

# FEDERAL TAX LAW: THE NEED FOR RADICAL REFORM

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## INTRODUCTION

A consensus is emerging in our society that revision of the federal income tax structure is necessary. Debate continues, however, regarding the revision's most appropriate form. The Reagan Administration and Congress could spend the next four years tinkering with the tax code by eliminating a tax preference here and plugging up a tax loophole there. On the other hand, they could discard the existing system and adopt a whole new approach. In the process, Congress and the Administration would gather bipartisan popular support from over 100 million taxpayers, many of whom now believe that the federal income tax structure is extremely unfair.<sup>1</sup> Under this alternate scheme, people would be taxed at a lower marginal rate. Additionally, this approach would eliminate those exemptions, credits, deductions, and loopholes which distort economic behavior and thereby sap the economy's productivity.

This article first examines the numerous problems inherent in the current tax system, discusses some proposed alternatives, and introduces and explains the Kemp-Kasten tax proposal.<sup>2</sup> This article then explains how the Kemp-Kasten proposal solves the problems which plague the present tax system while avoiding the pitfalls inherent in the proposed alternatives.

## THE NEED FOR REFORM

### Complexity of the Current System

The tax code needs fundamental and complete reform. Public opinion polls show that many Americans consider the U.S. tax system a national disgrace.<sup>3</sup> It is blatantly inefficient, grossly unfair, and enormously complicated. There is little logic, reason, or economic theory behind the current scheme of federal income taxation. Consisting of 5,100 pages and supplemented by approximately 10,000 pages of Internal Revenue Service Regulations and interpretations, the current tax code is horribly complex and nearly impossible for the layman to understand. Moreover, the tangled web of regulations and red tape imposes significant economic costs and tends to undermine the principle of a sound tax system to treat taxpayers in similar economic circumstances equally.

The paperwork is suffocating. Nearly 75% of the federal reporting require-

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1. *Flat-Rate Tax: Hearings Before the Senate Comm. on Finance, 97th Cong., 2d Sess. 245 (1982)* (statement of Louis Harris, Chairman and C.E.O. of Louis Harris and Associates) [hereinafter cited as *Flat-Rate Tax Hearings*]. According to Harris:

[I]n a recent [September 1982] Business Week Harris Poll — I call this shocking — by 86 to 7%, a majority, nationwide, feels that while most lower- and middle-income people now pay their federal tax by taking standard deductions, most higher income people get out of paying much of their taxes by hiring clever tax accountants and high-priced lawyers who show them how to use loopholes in the tax law for tax shelters and other devices.

2. H.R. 777, 99th Cong. 1st Sess., 131 CONG. REC. H215 (daily ed. Jan. 30, 1985).

3. See *supra* note 1.

ments arose from federal tax forms,<sup>4</sup> and few can figure out how to fill out all that paper.<sup>5</sup> Nearly 57% of all taxpayers who filed Form 1040 in 1982 were forced to hire a professional tax preparer at a total cost of sixty billion dollars.<sup>6</sup> In contrast, only 18% of all taxpayers had their taxes prepared professionally in 1954.<sup>7</sup> The public spent 613 million hours in 1977 filling out some 260 different tax forms—about seven hours for each of the ninety million corporate and individual returns filed.<sup>8</sup> The snarled knot of complex provisions has generated an enormous upsurge in tax computation errors. According to the Internal Revenue Service (IRS), 82% of all low income returns with itemized deductions contained errors.<sup>9</sup> The tax code has become so complex, in fact, that a 1975 IRS survey of its own trained employees showed that they computed the wrong tax 72% of the time, even when handling relatively simple problems.<sup>10</sup> One public interest research group sent out identical “test” tax returns to twenty-two different IRS offices and each office calculated a different tax liability, ranging from a refund of \$811.96 to an underpayment of \$52.14.<sup>11</sup>

### Unfairness Of The Current System

Many taxpayers are angered that our tax system permits wide disparity in tax bills among taxpayers of similar circumstances. There seems to be a sense that honest taxpayers are fools if they obey the law. This sense of frustration undermines the concept of voluntary compliance on which our income tax system relies.<sup>12</sup> Although the IRS employs legions of agents,<sup>13</sup> it cannot enforce the tax code without voluntary taxpayer compliance.

Much of the frustration generated by the perceived unfairness of the current system stems from the lack of true progressivity in tax liability. In spite of highly progressive tax rates, an irrational patchwork of tax shelters, loopholes, deductions, exemptions and credits has rendered the tax code regressive and inequitable. Responding to pressure from various special interests,<sup>14</sup> Congress has increased

4. See *Federal Paperwork Requirements: Hearing Before the Subcomm. on Government Regulation and Paperwork of the Senate Select Comm. on Small Business*, 96th Cong., 1st Sess. 2 (1979) (Statement of Sen. John Culver, D-Iowa) [hereinafter cited as *Federal Paperwork Hearing*]. This figure represents the percentage of federal reporting requirements received by the Internal Revenue Service before the passage of the Paperwork Reduction Act of 1980, 44 U.S.C. § 2(a) (1982).
5. See *Flat-Rate Tax Hearings*, *supra* note 1, at 100 (statement of Sen. Dan Quayle, R-Ind.). In 1954, over 80% filled out their tax forms personally. In 1981, 52.4% of all 1040 forms were prepared by specialists; 16.9% of all 1040A forms were prepared by specialists.
6. *Flat-Rate Tax Hearings*, *supra* note 1, at 75 (statement of Sen. Steven Symms R-Idaho). *But see*, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 45 (1983). The Internal Revenue Service reported that 40.1% of all taxpayers employed a professional tax preparer in 1982; only 37.3% employed one in 1981. Furthermore, a more simple tax form appears to reduce the need to employ a professional tax preparer. In 1982, 56.8% of the taxpayers who filed a 1040 form employed a tax preparer, while only 3.3% of those who filed a 1040EZ form employed one.
7. *Flat-Rate Tax Hearings*, *supra* note 1, at 100 (statement of Sen. Dan Quayle, R-Ind.).
8. *Federal Paperwork Hearing*, *supra* note 4, at 100 (testimony of Professor James T. Bennett).
9. *R. Hall & A. Rabushka*, *LOW TAX, SIMPLE TAX, FAIR TAX* (1983).
10. *Id.* at 4.
11. *Id.*
12. See *Tax Compliance Act of 1982 and Related Legislation: Hearings Before the House Comm. on Ways and Means*, 97th Cong., 2d Sess. 63 (1982) (statement of Roscoe L. Egger, Jr., Commissioner of Internal Revenue Service). Egger asserts that “the success of our tax system rests heavily on voluntary self-assessment and compliance by the taxpayer in this country.”
13. See INTERNAL REVENUE SERVICE ANNUAL REPORT 4 (1983). In 1983 the I.R.S. employed approximately 84,000 full-time employees. In the same year, the I.R.S. increased the number of employees to over 100,000 during the filing period. *Id.*
14. See *Flat-Rate Tax Hearings*, *supra* note 1, at 121-24 (statement of Sen. Dan Quayle, R-Ind.). According to Quayle, major industries, businesses and special interest groups lobby Congress for special preferences intended to benefit these groups. Congress responds by amending the tax code to provide

the number of special preferences, including those relating to businesses, from 50 in 1947 to 104 in 1982.<sup>15</sup>

Working Americans, who cannot afford the services of high-priced tax specialists, often feel that they are picking up the tab for cheaters, tax shelter promoters and tax finaglers. Because our upper income taxpayers are the major users of these tax-avoidance devices the tax code has earned a reputation as being "soft on the rich."<sup>16</sup> Working Americans resent that some of the "super rich" are not paying taxes at all.<sup>17</sup> Also contributing to the unfairness perceived by the taxpayer is the knowledge that over \$100 billion in taxes are never reported as a result of incomplete reporting, the underground economy, and outright cheating.<sup>18</sup>

While readily perceived as too indulgent to the rich, the income tax is too unfair to the poor. The most glaring injustice is that the poor pay taxes even though they are below the poverty line, or eligible for welfare.<sup>19</sup> This inequity results from the decline in value of the personal exemption and tax bracket creep. The personal exemption, which shields the poor from high taxes, has not kept pace with inflation or personal income. In 1948 the personal exemption was \$600<sup>20</sup> while today, after decades of rising inflation, the personal exemption is only \$1,000.<sup>21</sup> If the 1948 exemption was indexed for inflation, it would be over \$2,500.<sup>22</sup> If indexed for income growth, the exemption would equal \$5,600.<sup>23</sup> Some commentators assert that the decline in the personal exemption has been the most significant change in the tax system since World War II.<sup>24</sup> Tax bracket creep is a far greater problem for the poor than for the rich who are already in the highest tax bracket. Consequently, it has sharply increased taxes on lower income taxpayers. Even when the modest salaries of the poor keep up with inflation, they face the steepest progressivity in the tax code of any income group.<sup>25</sup> Due to these twin consequences of inflation, taxes on those earning 50% of the median income increased fourfold between 1965 and 1981.<sup>26</sup>

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special tax incentives for particular activities or tax relief for certain groups. Interest groups which receive special tax preferences include the automotive, banking, chemical, pharmaceutical, and tobacco industries. The commercial banking industry, for example, benefits from three tax preferences: tax-exempt income, accelerated depreciation, and investment tax credits. As a result of these preferences, commercial banks enjoy an effective tax rate of -12.6% (calculated as a percentage of net income paid in tax), while the average tax rate for all industries is 20.5%. See also, CONGRESSIONAL BUDGET REPORT, TAX EXPENDITURES: BUDGET CONTROL OPTIONS AND FIVE-YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1983-1987 89 (1982) (effect of tax expenditures on budget deficits) [hereinafter cited as CBO TAX EXPENDITURES]; *infra* note 220 and accompanying text.

15. CBO TAX EXPENDITURES, *supra* note 14, at 89. These tax expenditures will deprive the federal government of an estimated \$273.1 billion in fiscal year 1983. *Id.*
16. See *supra* note 1.
17. *Id.* at 64 (statement of Sen. William Bradley, D-N.J.). For example, it was reported that billionaire H. Bunker Hunt paid at most \$695 per year in personal income tax for the years 1975-1977. *Id.*
18. INTERNAL REVENUE SERVICE, DEP'T OF TREASURY, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS (1979); Gutmann, *The Subterranean Economy*, FIN. ANALYSIS J. 26 (Nov.-Dec. 1977). The size of the underground economy has been estimated to be as high as \$250 billion per year.
19. See *infra* note 132.
20. INTERNAL REVENUE SERVICE, U.S. TREASURY DEP'T, STATISTICS OF INCOME FOR 1948, pt. 1, at 39 (1953).
21. I.R.C § 151(a) (1982).
22. Steverle, *Tax Treatment of Married Couples and the 1981 Tax Law*, in TAXING THE FAMILY 74 (R. Penner, ed. 1983).
23. *Id.*
24. See e.g., Steurle and Hartzmark, *Individual Income Taxation 1947-79*, 34 NAT'L TAX J. 151 (1981).
25. Laffer, *Tightening the Grip of Poverty* CATO INST. (1984).
26. Between 1965 and 1981, median income for a family of four rose from \$6,957 to \$22,388. Meanwhile the median family was pushed into a higher tax bracket.

### Disincentives Within The Current System

A number of economic disincentives are inherent in the current tax system. Perhaps most disgraceful are the tax barriers to the economic advancement of the most disadvantaged. Certain groups, most notably the poor, the aged, and the unemployed, face government-created "traps" which result from the interaction of the income tax system and the government's "means test" programs. These traps can impose extremely high marginal tax rates on the poor.

Many poor families are caught in a "poverty trap" which results from the trade-off between increased taxes and decreased benefits. Typically, a poor family with rising income faces not only steeply progressive tax rates, but the cutoff of government benefits. If a member of an average welfare family takes a job, that worker pays 27 cents in taxes on each additional dollar of income<sup>27</sup> while the family loses 35 cents in reduced welfare benefits for every additional dollar earned.<sup>28</sup> The family is essentially "taxed" at a rate of 62%, and increases its income by a mere 38%. In many cases, the impact of increased taxes and reduced benefits is even greater. Indeed, some families may earn more pretax income but actually be worse off than before.<sup>29</sup>

Closely related to the "poverty trap," is the "unemployment trap." Ironically, unemployed people may often be better off receiving unemployment compensation than working.<sup>30</sup> Due to a combination of lost benefits and increased taxes, high marginal tax rates raise the cost of work relative to leisure, placing demoralizing barriers before those who would seek employment.

A third "trap" awaits retired individuals. Retired workers between the ages of 65 and 70 lose an additional 50 cents in Social Security payments for every dollar of earned income above the government-imposed ceiling of \$7,320.<sup>31</sup> Combining the loss of benefits with Federal, State, and local taxes on earnings, the retiree who wants to work could effectively be "taxed" at 96%.<sup>32</sup> As a result, the elderly may actually be encouraged not to work.

Apologists for the status quo defend high marginal tax rates as inherent in a progressive tax system.<sup>33</sup> High marginal tax rates, however, do not necessarily apportion tax liability according to the ability to pay.<sup>34</sup> It is possible to design a progressive tax system with low marginal tax rates. Alternatively, we can have a regressive tax structure with high marginal tax rates. In fact, it is likely that the

27. Laffer, *supra* note 25, at 4.

28. *Id.*

29. *See infra* note 145.

30. According to Martin Feldstein:

[T]he combination of a relatively high marginal tax on earnings and no tax on unemployment compensation implies that unemployment benefits replace a very high fraction of lost net income, typically about two-thirds. Add to that figure leisure and personal benefits and it becomes apparent that the system may have an inherent disincentive to work.

Feldstein, *The Private and Social Costs of Unemployment*, 68 AM. ECON. REV. 155, 155-57 (1978).

31. *See infra* note 156.

32. *See infra*, notes 155-157 and accompanying text.

33. *See, e.g.*, McIntyre, *Flat-Rate Talk*, NEW REPUBLIC, July 19-26, 1982, at 21. Robert McIntyre, a Director of Citizens for Tax Justice, argues:

Capitalism is a great way to generate innovation, efficiency and growth, but it is premised on the idea that there should be winners and losers. Given such a system, it's important to smooth out some rough edges — we can do part of that with a tax approach that tells the winners they have to pay more to support the system under which they have done so well.

34. Assessing taxes according to a taxpayer's ability to pay means that the taxpayer pays taxes in an increasing proportion to his wealth. According to this principle, taxpayers with the most wealth should pay the most tax, while those who are the least wealthy should pay the least tax, and taxpayers with equal wealth should pay the same amount in taxes. *See* R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 215-16 (1976).

higher the marginal tax rate, the larger the number of wealthy who are driven to tax sheltering, and consequently, taxes become more regressive.

It can be argued that our current high marginal tax rates are mostly illusory. Few people pay and little revenue is collected at the top marginal rate.<sup>35</sup> Income which would otherwise be taxed at this rate is invested in tax free bonds or other tax shelters or spent on lightly-taxed luxury goods.<sup>36</sup> As the rich avoid paying taxes, lower- and middle-income Americans are left with a greater tax burden.

Tax reformers who equate high marginal tax rates with equity understand neither human nature nor the importance of incentives. High marginal tax rates do not punish those already rich; they punish those striving to succeed. Thus, the up-and-coming entrepreneur or innovator, the hard-working small businessman, or investors risking their money on a new venture suffer the most from high marginal rates. Take away the fruits of their labors, and the labor itself will vanish, along with the spirit of enterprise and optimism.<sup>37</sup>

High marginal tax rates have proved to be an ineffective tool to promote more equitable income distribution. Despite high progressive rates, the income distribution has changed very little in the post-war period.<sup>38</sup> Indeed, between 1970-1979, when marginal taxes on most Americans soared, the income distribution shifted away from the lowest income groups. The cash income of the lowest percentile actually declined while the top 40% groups modestly strengthened their position.<sup>39</sup> Many economists agree that at some point, high marginal tax rates cause an enormous fiscal drag on the economy, demoralize taxpayers, and discourage productive activities.<sup>40</sup> Taxpayers plan many decisions, such as buying homes or life insurance, with an eye to the tax consequences.<sup>41</sup>

In addition, high marginal tax rates now apply to a broader spectrum of the taxpaying population than ever before. Tax rates above 25% were once reserved for the rich.<sup>42</sup> Now more than 30 million American taxpayers are taxed on margi-

35. See *infra* note 197.

36. See *infra* note 181 and accompanying text.

37. See generally G. GILDER, *WEALTH AND POVERTY* (1981).

38. The following chart reveals the lack of significant change in income distribution in the post-war period:

*Percentage Share of Aggregate Income*

Family Income Rank	1947	1950	1960	1970
Lowest Fifth	5.0	4.5	4.9	5.5
Second Fifth	11.8	12.0	12.0	12.0
Third Fifth	17.0	17.4	17.6	17.4
Fourth Fifth	23.1	23.5	23.6	23.5
Highest Fifth	43.0	42.6	42.0	41.6

Source: U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, *CURRENT POPULATION REPORTS*, SERIES P-60, No. 85 (1972).

See also R. McNOWN AND D. LEE, *ECONOMICS IN OUR TIME: MACRO ISSUE 106-18* (1976).

39. Between 1970 and 1980, the percentage of American families with incomes below \$10,000 (in 1983 dollars) grew from 14.1% to 14.7%. U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, *CURRENT POPULATION REPORTS*, SERIES P-60, No. 145 (1983).

40. See *infra* notes 181-196 and accompanying text.

41. See SCHNEPPER, *HOW TO PAY ZERO TAXES* 24, 32 (1983). For example, group term life insurance coverage provided by an employer at \$50,000 or less is not considered income. I.R.C. § 79 (1982). Income from other life insurance policies is considered income and is, therefore, taxable. Interest on money borrowed to purchase life insurance is not deductible to the extent related to producing tax-exempt income. I.R.C. § 265 (1982). Raby and Tidwell note "that almost all decisions have tax implications, even those that do not show up on tax returns." W. RABY & V. TIDWELL, *INTRODUCTION TO FEDERAL TAXATION 1* (1980).

42. In 1928 the tax code provided a \$1500 exemption for each single person, \$3500 for a married person and \$400 for each dependent. A normal tax rate of 1.5% applied on the first \$4000 in income, 3% on the second \$4000 and 5% on the balance over \$8000. There was a surtax of 1% on income over \$10,000 and 20% on income over \$100,000. I.R.C. § 11 (1928) (amended 1932).

nal incomes at rates of 25% or more.<sup>43</sup> As long as a substantial portion of Americans pay rates of 20-40%, there will be incentives to take advantage of tax loopholes and the economy will hobble along at less than full potential.

### Inefficiencies Of The Current Corporate Income Tax

The corporate income tax system is in even greater need of revision than the personal income tax. Most economists agree that the current corporate tax structure results in an amazing array of economic distortions.<sup>44</sup> The corporate profits tax distorts capital spending,<sup>45</sup> promotes corporate financing toward debt rather than equity,<sup>46</sup> and depresses the level of corporate investment.<sup>47</sup>

The tax code's depreciation provisions illustrate additional problems. While the 1981 depreciation changes<sup>48</sup> represent an improvement over the previous

43. For example, unmarried individuals with taxable income over \$18,200 are taxed at a marginal tax rate between 31% and 50%. I.R.C. § 1(c)(1)(1982). Married individuals filing jointly, with taxable income over \$20,200, are taxed at a marginal rate between 29% and 50%. I.R.C. § 1(a)(1)(1982).

44. See, e.g., Thuronyi, *The Taxation of Corporate Income: A Proposal For Reform*, 2 AM. J. TAX POL'Y 109, 109-10 (1983). Thuronyi claims:

[O]ur system for taxing corporate income distorts the economy and plays mischief with corporate financial decisions. The corporate income tax encourages corporate takeovers, distorts investment, discourages job creation and generally burdens corporate activities. The basic source of these problems is that the corporate income tax does not mesh well with the individual income tax on shareholders.

See also Auerbach, *Whither the Corporate Tax: Reform After A.C.R.S.*, 35 NAT'L TAX J. 275 (1982). According to Auerbach, "it seems appropriate to ask whether the corporate tax, with its small revenue and great complexity and distortions, should be abolished." *Id.* at 275.

45. See Gravelle, *Effects of the 1981 Depreciation Revisions on the Taxation of Income from Business Capital*, 35 NAT'L TAX J. 1 (1982). Gravelle claims that the current corporate profit tax "[m]isallocates capital to equipment at the expense of structures. . . this misallocation is exacerbated by the new A.C.R.S. (Accelerated Cost Recovery System) . . ." *Id.* at 1.

46. See Thuronyi, *supra* note 44, at 115. Thuronyi explains that "[t]he tax system favors debt financing relative to new equity issues. Because interest payments are fully deductible by the corporate borrower, the interest, unlike the return on equity capital, is taxed only once, in the hands of the investor." *Id.* at 115.

47. *Id.* at 109. See also J.A. PECHMAN, *COMPREHENSIVE INCOME TAXATION* 139-40 (1977).

48. Economic Recovery Tax Act of 1981, Pub. L. No. 97-345, 95 Stat. 172 (codified at I.R.C. § 168) (1982). See also S. Rep. No. 97-144, 97th Cong., 1st Sess. 48, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 153.

The Senate Finance Committee report describes the 1981 amendments:

The committee bill replaces the present system of depreciation with the Accelerated Cost Recovery System (ACRS). ACRS permits recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over predetermined recovery periods generally unrelated to, but shorter than, present useful lives. The methods of cost recovery and recovery periods are the same for both new and used property.

Under the new system, the cost of eligible personal property is recovered over a 15-year, 10-year, 5-year, or 3-year period depending on the type of property. Most eligible personal property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. Theme park structures, railroad tank cars, and certain long-lived public utility property has a 15 year recovery period. Eligible real property is placed in a separate 15-year real property class. To provide flexibility, certain longer optional recovery periods are provided.

Recovery of costs generally is determined by using a statutory accelerated method. As an option, the taxpayer may choose to recover costs using the straight-line method over either the regular recovery period or the longer recovery periods provided.

The entire cost or other basis of eligible property is recovered under the new system, eliminating the salvage value limitation under present law.

Eligible property includes depreciable property other than (1) property the taxpayer properly elects to amortize (e.g., leasehold improvements or low-income rehabilitation expenditures) and (2) most property the taxpayer properly elects to depreciate under a method not expressed in terms of years (e.g. unit-of-production or income forecast methods). However, railroad property currently depreciated under the retirement-replacement-betterment method is included in ACRS, subject to special transitional rules.

The committee bill provides a provision for the limited expensing of eligible property and

schedules,<sup>49</sup> the current system still imposes an irrational range of effective tax rates on corporate investment. Long-term assets are taxed at incredibly high tax rates,<sup>50</sup> while some short-term assets are actually subsidized by the tax code.<sup>51</sup> Essentially, we are taxing structures to subsidize equipment. The interaction of the investment tax credit,<sup>52</sup> which is mostly applicable to short-term equipment,<sup>53</sup> and the accelerated depreciation classes,<sup>54</sup> which provide preferential treatment to short-term assets produce this subsidy.<sup>55</sup>

This system has proven very unfair to less capital-intensive companies,<sup>56</sup> including the "high-tech industries."<sup>57</sup> Tax rates vary widely among industries.<sup>58</sup> The waste in the system is tremendous. University of Virginia professor, Don

special rules relating to cost recovery for foreign assets, normalization requirements for public utility property, and the computation of earnings and profits and of the minimum tax. Special rules also are provided to prevent the "churning" of used property between certain persons solely to obtain the benefits of increased investment incentives under ACRS. In addition, ACRS establishes new rules for determining if the nominal lessor is entitled to recovery deductions and investment credits for certain leased recovery property.

49. See S. REP. NO. 144, 97th Cong., 1st Sess. 47 (1981) ("rules for determining depreciation allowances and the investment credit [needed] to be replaced because they [did] not provide the investment stimulus that is essential for economic expansion").
50. See Parker, *New Tax Rules for Depreciable Assets: Assessing the Impact*, 34 TAX EXEC. 181 (1982). Long-lived assets are depreciated over a longer period of time, therefore there is less annual depreciation deduction and less tax saving. Furthermore, Investment Tax Credit (I.T.C.) only applies to personal property. I.R.C. § 48(a) (1982) defines § 38 (I.T.C) property as applying only to tangible, personal property, other than air-conditioning or heating units, or other tangible property not including buildings and other structural components.
51. J. PECHMAN, *FEDERAL TAX POLICY* 147 (4th ed. 1983). Pechman notes that: [m]ajor distortions have been introduced by the allowances for investment and the deduction for interest on borrowed capital. Depreciation allowances under the accelerated cost and investment credit are equivalent on average to expensing of capital equipment. . . . If the investment is financed by debt, the tax is actually converted into a subsidy."

*Id.*

52. I.R.C. § 38 (1982).
53. I.R.C. § 48(a) (1982). See *supra* note 50.
54. See Davis, *I.T.C. Basis Adjustments and § 1245 Recapture*, TAXES Feb. 1984, at 95. According to Davis, "[i]t was felt that the accelerated depreciation write-offs, when coupled with the I.T.C. allowances, resulted in total tax benefits that were more advantageous than immediate expensing of the asset's cost." *Id.* at 95.
55. Gravelle asserts that "under A.C.R.S. the flat depreciation periods favor long-lived equipment assets within a given class. This favoritism towards long-lived assets is more than offset by the value of the investment credit, however, so that short-lived equipment is favored over longer-lived equipment under A.C.R.S." Gravelle, *supra* note 45 at 10. Pechman explains that "[i]nvestment tax credit is allowed only for equipment and the depreciation allowances under A.C.R.S. are much less generous for buildings than for equipment. The result is that machinery is treated much more favorably than plant and other structures, inventories and intangibles." J. PECHMAN, *supra* note 51, at 147.
56. MCGRAW-HILL, *ENCYCLOPEDIA OF ECONOMICS* 118 (1982):

A capital-intensive industry is generally regarded as one in which the ratio of plant and equipment costs. . . to total costs is higher than the average such ratio for all industries. The capital intensity of an industry can also be inferred from the relationship of its capital input to its labor input. Hence, more capital input than labor input connotes a capital-intensive industry.

The distortion caused by the current tax law is demonstrated by the following table:

*Theoretical Tax Rates on New Corporate Investment under Current Law*

Investment	4% Inflation	6% Inflation
3 year equipment	-21.8%	-3.9%
5 year equipment	-13.6	-0.3
10 year equipment	15.5	22.0
15 year equipment	30.5	36.3
15 year structures	33.2	36.6
Weighted average	20.7%	28.4%

Source: Calculations were provided to the author by the Joint Committee on Taxation

57. Four years ago Congress authorized \$285 million to assist American industry in exploring the potential of high technology. Now several bills that propose the funding of industrial research of technology are moving through Congress. Most observers regard the development of high-tech industries as vital

Fullerton, has estimated that the current corporate tax system costs the economy fifty billion dollars a year by misdirecting capital investment.<sup>59</sup> More concrete evidence of the cost of the corporate tax system is the lagging investment in long-term assets in the current economic recovery. While spending in equipment has set a record for any post-war recovery year<sup>60</sup> and is expected to rise another 14% in 1984,<sup>61</sup> investment in structures and long-term assets actually fell by over 7% in 1983,<sup>62</sup> and is expected to grow by a modest 3.8% in 1984.<sup>63</sup> The corporate tax structure also distorts the manner in which corporations raise capital by effectively making debt less expensive than equity. A ten million dollar interest expense is tax deductible,<sup>64</sup> reducing the companies' tax bill by \$4.6 million, at the current 46% marginal statutory rate.<sup>65</sup> Ten million dollars paid in dividends, however, does not reduce the company's tax bill a penny. Clearly debt receives favored tax treatment.

There is an enormous anti-saving, anti-investment bias in our tax code. Corporate profits are currently susceptible to double taxation. Corporate profits are taxed to the corporation at 46 percent,<sup>66</sup> and then at rates up to 50%, if distributed to shareholders as dividends,<sup>67</sup> and 20% if capital gains.<sup>68</sup> These same corporate profits are also subject to property taxes, state and local income taxes, sales taxes, and numerous incidental taxes. Thus, the combined corporate tax rate could exceed 70%. These high business tax rates severely depress the level of business investment.<sup>69</sup>

Ironically, while the corporate profits tax generates a wide range of distortions, it accounts for a relatively small, and falling, share of total federal tax revenues.<sup>70</sup> In 1984, for example, only 8.5% of all federal tax revenues came from

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to our continuing economic leadership. See Wall St. J., Aug. 1, 1984, at 27, col. 3. See also R. OAKLEY, *HIGH TECHNOLOGY SMALL FIRMS* 2 (1984).

58. In 1982, tax rates ranged from 4.1% for railroads and 15.6% for the utilities to much higher rates on high-tech industries such as those producing computers and office equipment (26.4%) and instruments (21.9%). Auerbach, *Corporate Taxation*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 468 (1983).
59. Fullerton, "Working Paper" prepared for Nat'l Bureau of Economic Research.
60. Business expenditures for new plants and equipment increased from \$261.16 billion in the March-May quarter of 1983 to \$270.05 billion in the June-August quarter of 1983 (measured at an annual rate). U.S. DEPT. OF COMMERCE, *BUSINESS CONDITIONS DIGEST* 24, 67.
61. Business expenditures for new plant and equipment are expected to rise from \$1076.88 billion in 1983 to \$1230.4 billion in 1984, representing a 14% increase. *Id.* at 67.
62. Investment in structures declined from \$213.4 billion in 1982 (1972 dollars) to \$196.8 billion in 1983 (1972 dollars). This represents a decline of 7.7%. *Id.*
63. In the last quarter of 1983 (September — November) investment in structures was \$51.4 billion (measured at an annual rate in 1972 dollars). During the first quarter of 1984 (December 1983 to February 1984) investment in structures was \$54.1 billion (measured at an annual rate in 1972 dollars) and was expected to rise to a high of \$56.8 billion (measured at an annual rate in 1972 dollars) in the second quarter (March through May). *Id.*
64. I.R.C. § 163(a) (1982) provides that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."
65. I.R.C. § 11(b)(5) (1982) provides that "[t]he amount of the tax imposed by subsection (a) [corporations] shall be the sum of 46% of so much of the taxable income as exceeds \$100,000."
66. *Id.*
67. I.R.C. § 301(c)(1) (1982). The portion of the distribution which is a dividend shall be included in gross income. Hence, it would be taxed as ordinary income.
68. I.R.C. § 302 (1982).
69. See *infra* notes 188 and 196 and accompanying text. See also G. GILDER *supra* note 37, at 219-224.
70. In 1982, corporate tax revenue constituted only 10.4% of total tax revenue, while in 1945 it constituted 36.5% of total tax revenue.



corporate income tax.<sup>71</sup> This represents less than 1.6% of GNP.<sup>72</sup> By contrast in 1964 the corporate income taxes contributed 21.8% of federal revenue or 3.8% of the Gross National Product (GNP),<sup>73</sup> more than double the current level. Nevertheless, executives continue to make decisions which minimize their tax liability, but which otherwise make little economic sense and do little to enhance economic growth. This tendency to trade off maximization of economic efficiency in order to minimize tax liability can only be reversed through substantial revision of the corporate tax structure.

### PROPOSALS FOR TAX REFORM

The case against the current corporate and personal income tax system is overwhelming. Few have ever come forward in its defense. The system fails and fails miserably on the traditional public finance criteria<sup>74</sup>: equity<sup>75</sup>, efficiency<sup>76</sup> and simplicity.<sup>77</sup> It is a monstrous system which cries out for major overhaul. Piece-

Year	Corporate Tax Revenue (in billions)		
	Total Tax Revenue	Corp. Tax Revenue	Corp. Tax as % of Total
1982	632.2	66.0	10.4
1981	606.8	73.7	12.1
1980	519.4	72.4	13.9
1979	460.4	71.4	15.5
1975	293.0	45.7	15.6
1970	195.7	35.0	17.9
1965	114.4	26.1	22.8
1964	112.2	24.3	21.7
1960	91.8	22.2	24.2
1955	66.3	18.3	27.6
1950	38.9	10.8	27.8
1945	43.8	16.0	36.5

STATISTICAL ABSTRACT OF THE UNITED STATES 1984 326 (4th ed. 1983); U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, 2 HISTORICAL STATISTICS OF THE U.S., COLONIAL TIMES TO 1970 1107 (1975).

71. BUDGET OF THE UNITED STATES (1984).

72. *Id.*

73. *Id.* The Gross National Product for 1964 was \$637.7 billion. U.S. DEP'T OF COMMERCE, BUREAU OF ECON. ANALYSIS, BUSINESS STATISTICS 1982 (1983). Corporate tax revenue was 24.3 billion in 1964. See *supra* note 70. Thus, corporate tax revenue in 1964 accounted for 3.8% of the total GNP.

74. For further detailed discussion of "traditional public finance criteria" see R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 1-2, 59-63, 72-76 (3d ed. 1973); Hatfield, *Tax Reform: It's Time to Fulfill the Promise*, 22 TAX NOTES 407-17 (1984); McLennan & Simpson, *Special Report: Income Distribution Effects of Moving to a Broad-Based Low-Rate Individual Income Tax*, 22 TAX NOTES 509 (1984).

75. Two ideas stem from the basic notion that taxes must be fair and equitable. "First, people in equal positions should pay equal amounts of taxes; second, people in unequal positions should pay different amounts related in a meaningful fashion to a difference in position. These two requirements are referred to respectively as 'horizontal' and 'vertical' equity." Musgrave, *In Defense of an Income Concept* 81 HARV. L. REV. 45 (1969).

76. According to Hatfield "[a]n efficient tax system is neutral, so that personal and business decisions are based on their perceived value, apart from tax considerations." HATFIELD, *supra* note 74, at 411.

77. Our tax system should be simple, so that people understand the basic requirements of the tax law and are able to file the returns by themselves without professional assistance. McLennan & Simpson, *supra* note 74, at 510. While tax simplicity has been the objective of Congress and every administration in recent years, the income tax has become more and more complicated. The 1982 income tax return (Form 1040) contained: (1) a 2 page initial summary; (2) 9 separate schedules; (3) 35 supplementary forms for detailed reporting of income receipts, deductions and credits; and (4) 8 adjustments for arriving at adjusted gross income and 8 tax credits.

Public opinion polls report that millions of taxpayers feel inadequate to take care of their tax reporting and thus seek professional assistance. See J. PECHMAN, *supra* note 51, at 125-26. See also *supra* notes 4-11 and accompanying text.

meal reform will only paint over a foundation which is cracked and flawed to its core.

We need a tax system which is simple, throwing away the thousands of pages of complex rules and regulations. We need a tax system which is fair. Fairness means that taxes should be proportional to the ability to pay.<sup>78</sup> We need a tax code which rewards enterprise, initiative and thrift. Only if the tax code provides incentives for productive activities will the economy flourish, job opportunities increase and poverty diminish.

Dozens of tax reform plans have been introduced in Congress.<sup>79</sup> Dozens more may well be introduced before comprehensive reform is achieved. Fortunately, however, the issue is not as bewildering as it may seem. Conceptually, there are three basic approaches to comprehensive tax reform: the "pure" flat income tax, the "pure" consumption-based tax, and a "hybrid" or "progressive flat tax." Both the Bradley-Gephardt<sup>80</sup> and Kemp-Kasten<sup>81</sup> proposals embrace the "progressive flat tax approach." This approach is both politically and economically feasible. The two "pure" approaches lack this feasibility, but provide a historical and conceptual framework within which to examine Kemp-Kasten. Accordingly, the following analysis examines the weaknesses of these two approaches.

### The Pure Flat Income Tax

The purest flat income tax would simply tax everything that gives a person command over wealth at the same flat tax rate.<sup>82</sup> This system would close every "loophole" and eliminate all exclusions, deductions, credits and exemptions. With such a tax system, the aggregate national taxable income would be so high that a flat rate as low as 10% or 15% could be expected to raise the same amount of revenue as the current law.<sup>83</sup> This approach has obvious intuitive appeal, but has substantial economic and political problems.

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78. The commonly accepted meaning of "ability to pay" is that there must be a direct correlation between a person's income and his or her tax-paying ability. See J. PECHMAN, *supra* note 51, at 60 ("In our democratic society taxation according to the principle of ability to pay has received wide acceptance as the most equitable method of raising revenue"). See also J. RUSKAY & R. OSSERMAN, *HALFWAY TO TAX REFORM* 222 (1970).
79. The tax reform movement picked up momentum during the summer of 1982. Indeed, twelve bills calling for revision of the Internal Revenue Code were introduced during the 97th Congress. Ten of the twelve tax-reform bills were reintroduced into the 98th Congress. See, Note, *Flat Tax, Fair Tax: New Hope For Reforming the Internal Revenue Code*, J. LEGIS. 521-22 (1984).
80. S. 1421, 98th Cong. 1st Sess., 129 CONG. REC. S7838-45 (daily ed. June 8, 1983), introduced by Senator William Bradley, (D-N.J.); H.R. 3271, 98th Cong., 1st Sess., 129 CONG. REC. H3846 (daily ed. June 9, 1983), introduced by Representative Richard Gephardt, (D-Mo.).
81. H.R. 777, *supra* note 2.
82. The Hall-Rabushka Bill, S. 557, 98th Cong., 1st Sess. 129 CONG. REC. 1509-10 (1983), introduced by Senator DeConcini (D-Ariz.) proposes a flat-tax plan. This bill, formulated by Robert Hall and Alvin Rabushka of the Hoover Institution, imposes a single "flat" rate of 19% on all income—individual and corporate. The aim of the Hall-Rabushka bill is to develop an uncomplicated and simple means of raising revenue through taxes. Thus, along with the single flat rate, the bill eliminates all deductions from gross income (except for personal allowances for the individual taxpayer and the cost of doing business for business taxpayers) and provides no tax credits. See Note, *supra* note 79, at 527.
83. According to a Joint Economic Committee Study, "a flat-tax of 11.8% on adjusted gross income would produce about the same revenue as the present system would have in 1981, if all the Reagan tax cuts had been in effect then." *The Flat-Rate Tax: Hearings Before the Subcomm. on Monetary and Fiscal Policy of the Joint Economic Comm.*, 97th Cong., 2d Sess. 110 (1983). [hereinafter cited as *Joint Econ. Comm.*]. Other proponents of flat-tax plans, particularly the Hall-Rabushka Bill, *supra* note 82, and the Bradley-Gephardt plan, *supra* note 80, profess that a flat-tax will bring in roughly the same amount of revenue as current law and economists agree. Indeed, both approaches contain "hidden revenue-raising potential, which would take effect a year or a little more after either plan becomes law." *Flat Taxes: The Winners and Losers* BUS. WEEK Mar. 29, 1984, at 99. Economist Joseph J. Minarik estimates that "if Bradley-Gephardt were enacted in 1985, it would pull in \$25 billion a year more than the present system by 1987 and possibly \$50 billion more by 1989." *Id.*

From an economic perspective, the elimination of all "loopholes" does not result in a rational, or even a simple, tax system. For example, one "loophole" in the current law allows a person to deduct alimony paid from taxable income.<sup>84</sup> Removing this deduction would tax the same income twice: once when earned by the payer, and again when received by the payee. This is only one of many examples.<sup>85</sup> Also, to be consistent, such a tax system would have to tax "income" which is not received in cash, such as the imputed value of automobiles and owner-occupied homes, unrealized capital gains, in-kind employer benefits and government social welfare payments.<sup>86</sup> This would create considerable problems in measurement, fairness, and enforcement.<sup>87</sup>

The "pure" flat tax is politically unfeasible since it would shift the tax burden from higher to lower income levels. With a 15% tax rate for example, taxes might be cut by 70% at the highest income levels, and raised up to one third at the

84. I.R.C. § 215(a) (1982).

85. The removal of numerous other deductions would likewise lead to neither an equitable nor a simple result. A partial list of these deductions includes: child support payments, I.R.C. § 71(c) (1982); meals and lodging furnished for the convenience of the employer, I.R.C. § 119 (1982); the sale of a residence, I.R.C. § 121 (1982); scholarship and fellowship grants, I.R.C. § 117 (1982); accident and health plan benefits, I.R.C. § 105 (1982); and educational assistance programs, I.R.C. § 127 (1982).

86. "Gross income" is defined in I.R.C. § 61(a) (1982) as all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

It has been said that "in the United States, there is a tradition that a taxpayer's income is a valid measure of his or her ability to pay taxes. In this context, income is defined as the ability to provide oneself with goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income is generally measured by subtracting from the sum of the gross receipts and appreciation in asset value of a taxpayer the amounts spent on goods or services which are costs of generating those gross receipts on that appreciation."

STAFF OF JOINT COMM. ON TAXATION, , ANALYSIS OF PROPOSALS RELATING TO BROADENING THE BASE AND LOWERING THE RATES ON THE INCOME TAX, 97th Cong. 2d. Sess. 3 (Comm. Print. 1982)

87. For a discussion of the inherent problems with the measurement, fairness and enforcement of the Hall-Rabushka bill, see JOINT ECON. COMM., *supra* note 83, at 113-18.

lowest income levels.<sup>88</sup> Preserving large personal exemptions and zero bracket amounts would mitigate this problem, but would require a higher flat tax rate than proposed by Hall-Rabushka in order to be revenue-neutral. This higher flat tax rate would merely shift the majority of the tax burden to the middle class, and would exacerbate the economic distortions caused by multiple taxation of the same income. Moreover, since the pure flat tax approach would eliminate personal exemptions<sup>89</sup> as well as deductions for home mortgage interest,<sup>90</sup> charitable contributions,<sup>91</sup> catastrophic medical expenses,<sup>92</sup> IRAs,<sup>93</sup> and other pension arrangements,<sup>94</sup> the tax increases would disproportionately hit homeowners, charitable donors, the catastrophically ill, savers, and families with children and senior citizens. Obviously, the "pure" flat tax suffers from serious theoretical and practical problems.

### The Pure Consumption-Based Tax

The pure consumption-based tax attempts to eliminate the saving disincentive inherent in both the current and a "pure" flat tax system.<sup>95</sup> This saving disincentive exists because a person must save out of after-tax income, and is then taxed again on the return on savings.<sup>96</sup> This bias tilts the incentives toward consumption and away from saving.

The consumption-based tax takes many forms ranging from the value-added tax<sup>97</sup> to the consumed-income tax,<sup>98</sup> but economically the different forms are

88.	Income Group	Effect of 17% Rate		
		% Change	Present law	Flat rate of 17%
	\$0-5,000	1900% decrease	\$20	\$1
	5,000-10,000	35% decrease	301	223
	10,000-15,000	15% increase	750	880
	15,000-20,000	17% increase	1,342	1,609
	20,000-25,000	14% increase	2,034	2,380
	25,000-35,000	15% increase	2,968	3,505
	35,000-50,000	12% decrease	4,736	5,382
	50,000-100,000	9% decrease	9,902	9,063
	100000-500000	49% decrease	36,679	24,562
	500000-1000000	65% decrease	174,039	105,105
	Over 1000000	42% decrease	513,605	360,423

Source: Flat Taxes, *supra* note 83. (from study by Joseph E. Pechman and John Karl Scholz).

89. I.R.C. §§ 151-153 (1982).

90. I.R.C. § 25 (1982).

91. I.R.C. § 170 (1982).

92. I.R.C. § 213 (1982).

93. I.R.C. § 408(e) (1982).

94. I.R.C. § 404 (1982).

95. See Tannenwald, *Should We Adopt an Expenditure Tax?*, NEW ENG. ECON. REV., Mar.-Apr. 1984, at 35. Note, *The CEA on Taxes and Personal Saving*, 18 TAX NOTES 532 (1983); Boskin, *Taxation, Saving and Rate of Interest*, 1976 NAT'L TAX A. TAX INST. OF AM. PROC. See also *infra* notes 190-91 and accompanying text.

96. I.R.C. § 61(a)(4) (1982).

97. See R. LINDHOLM, A NEW FEDERAL TAX SYSTEM (1984); Viehweger, *Implications of a United States Value Added Tax*, 16 AM. ECON. DEV. COUNCIL 35 (1981); Bullock, *The Value Added Tax: Some Pros and Cons*, 7 BUS. AND PUB. AFF. 79 (1980); Ullman, *Rebuild the Economy With a Value-added Tax*, 7 J. OF THE INST. FOR SOCIOECON. STUD. 62 (1982).

98. The Consumed Income Tax, sometimes referred to as an Expenditure Tax, is imposed on the amount which is the difference between an individual's net income and the change in net worth during the taxable year. A consumer calculates net spendable receipts (wages, borrowed income, proceeds from the sale of assets, withdrawals from savings accounts and all income in kind) then subtracts all savings and investments (i.e. costs of earning income, purchases of plant and equipment, repayment of loans,

equivalent. In each form, a taxpayer may deduct either net savings or the return on that savings from his taxable income.<sup>99</sup> In other words, the treatment of savings would resemble either individual retirement accounts<sup>100</sup> (but without limits on annual contributions or penalties for early withdrawal), or tax-free municipal bonds<sup>101</sup> (taxpayers save out of after-tax income, but are not taxed on the interest). The two are economically equivalent.

While the consumption-based tax eliminates the bias against savings it is even more inequitable than the comprehensive income tax. At the bottom of the income scale, roughly 90% of income comes from wages and salaries,<sup>102</sup> while at the top of the income scale, between one-third and more than one-half of total income is investment income.<sup>103</sup> This investment income would be tax-deferred under a consumption tax. As a result, a flat-rate consumption tax would result in an even greater shift of the tax base than the "pure" flat tax. A progressive consumption tax might help prevent these shifts, but the marginal tax rates would have to approach 40% in order to accomplish this task.<sup>104</sup> Thus, the highest marginal rates would closely approximate those under current law.<sup>105</sup> The fundamental fairness of a consumption based tax is questionable. For example, this approach would tend to impose a net negative effect on families with children. For the purposes of a consumption tax, children would be treated as "consumption goods" rather than "investments."<sup>106</sup> For example, the cost of education would not be tax-deductible, but any increased income due to that education would be taxed. Moreover, elderly citizens who had saved for a lifetime out of after-tax income at high tax rates would now be taxed yet again for consuming those hard-earned savings.

A final problem is complexity. While the consumption-based tax has a certain elegant simplicity in operation, the transition from the current law to the new system would require a ten to fifteen year transition period.<sup>107</sup> This would be necessary to minimize multiple taxation of the same income, or outright tax avoidance while changing to the new system.<sup>108</sup> Indeed, ten or fifteen years would

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reinvested dividends and interest— all deductible without limit). This difference is the taxable consumed income. U.S. DEPT. OF THE TREAS. OFFICE OF TAX ANALYSIS, BLUEPRINTS FOR BASIC TAX REFORM 113-212 (1977) [hereinafter referred to as TREASURY BLUEPRINTS].

99. *Id.* at 204. See also Fiedler, *A Federal Consumption Tax?*, 20 *ACROSS THE BOARD* 3, 4-5 (1983).

100. I.R.C. § 219(a) (1982). Individuals are allowed to deduct an amount equal to the qualified retirement contributions from their gross income. *Id.*

101. I.R.C. § 103(a)(1) (1982). Interest received on certain governmental obligations is not included in gross income. *Id.*

102. See STAFF OF HOUSE COMM. ON WAYS AND MEANS, *BACKGROUND MATERIAL ON POVERTY* 31, 98th Cong., 1st Sess. (Comm. Print 1983).

103. DEPT. OF THE TREASURY, *INTERNAL REVENUE SERVICE*, 1 *STAT. INCOME BULL.* 8 (1981).

104. See Clark, *Need for More Revenue Prompts Search for Alternatives to the Income Tax*, 16 *NAT'L. J.* 308, 311 (1984). High marginal tax rates would be required under a consumption tax system because, although personal consumption exceeds taxable personal income, the expenditure tax imposed solely on consumers would need to raise revenue currently raised by personal and corporate income taxes combined.

105. Tannenwald, *supra* note 95, at 35.

106. See TREASURY BLUEPRINTS, *supra* note 98, at 116. Because a \$50,000 wage earner with a spouse and two children would spend more income on consumption, they would pay higher taxes than a single individual with an equivalent income. *Id.*

107. *Id.* at 204. See also Fiedler, *supra* note 99, at 5. The U.S. Treasury Department proposed at minimum a 10 year transition period in which taxpayers would compute their tax liability under both the current tax system and the new tax law, and pay the higher of the two. This would require numerous calculations, retrieval of records from many different sources and additional computations based on the number and type of tax preferences Congress may include. Further complications would arise as states continue to impose both individual and corporate income taxes.

108. See TREASURY BLUEPRINTS, *supra* note 98, at 204-12; Fiedler, *supra* note 99, at 5. Multiple taxation would result for those people who were taxed on the income they earned under the current system and

not be long enough to fully solve the problem in many cases, such as those problems which would affect senior citizens.<sup>109</sup> Obviously, few taxpayers, and even fewer members of Congress, would actively support a plan which would take ten to fifteen years to implement. Therefore, a consumption-based tax cannot be considered a realistic alternative.

### THE KEMP-KASTEN ALTERNATIVE

Economic and political realities lead very quickly to the conclusion that neither a "pure" flat income tax nor a consumption-based tax is practical. The Kemp-Kasten approach which borrows some of the best features of each, while avoiding their pitfalls, is the most realistic alternative. Kemp-Kasten is sometimes called a "progressive flat tax" because it combines a single flat tax rate with a progressive tax base. It resembles the comprehensive income tax in repealing a majority of tax preferences,<sup>110</sup> although it retains important deductions for mortgage interest,<sup>111</sup> real property taxes,<sup>112</sup> charitable contributions,<sup>113</sup> and catastrophic medical expenses.<sup>114</sup> At the same time, it resembles the consumption-based tax by retaining current tax treatment for IRAs<sup>115</sup> and Keoghs,<sup>116</sup> general obligation municipal bonds,<sup>117</sup> private pension plans,<sup>118</sup> Social Security,<sup>119</sup> and homeownership.<sup>120</sup>

Kemp-Kasten departs from both approaches, however, with its special provisions for workers, the poor, families with children, and senior citizens. These include a doubling of the personal exemption to \$2,000,<sup>121</sup> additional \$2,000 exemptions for the elderly<sup>122</sup> and the blind,<sup>123</sup> increased zero bracket amounts,<sup>124</sup> and a new exclusion for 20% of "employment income," up to about \$40,000.<sup>125</sup> This tax base, combined with a 24% tax rate on taxable income,<sup>126</sup> prevents any shifting of the tax burden to the poor or the middle class. Tax indexing is retained, and extended to new items such as the capital basis.<sup>127</sup> This retention of

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who had saved and invested their money, only to have it taxed again under the new system when they consumed it.

Adoption of a consumption-based tax would provide an incentive to hoard cash and consumption goods prior to the effective date in order to avoid taxes on wealth previously liquidated. Thus, consumption out of wealth existing on the effective date of the new tax system would be grandfathered and exempt from taxation, allowing wealthy people who could support themselves on their existing supply of assets to avoid paying an expenditure tax for years, perhaps even the rest of their lives.

109. Senior citizens, for instance, may have spent their lifetimes accumulating savings to live on during their retirement. The income that generated those savings was taxed by the current income tax system. To institute a pure consumption tax now would essentially subject the income to double taxation, since they would be taxed as they spent the money for consumption.

110. H.R. 777, *supra* note 2, §§ 201, 211, 221, 228.

111. I.R.C. § 163 (1982)

112. I.R.C. § 164 (1982)

113. I.R.C. § 2522 (1982).

114. I.R.C. § 213(a)(1) (1982).

115. I.R.C. § 408 (1982).

116. I.R.C. § 404(a)(2) (1982).

117. I.R.C. § 103 (1982).

118. I.R.C. § 404(a)(9) (1982).

119. I.R.C. § 37(d)(3)(A)(i)(I) (1982).

120. I.R.C. § 163 (1982)

121. H.R. 777, *supra* note 2, § 111(1).

122. *Id.*

123. *Id.*

124. *Id.* § 112.

125. *Id.* § 134. This provision defines "employment income" to include "earned income" as defined by I.R.C. § 32(c)(2) (1982), and qualified alimony as defined by I.R.C. § 219(b)(4)(B) (1982).

126. *Id.* § 101.

127. *Id.* § 213. In 1982, corporate tax revenue constituted only 10.4% of total tax revenue. See *supra*, note 70.

indexing prevents shifting the tax burden to the poor and the middle class in future years.

### Tax Simplification

Simplification and fairness are the hallmarks of Kemp-Kasten. Kemp-Kasten broadens the tax base by eliminating most of the deductions, exclusions, exemptions, and other "loopholes" which encumber our current system. The bill does retain, however, the current treatment of IRAs, Keoghs, Social Security benefits and veterans' benefits as well as deductions for mortgage interest, charitable contributions, property taxes, and catastrophic medical expenses.<sup>128</sup> Nevertheless, most taxpayers could fit their entire return on one piece of paper.

### Tax Fairness

Kemp-Kasten also provides the fairness missing from the current system. By eliminating wasteful loopholes, the bill assures that all taxpayers pay their fair share of taxes. This fairness benefits all taxpayers but particularly those taxpayers who are victims of the current system's inherent inequality.

For example, Kemp-Kasten helps the working family. The current system effectively penalizes families since the dependency exemption has not kept pace with inflation.<sup>129</sup> Kemp-Kasten doubles this exemption to \$2,000<sup>130</sup> and indexes it to allow for inflation<sup>131</sup>.

The combination of higher dependency exemptions and higher zero bracket amounts also protects the poor. Kemp-Kasten is designed so that Americans near or below the poverty level will no longer pay income taxes.<sup>132</sup> For example the income level at which single people start paying taxes would increase from \$3,445 to \$5,750.<sup>133</sup> For a family of four the increase is from \$8,936 to \$14,125.<sup>134</sup> The

128. See *supra* notes 111-20 and accompanying text.

129. See *supra* notes 20-24 and accompanying text.

130. H.R. 777, *supra* note 2, §111(1).

131. *Id.* §§ 111, 112.

132. For example, the poverty level for a family of four is \$10,178. Deductions for personal exemptions reduce this amount by \$8,000 to \$2178, which is below the zero bracket amount of \$3,500 for married individuals filing a joint return. The poverty levels and corresponding income tax thresholds under Kemp-Kasten are as follows:

	Poverty Level	Income Tax Threshold
One person	\$ 5061	\$ 5875
Two persons	6483	9375
Three persons	7938	11875
Four persons	10178	14375

U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORTS, SERIES P-60, No. 145, (March 1984); H.R. 777, *supra* note 2, at §§ 111-112, 121 (1984). See also, STAFF OF JOINT COMM. ON TAX'N, FEDERAL TREATMENT OF FAMILIES BELOW THE POVERTY LINE, 98th Cong., 2d Sess. (Comm. 1984)

133. Except when noted below, the numerical calculations and estimates supporting the discussion in this and subsequent sections were provided to the author by the Joint Committee on Taxation. The estimates are based, for technical reasons, on a static distributional model which assumes that taxpayers have the levels of income and deductions they had in 1981. More recent data are presently being collected and compiled by the Treasury Department and may alter some results. See Letter from David H. Brockway (Chairman, Joint Comm. on Taxation) to Rep. Jack Kemp (Aug. 9, 1984) (available in *Journal of Legislation* office). See also JOINT COMMITTEE ON TAXATION, FEDERAL TAX TREATMENT OF FAMILIES BELOW THE POVERTY LINE, 98th Cong., 2d Sess. 9 (1984).

The income tax threshold is calculated from the zero bracket amount, number of personal exemptions, the earned income tax credit (slightly modified from current law), and the 20% income exclusion, which is applied to the zero bracket amount and personal exemption as follows:

Kemp-Kasten indexing provisions also help the poor since inflation is often hardest on this group, pushing them into much higher marginal tax rates. The indexing provisions also apply to capital gains to limit "gains" resulting solely from inflation on assets such as homes.<sup>135</sup>

Unlike many other tax reform measures, Kemp-Kasten does not reform taxes by overtaxing middle-income Americans.<sup>136</sup> Kemp-Kasten includes an exclusion for employment income to protect wage and salary earners. This provision excludes 20% of income up to approximately \$41,700 and is then phased out entirely at approximately \$83,400.<sup>137</sup> This exclusion effectively lowers the marginal income tax rates and offsets the Social Security payroll tax,<sup>138</sup> resulting in a smooth, virtually flat, overall tax rate.<sup>139</sup>

Finally, Kemp-Kasten makes the tax code more equitable without making it less profitable. Kemp-Kasten raises roughly the same tax revenues as the current system,<sup>140</sup> and also maintains the same distribution of the tax burden on the various tax groups.<sup>141</sup> Because many tax preferences are eliminated, most taxpayers whose current deductions are no more than average would actually receive a tax cut. For example, a family of four earning \$30,000, which does not itemize deductions, would receive a \$500 tax cut.<sup>142</sup>

### Elimination of Disincentives

Kemp-Kasten also eliminates disincentives which plague the present tax code. Specifically, the bill treats the causes of the "poverty trap," the "unemployment trap," and the "retirement trap." The following analysis addresses each of these factors individually.

#### *The "Poverty Trap"*

As discussed earlier,<sup>143</sup> current tax laws and social programs combine to create a "poverty trap." Under current law, low-income individuals who obtain jobs suffer from very marginal income and payroll tax rates as well as a decrease in social welfare benefits.<sup>144</sup> In some instances, the net effect of the tax increase and

	<u>Married (2 children)</u>	<u>Single</u>
Zero Bracket Amount:	\$3,300	\$2,600
Exemptions (\$2000 x 4)	<u>8,000</u>	<u>2,000</u>
SUBTOTAL	\$11,300	\$4,600
20% income exclusion (x 5/4)	\$14,125	\$5,750

134. See calculations *supra* note 133.

135. H.R. 777, *supra* note 2, § 231.

136. See Note, *supra* note 79, at 533-36 (discussing the effects of the Bradley-Gephardt and Hall-Rabushka tax proposals on lower and middle income taxpayers).

137. See *infra* notes 163-65.

138. See *infra* note 162.

139. See *infra* note 167.

140. The revenue and distribution estimates for the Kemp-Kasten bill (H.R. 777) are currently under analysis by the Joint Committee on Taxation and the Department of Treasury. Preliminary data support the distributional neutrality of the bill for income groups below \$100,000. See *supra* note 133.

141. *Id.*

142. See *supra* note 133.

143. See *supra* notes 27-28 and accompanying text.

144. See *supra* notes 27-31 and accompanying text. Our current tax system overlaps with the welfare system causing potent work disincentives. These disincentives operate through a combination of rules regarding the effect of new wage income on benefit payments and program eligibility, much like a marginal tax rate. *Flat-Tax Rate Hearings*, *supra* note 1, at 235 (testimony of Sen. Domenici, R-N.M.).



benefit decrease may actually cause the individual to be worse off than before.<sup>145</sup> This effect provides a clear disincentive for the poor to seek employment.

Kemp-Kasten reduces the number of people caught in the poverty trap by increasing the income tax threshold so that no person below the poverty level will ever pay federal income tax.<sup>146</sup> The bill accomplishes this by reducing marginal tax rates on low-income individuals<sup>147</sup> and doubling the personal exemption.<sup>148</sup> Under the current tax code a family of four starts paying taxes on an income of approximately \$9,000,<sup>149</sup> while the poverty level for a family of four has been established at over \$11,000.<sup>150</sup> Under Kemp-Kasten that same family would not pay taxes on the first \$14,125<sup>151</sup> of income, approximately 130% of the present poverty level. Similarly, a single taxpayer would not pay taxes on the first \$5,750 of income,<sup>152</sup> compared with a poverty level of about \$5,000.<sup>153</sup> These provisions allow low income workers to keep more of their earnings as they enter the work force and reduce their dependency on government benefits. In addition to providing this incentive to certain low-income workers, Kemp-Kasten would remove approximately one and one-half million other low-income taxpayers from the tax rolls.<sup>154</sup>

### *The "Retirement Trap"*

Senior citizens, like the poor and unemployed, face a government created trap which results from the interaction of the income tax code and the regulations governing distribution of social welfare benefits. Under current laws, senior citizens face increased taxes and decreased benefits which may reduce their marginal income by as much as 96%.<sup>155</sup>

The major cause of the "retirement trap" is the so-called "retirement test" which reduces Social Security benefits by 50% for each dollar earned over \$7,320 per year.<sup>156</sup> This effectively reduces marginal income by 50%, providing tremendous disincentives to employment. Kemp-Kasten would initially reduce, and subsequently eliminate, this disincentive by phasing out the retirement test. Specifically, the bill would reduce the retirement test benefit reduction from 50% to 25% initially, with zero reduction in benefits after five years.<sup>157</sup>

### *The "Social Security" Trap*

One of the most advantageous features of Kemp-Kasten is its coordination with other federal programs to avoid rules which result in economic disincentives. For example, the current policy produces an inequitable tax liability because of a

145. The Congressional Research Service has computed the combined effect and has found that a welfare mother with two children will only receive a 15% increase in income if she takes a full-time job at minimum wage. This represents an 85% marginal tax on earnings, not including the possible Medicaid cut-off on additional work-related expenses such as transportation and clothing. *Id.* at 146. See *supra*, note 132.

146. See *supra*, note 132. Until low-income people or families cross the income tax threshold, their marginal rate is 0%. This threshold is higher than under the present tax code.

147. H.R. 777, *supra* note 2, § 111(1).

148. See *supra* note 134 and accompanying text.

149. See *supra* note 132.

150. See *supra* note 134 and accompanying text.

151. *Id.*

152. See *supra* note 132.

153. *Id.*

154. See *supra* notes 140-41 and accompanying text.

155. See Baldwin, *The 96% bracket*, FORBES, June 4, 1984, at 78.

156. See 20 C.F.R. §§ 404.415(a), 430, 434(a) (1984)

157. H.R. 777, *supra* note 2, §§ 414, 501(j).

lack of such coordination between the tax code's assessment of income taxes and Social Security taxes. Specifically, the current code assesses tax on income which begins at 0% on the first dollar of income and progresses to 50% with no upper income limit.<sup>158</sup> In contrast, the Social Security payroll tax<sup>159</sup> is assessed at a flat 7% on earnings<sup>160</sup> from the first dollar and stopping at a threshold of \$41,700.<sup>161</sup> Two problems result from this lack of coordination between income and payroll taxes. First, taxpayers pay significantly higher tax rates on income below the \$41,700 Social Security limit than above this limit. Second, there is a significantly higher combined income and payroll tax on employment income than on savings income.<sup>162</sup>

Kemp-Kasten addresses both problems. Under Kemp-Kasten taxpayers may exclude 20% of their employment income from income taxation up to the Social Security wage base.<sup>163</sup> Above this wage base the exclusion is gradually phased out,<sup>164</sup> and completely eliminated by the time income reaches \$83,400.<sup>165</sup> Accordingly, under this provision the 20% exclusion would be phased out for those

158. I.R.C. § 1 (1982).

159. I.R.C. § 3101 (1982).

160. The Federal Insurance Contributions Act for the year 1984 imposes a tax on the income of every individual according to the following percentages:

(a) old-age, survivors, and disability insurance — 5.7%

(b) hospital insurance — 1.3%

Total — 7.0%

I.R.C. § 3101 (1982)

161. This threshold is determined by a formula set out in 20 C.F.R. § 404.1047-1048 (1984). The threshold is adjusted annually to account for inflation.

162. This principle is illustrated by the following table:

Taxable income	marginal* income tax rate	marginal** social security tax rate	combined marginal rate
39,000	38%	7%	45%
41,000	38%	0%	38%

\* I.R.C. § 1(c)(3) (1982)

\*\* Marginal Social Security tax rate drops to 0% at the FICA maximum wage base (\$39,300 in 1985). Effectively, an individual earning \$41,000 has a combined marginal tax rate of 38%, 7% less than if he were earning \$39,000.

163. H.R. 777, *supra* note 2, at § 134:

(a) Gross income of an individual does not include an amount equal to 20 percent of the amount received during the taxable year by such individual as employment income, (b) the amount excludable under subsection (a) for any taxable year shall not exceed 20 percent of the FICA maximum wage base for the calendar year in which such taxable year began. *See supra* note 161.

164. H.R. 777, *supra* note 2, at § 134(2):

In the case of a taxpayer with employment income for any taxable year in excess of the FICA maximum wage base for the calendar year in which such taxable year began, the amount excludable under subsection (a) shall not exceed the amount determined under paragraph (1) reduced (but not below 0) by an amount equal to the product of —

(A) 12.5 percent, and

(B) the amount by which the employment income of the taxpayer for such taxable year exceeds the FICA maximum wage base for such calendar year.

165. According to the formula in note 164 *supra*, the 20% exclusion is entirely phased out at \$104,000 as evidenced by the following equation (W = wage amount at which 20% exclusion will no longer apply, FICA = 40,000 [39,300 in 1985]):

$$(20\% \times \text{FICA}) - 12.5\%[\text{W} - \text{FICA}]$$

$$8,000 - (.125\text{W}) + 5,000$$

$$13,000 - .125\text{W}$$

$$125\text{W} = 13,000$$

$$\text{W} = \$104,000$$

taxpayers earning \$41,700, but this would be offset by the elimination of the 7% payroll tax.<sup>166</sup> This coordinated program would lead to a smooth, nearly flat, combined federal income and payroll tax rate,<sup>167</sup> and would eliminate the current dichotomy between employment and savings income.

### Kemp-Kasten And The Corporate Tax

Kemp-Kasten brings some economic reality into the realm of corporate taxation. Kemp-Kasten rewards profit by lowering the marginal tax rate from 46% to 35%.<sup>168</sup> The bill also provides for a reduced rate for small businesses, which will provide incentives for new business development. Under these provisions, profits up to \$25,000 will be taxed at a flat rate of 15%,<sup>169</sup> while profits between \$50,000 and \$100,000 will be taxed at a 25% rate.<sup>170</sup>

Kemp-Kasten replaces the current ACRS depreciation system with one which permits the economic equivalent of first-year expensing for all new investment.<sup>171</sup> To avoid reducing total tax revenues, the suggested depreciation system moderately expands the current ACRS classes as it increases the total capital "write-off."<sup>172</sup> The new depreciation system is referred to as the Neutral Cost Recovery System as it is much more neutral than the present ACRS in reducing the amount of tax-driven investment spending.<sup>173</sup> Further, Kemp-Kasten reduces the corpo-

166. Using the formula in note 165, *supra*, to calculate the marginal tax rate above the FICA maximum wage rate results in a marginal tax rate of 28%:

Employment Income	54,700
Exemption	4,700
Taxable Income	50,000
20% Exclusion Phased Out	6,700
New Taxable Income	43,250
Tax Due	10,812
Marginal Tax Rate	28%

167. The effective combined marginal federal tax rate is demonstrated by the following chart:

Income	Marginal Tax Percentage
5,875	20%
10,000	20%
20,000	20%
30,000	20%
40,000	28%
50,000	28%
60,000	28%
70,000	28%
80,000	28%
90,000	28%
100,000	28%
104,000	25%

168. Under the current tax code, corporate income is taxed on a graduated basis as follows:

- 15 percent on the first \$25,000 of income
- 18 percent on income between \$25,000 and \$50,000
- 30 percent on income between \$50,000 and \$75,000.
- 40 percent on income between \$75,000 and \$100,000.
- 46 percent on income over \$100,000.

I.R.C. § 11(b)(1982).

Under Kemp-Kasten, corporate marginal income tax rates would be reduced to:

- 15 percent on the first \$50,000 of income.
- 30 percent on the income over \$50,000.

H.R. 777 *supra* note 2, § 102.

169. *Id.* Under Kemp-Kasten, corporate income up to \$50,000 is taxed at 15 percent. H.R. 777, *supra* note 2, § 102. Currently, income up to \$25,000 is taxed at 15 percent, while the amount of income which exceeds \$25,000 but does not exceed \$50,000 is taxed at 18 percent. I.R.C. § 11(b) (1982).

170. H.R. 777, *supra* note 2, § 102.

171. *Id.*, § 301.

172. *Id.*

173. *Id.* See *supra* notes 48-55.

rate capital gains rates from 28% to 20%.<sup>174</sup>

As a result of its new depreciation system Kemp-Kasten reduces the disparity in tax rates between different investments and among different industries. Currently, tax rates vary between a negative 22% for investments in 3-year equipment to a positive 36% for investments in 15-year equipment, considering 6% inflation for both.<sup>175</sup> By eliminating the investment tax credit<sup>176</sup> and lowering marginal tax rates,<sup>177</sup> Kemp-Kasten ends the implicit subsidy of equipment and creates a much more consistent range of tax rates for new investments.

Kemp-Kasten provides more fairness to labor intensive firms.<sup>178</sup> While many innovative "high-tech" firms are labor-intensive, they do not benefit from tax advantages such as those provided by the 1981 capital cost recovery provisions.<sup>179</sup> By cutting the marginal corporate tax rate to 35%,<sup>180</sup> Kemp-Kasten creates a greater incentive for firms to invest in new projects, regardless of their labor-capital mix. This 35% tax rate also reduces the bias towards debt financing since at 35%, one dollar of debt reduces the corporate tax bill by only 35 cents compared to the current 46 cents.

### KEMP-KASTEN AND ECONOMIC EFFICIENCY

Undoubtedly, Kemp-Kasten's most important feature is its low marginal tax rates, which encourages upward mobility, thrift, and enterprise. Kemp-Kasten cuts the top marginal tax rate in half, from 50% to 24%. This increases after-tax incentives by up to one-half. At a marginal tax rate of 50%, every dollar of tax deduction is worth 50 cents. If the tax rate was 24%, however, many tax shelters and deductions would not be profitable. Taxpayers would no longer be rewarded for investing in boxcars, paper transactions, and tax scams.<sup>181</sup> Few would pay 30 to 40 cents on every dollar for a tax shelter, which only saved 24 cents in taxes.

A low marginal tax rate also lowers the cost of labor while increasing its reward. It minimizes the "tax wedge," which may be characterized as the difference between workers' after-tax wage and the cost of their services to their employees. Many workers consider the after tax wage, the net of all deductions and taxes as the true compensation for services. Workers will be more productive if increased productivity is correlated with higher after-tax pay.<sup>182</sup> An employer, however, is primarily interested in the worker's cost to the firm. The total costs includes payroll taxes, federal, state, and local income taxes, and payroll deductions. The greater the gross wage of each additional worker, the fewer workers the firm can afford to hire.<sup>183</sup>

174. H.R. 777, *supra* note 2, at § 232(a).

175. See *supra* notes 55-56 and accompanying text.

176. H.R. 777 *supra* note 2, § 201(12).

177. See *supra* note 168 and accompanying text.

178. "Labor intensive" means the ratio of labor costs to total costs is higher than the average such ratio for all industries. Alternately, more labor input than capital input connotes a labor intensive industry. Thus, a labor intensive industry is one that requires a high proportion of labor compared with the other factors employed, especially capital. Examples of labor intensive industries include textiles, leather products, furniture, and the production of services. MCGRAW-HILL, *supra* note 56, at 118.

179. See *infra* note 183.

180. H.R. 777, *supra* note 2, § 102(b)(2).

181. Some examples of tax provisions used in tax scams are 26 U.S.C. § 168 (accelerated depreciation), 26 U.S.C. § 280 (books and films), 26 U.S.C. § 1231 (livestock, including those for sport such as race-horses), 26 U.S.C. § 1252 (citrus groves). See also, Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1980) (accelerated depreciation of boxcars).

182. See generally G. GILDER, *supra* note 37.

183. The marginal revenue product (MRP) of labor is the additional revenue secured by using one more unit of labor. The MRP schedule for labor is equal to the demand schedule for labor since the employer will only produce to the point where the MRP of labor equals the cost of labor. The MRP of

For the typical auto firm, a \$1.45 per hour wage raise is reduced to \$1.00 after taxes.<sup>184</sup> The 45 cent tax wedge, most economists believe, imposes a cost on the economy far in excess of the value of the revenue raised.<sup>185</sup> The tax wedge distorts the efficient level of work,<sup>186</sup> savings,<sup>187</sup> and investment,<sup>188</sup> creating what economists call a “deadweight loss”.<sup>189</sup> In short, the tax wedge reduces the demand for workers, increases unemployment, and lowers the rewards for working. All of these effects reduce the economy’s potential output.

Taxes on interest also introduce a differential between the return on after-tax savings, which is the “reward” that savers receive for foregoing consumption, and the pretax interest rate, which represents the real benefit of savings to society. The tax wedge reduces the incentive to save, drives down the level of saving,<sup>190</sup> increases the cost of borrowing, and thus tends to reduce overall investment.<sup>191</sup>

In Kemp-Kasten, average tax rates remain approximately what they are now.<sup>192</sup> Marginal taxes, however, are cut dramatically. This scheme reduces the tax wedges on savings, investment, and work. Kemp-Kasten will encourage additional employment by reducing the cost of labor,<sup>193</sup> and will increase the supply of

labor is a downward sloping function because of diminishing marginal returns to labor and because as production increases supply, the equilibrium price (revenue) will fall. Thus, a high cost of labor requires a high marginal revenue product of labor. The marginal revenue product of labor remains higher with fewer workers. L. REYNOLDS, *LABOR ECONOMICS AND LABOR RELATIONS* 59-74 (1979); E. BURTT, *LABOR IN THE AMERICAN ECONOMY* 62-67 (1979)

184. If the auto worker is married, lives in Detroit, Michigan, and earns \$15.00 per hour (\$30,000 per year) his marginal tax rate will be 43.6% in 1984. The Federal income tax rate is 28%; 26 U.S.C. § 1 (1982). The Michigan State income tax is 5.8%; MICH. COMP. LAWS § 206.51 (Supp. 1984). The Detroit city income tax is 3%; MICH. COMP. LAWS § 141.503 (Supp. 1984). (The 0.2% discrepancy is due to a credit toward state income tax for city income tax paid.) MICH. COMP. LAWS § 206.257 (Supp. 1984).
185. See R. DORNBUSCH AND S. FISCHER, *MACROECONOMICS* 68-79 (1981). Economists believe that income taxes reduce the consumption multiplier. Each dollar of income spent on consumption produces a dollar of income for another consumer. This chain continues indefinitely, multiplying consumption. An income tax of 44% would reduce the first consumer’s dollar to \$.56, the second consumer’s \$.56 to \$.31 and so on. Eventually taxes claim the entire dollar and consumption stops. *Id.* See also R. MUSGRAVE & P. MUSGRAVE, *supra* note 34. 378-79 (1976). The income tax affects consumption choices, output choices, and employment. The consumer will rearrange his consumption choices because of the higher relative price of goods. Workers may work less because of the tax burden. The resulting drop in income to workers and loss of output to employees must be considered in assessing the final effect of the tax.
186. See R. MUSGRAVE AND P. MUSGRAVE, *supra* note 34, at 379. Taxes alter the aggregate demand for labor by altering the cost of labor relative to other input factors. *Id.*
187. See E. MANSFIELD, *MICROECONOMIC THEORY AND APPLICATIONS* 501-04 (1979). Taxes on interest reduce the return on savings. *Id.*
188. *Id.* Because taxes reduce the real interest rate, borrowers must offer higher nominal interest rates. Some borrowers may forego investment if the return on investment is lower than the nominal interest rate.
189. See R. MUSGRAVE & P. MUSGRAVE, *supra* note 34, at 378. A burden is placed on the economy in excess of the tax. Workers may work less, decreasing their wages and consumption, and reducing the employers output. The overall burden suffered by the economy exceeds the tax revenue.
190. See E. MANSFIELD, *supra* note 187, at 514. Lower real interest rates cause consumers to forego some saving for present consumption. The present value of consumption in the present outweighs the present value of consumption in the future. The effect is more dramatic in an inflationary economy. A dollar will buy less in the future, therefore consumers buy in the present. Unless the real interest rate after taxes sufficiently exceeds the inflation rate, consumers will save less. See also Laffer, *Supply-Side Economics*, *FIN. ANALYSTS J.* 12 (1984).
191. See E. MANSFIELD, *supra* note 187, at 505-8. See also, R. MUSGRAVE & P. MUSGRAVE, *supra* note 34 and accompanying text.
192. See *supra* note 140.
193. The employer produces to the point where the marginal revenue product of labor equals the cost of labor. The marginal revenue product of labor schedule equals the demand schedule for labor. When cost is lowered, demand increases. L. REYNOLDS, *supra* note 183, at 59-74.

workers by enhancing the reward for employment.<sup>194</sup> It will generate more saving, by increasing the after-tax return,<sup>195</sup> and will increase the demand for saving by increasing the rate of return on investment.<sup>196</sup> Both the level and combination of labor and capital will be more efficient under Kemp-Kasten. The economy's potential output, employment rate, and efficiency all will be bolstered.

There is strong evidence that high marginal tax rates cost taxpayers far more than they yield to the government. Shaving the top marginal tax rate to 24% probably will not cost any tax revenue. IRS tax return data for 1982 show that when the top marginal tax rate was reduced from 70% to 50%, tax revenues from the rich soared.<sup>197</sup> Those making \$1 million or more, for example, paid 41% more in tax revenues in 1982.<sup>198</sup> Although tax rates on investment income were reduced by almost 30% for the top bracket taxpayers,<sup>199</sup> tax revenues increased by 12.4% from those earning over \$100,000.<sup>200</sup> Those earning under \$25,000, by comparison, paid 12% less tax revenues.<sup>201</sup>

Not only did upper-income taxpayers contribute more taxes, but they also shouldered a larger proportionate share of the overall income tax liability than before. The share of taxes paid by those making \$40,000 or more increased from 45% to 48%.<sup>202</sup> In contrast, the tax burden of those making \$40,000 or less declined from 54.81% to 51.93%.<sup>203</sup> The substantial shift in the tax burden of upper-income groups in the midst of one of the most severe recessions on record<sup>204</sup> is

194. A rise in the wage level attracts voluntarily unemployed workers and workers who are underemployed to join the labor market. *Id.* at 68-72.

195. See *supra* note 187 and accompanying text.

196. See *supra* note 188 and accompanying text. The real return on investment equals the nominal return less taxes. When profits are taxed, the remaining return is a smaller percentage or rate. By decreasing taxes, the real return increases. It will become profitable to invest more because interest rates will be less relative to the real return.

197. *Changes in Tax Revenues and Tax Burden  
by Adjusted Gross Income (AGI)*  
(billions \$)

All Returns (\$ thousands)	1981 tax revenues	1982 tax revenues	% Change in taxes 1981-1982	1981 tax as a % of total tax	1982 tax as a % of total tax
under 5	.7	.7	2.3	.25	.26
5- under 10	7.9	7.0	-11.8	2.72	2.46
10- under 15	17.7	15.7	-11.4	6.07	5.52
15- under 20	23.4	20.2	-13.6	8.03	7.12
20- under 25	27.9	24.7	-11.6	9.60	8.71
25- under 30	29.2	28.4	-2.7	10.01	10.01
30- under 40	52.8	50.6	-4.2	18.13	17.85
40- under 50	35.5	35.6	-0.1	12.20	12.55
50- under 75	37.1	36.7	-1.1	12.76	12.96
75- under 100	15.0	14.7	-2.0	5.16	5.19
100- under 200	21.8	22.2	1.9	7.48	7.83
200- under 500	12.8	14.3	11.8	4.41	5.06
500- under 1000	4.1	5.6	35.6	1.42	1.97
1000 or more	4.9	6.9	41.2	1.69	2.44
Total	291.1	283.5	-2.6	100.00	100.00

198. *Id.*

199. In the 1981 Internal Revenue Code, the marginal tax on the top bracket was 70 percent. I.R.C. § 1 (Supp. V 1981). In the 1982 Internal Revenue Code, the marginal tax on the maximum tax bracket was reduced to 50 percent. Pub. L. No. 97-34, § 101(a), 95 Stat. 176 (codified at I.R.C. § 1 (1982)). This represents a decrease of approximately 30 percent.

200. See *supra* note 197.

201. *Id.*

202. *Id.*

203. *Id.*

204. The recession lasted from July 1981 to November 1982. GNP declined from 1513.5 to 1478.8 (annual rate in billions of dollars) in 1972 dollars. BUSINESS CONDITIONS DIGEST, Sept. 1984, at 40, 80.

a powerful vindication of the incentive-enhancing effects of marginal tax rate reductions.

### COMPARISON WITH BRADLEY-GEPHARDT

Kemp-Kasten is similar to Bradley-Gephardt in many respects. Both plans broaden the tax base<sup>205</sup> and retain deductions for mortgage interest,<sup>206</sup> real property tax,<sup>207</sup> charitable contributions,<sup>208</sup> and catastrophic medical expenses.<sup>209</sup> Both plans retain the exclusion for the IRA and Keogh plans.<sup>210</sup> Both plans also lower the top tax rate considerably.<sup>211</sup> On the business side, both plans repeal most tax preferences,<sup>212</sup> including the tax credit,<sup>213</sup> and lower the top corporate rate to 35%.<sup>214</sup>

I like all these features of the Bradley-Gephardt plan. Nonetheless, there are also significant differences between the two proposals. Bradley-Gephardt has three tax rates instead of one.<sup>215</sup> It caps the values of the deductions, including the mortgage interest and the personal exemption, at only 14%;<sup>216</sup> it holds the value of the personal exemption for dependant children at only \$1,000, where it has been since 1978;<sup>217</sup> it repeals indexing of the tax code,<sup>218</sup> which would shift the tax burden over time to lower- and middle-income taxpayers. Furthermore, it increases the top capital gains tax rate from 20% to 30%<sup>219</sup> and generally has fewer incentives for savings and investment. While these are concerns to me, I think there is clearly room for dialogue among the sponsors of the Kemp-Kasten and Bradley-Gephardt bill.

### CONCLUSION

The current tax system needs radical reform. Piecemeal changes will neither solve the monstrous problems of the current system nor overcome the political challenges of the special interests which stand behind every tax break.<sup>220</sup> Tinkering with the tax code will not effectively simplify taxes, restore fairness, create jobs, or spur economic growth.

The Kemp-Kasten bill is economically and politically viable. It recognizes that the tax system is unfair, riddled with loopholes, and harsh on the poor. It also recognizes that high marginal tax rates damage economic growth. We need to change the tax system in one bold stroke. Such a major revision will disarm special interests, but will gather broad public support. Even those who may lose

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205. H.R. 777, *supra* note 2, §§ 201-219; H.R. 3271, *supra* note 80, §§ 201-219.

206. *See supra*, note 120.

207. *See supra*, note 112.

208. *See supra*, note 113.

209. *See supra* note 114.

210. *See* I.R.C. §§ 62(7), 62(10), 86, 219, 408(e) (1982).

211. H.R. 777, *supra* note 2, § 101; H.R. 3271, *supra* note 80.

212. *See, e.g.*, H.R. 3271, *supra* note 80, §§ 241, 311; H.R. 777, *supra* note 2, §§ 201, 232(e).

213. H.R. 777, *supra* note 2, § 201(8), (12); H.R. 3271, *supra* note 80, § 201 (2).

214. H.R. 777, *supra*, note 2, § 102; H.R. 3271, *supra*, note 80, § 102.

215. H.R. 3271, *supra* note 80, § 101.

216. *Id.*

217. I.R.C. § 151 (1982), (as amended by Revenue Act of 1978, Pub. L. No. 95-600, § 102(a), 92 Stat. 2763).

218. H.R. 3271, *supra* note 80, § 121(b).

219. *Id.* § 241(a).

220. *See* Birnbaum, *Writing a Tax Bill: Lobbyists are Looking for a Break*, Wall St. J., June 15, 1984, at 54. Birnbaum describes the lobbying at the House-Senate conference on the tax bill of 1984, including the lobbyists representing interest groups ranging from state governments to corporations. Long lines of lobbyists, starting as early as 5:30 a.m., went to attend the panel's sessions. *See also supra* notes 14-15 and accompanying text.

one loophole or another will support a reform which promises a larger economic pie.