competitive Economy, is even more critical of the administration's performance in transportation regulation.

While the recognition of the importance of free-market reforms is generally good — even to the extent of calling for

the abolition of subsidies to nuclear power, sometimes a weak spot for conservatives — there are a few lapses. In the chapter on the Commerce Department, essays by *Policy Report* editor David Boaz on ending business subsidies, and by Heritage Senior Fellow S. Fred Singer on privatization and user fees in the Weather Service, are juxtaposed with a call for stricter regulation of high technology exports to Warsaw Pact nations. Congressional economist Robert E. Weintraub, rather than calling for a gold standard or some other form of depoliticized money, instead proposes to "make the Fed accountable" — not to Congress but to the President. While this may seem attractive today, one wonders whether the Heritage Foundation would be pleased to have a Federal Reserve Board directly controlled by, say, President Walter Mondale.

The chapter on the defense budget commendably recognizes the need for some changes in procurement practices to deal with cost overruns and weapons systems that don't work. But it fails to ask the really tough question: "What is our foreign policy, and can we afford it?" If it did, it might come up with some surprising answers about why the United States spends more than \$100 billion a year on the defense of Western Europe and \$40 billion on Japan and South Korea.

The press has reported that some 60% of the recommendations in *Mandate for Leadership* were implemented by the Reagan administration. Implementation of the right 60% of the suggestions in this volume would be a major step toward economic prosperity. ■

### Coming Up in Policy Report

Henry Wallich, Alan Reynolds, Michael D. Bordo and Anna Schwartz, Robert Weintraub, Leland Yeager, Joseph Salerno, and others on "The Search for Stable Money"

# "To be governed . . ."

## Watch what we say

[U.S. Trade Representative William E. Brock] cautioned against following the protectionist route which is being pushed by many labor and business leaders and which has strong support in Congress.

"Protectionism is not the right response because it hurts us more than anyone else," said Brock. . . .

Meanwhile, Brock said he will hold talks in Tokyo next month on an extension of an agreement that for the past two years has limited U.S. imports of Japanese autos.

—*Washington Post*, Jan. 22, 1983

## Consumer protection around the world

Despite a ban on moppets up to 11 years old, "E.T." in Sweden is on course to top "Foul Play," the alltime champ. . . .

The ban, brought in by the local censorship board, was effected because the bluenoses felt that adults in the film were presented as hostile to kids and to the friendly alien. Presentation of grownups in this way was felt likely to harm youngsters under 11 years.

—*Variety*, Jan. 10, 1983

## The most ideological administration in this century?

Though his views remain conservative, ideas go by the wayside when he [White House business liaison Wayne Valis] or Reagan is in a fight.

—*Fortune*, Jan. 24, 1983

## And George Will and Tip O'Neill think we have too little government?

Billions of dollars in uncashed, government-issued checks, some more than 30 years old, are causing major headaches for Treasury Department officials, who are thinking of asking that future checks be canceled one year after issue. . . .

To make matters worse, because of its accounting system, the department has no idea what agencies wrote what checks, for how much, and to whom.

—*Coin World*, Jan. 19, 1983

Meter maids ticketed a parked car at least twice while the vehicle's owner was slumped dead over the steering wheel with a puncture wound to his neck, police said today.

—*Washington Post*, Jan. 27, 1983

About 500 Postal Service workers in Vermont will get paid three days late because their checks were lost in the mail.

The bag of checks was "temporarily misrouted" and is still missing, said Burlington Postmaster Michael Shinay. "We've been looking for them since last Thursday," he said.

—*Washington Post*, Jan. 31, 1983

## A tough year for whom?

"It's going to be a tough, tough year for governors," says Governor Scott M. Matheson of Utah. . . .

Oregon Governor Victor Atiyeh, for example — a month after winning reelection and opposing new taxes —

asked for a \$350 million increase. Thomas H. Kean, New Jersey's governor, had vowed to oppose an income tax boost but signed sales and income tax hikes passed by the legislature in the waning hours of 1982.

—*Business Week*, Jan. 17, 1983

## First things first

D.C. Mayor Marion Barry is giving some of his senior aides incentive bonuses totaling \$42,500, including \$10,000 for outgoing City Administrator Elijah B. Rogers.

—*Washington Post*, Jan. 13, 1983

Mayor Marion Barry and City Council Chairman David A. Clarke, grappling with the city's mounting financial difficulties, yesterday discussed ways to persuade the city's 30,000 unionized employees to forgo part of a pay increase of 6 to 9 percent scheduled to take effect in October.

—*Washington Post*, Jan. 13, 1983

## Shuffling the numbers

Completed in a mere three weeks, the Congressional Budget Office study [on the effects of the Reagan economic program] appears to have been tailored to provide political ammunition. It was requested by two Democrats. . . . "There's no question that if it had been requested by Senator [Pete V.] Domenici [Republican chairman of the Senate Budget Committee] it would have been done differently," says Joseph Minarik, a CBO tax analyst.

—*Fortune*, Jan. 24, 1983

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