A PROPOSED SIMPLE AND FAIR TAX

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INTRODUCTION

The income tax system has become remarkably complex since its enactment in 1913.[1] This growth in complexity has been accompanied by increased taxpayer dissatisfaction with the tax system.[2] Four out of five taxpayers believe the current tax system benefits the rich at the expense of ordinary working people. [3] Almost one person in five admits to cheating on his or her taxes.[4]

Because of the great problems in the present Federal tax system a new and simpler tax system should be implemented. This article first will explore several major shortcomings of the present tax system and how these weaknesses arose. The article will then present a simpler alternative tax system, discussing both its economic and practical advantages. The article concludes that the alternative system offers a coherent solution to the current tax problem because it is fair, simple, efficient, and workable.

ROOTS OF CURRENT DISCONTENT

The present Internal Revenue Code is too complex, too uncertain, and too riddled with loopholes. It promotes economic inefficiency by encouraging people to devise tax shelters or cheat on their tax forms.

Complexity

The complexity and confusion surrounding the tax code has been widely reported.[5] Many people fear and resent the Internal Revenue Service. These feelings are not limited to taxpayers of specific socioeconomic backgrounds, education

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1. U.S. CONST. amend. XVI states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." In 1913, the personal income tax return, Form 1040, and the accompanying instructions were each two pages long. In contrast, the 1984 Form 1040 booklet included 10 pages of the most frequently used schedules and 39 pages of instructions to assist taxpayers in preparing their returns. The index to the booklet contained 148 entries and an order blank on the inside rear cover listed 63 additional forms and instruction booklets that taxpayers could request by mail. R. HALL & A. RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX 2 (1983).
2. *Flat-Rate 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 & 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.
3. *Id.*
4. *See* Washington Post, Dec. 4, 1984, at E3, col. 2.
5. Hall and Rabushka have described this situation. *See* R. HALL & A. RABUSHKA, *supra* note 1, at 2-5. The growth of commercial tax preparation reflects this complexity. Thirty years ago, only 10 to 15% of the population sought professional help to complete tax returns. By 1976, the figure reached 45% and now exceeds 50%. *Id.* at 4. The United States Internal Revenue Service estimates that college level reading ability is required to comprehend 90% of the instructions for preparing Form 1040A.

levels, or income levels.[6] According to sources as diverse as the Citizens Choice National Commission on Taxes and the IRS, there is a single cause underlying most of the fear and resentment toward that agency. The Commission concludes that "the overwhelming complexity and scope of the system of taxation is responsible for the dissatisfaction, bordering on rebellion, that exists in our country today."[7] Tax laws and regulations have ramified into a bewildering maze of exemptions, deductions, credits, allocations, qualifications, and exceptions, almost invariably written in obscure jargon. The American tax code has passed the point of rational human comprehension. Understandably, people fear that which they do not understand.[8]

Inefficiency

The present tax system is inefficient both because it imposes excessive compliance costs and because of its impact on economic activity. As originally conceived, the progressive personal income tax sought to balance the dual objectives of preserving economic incentive and promoting income redistribution. As presently administered, however, our tax system fails to achieve that balance. One reason for the disequilibrium has been the substantial market-distorting impact of high marginal tax rates. As recently as 1961, few Americans paid income tax at the highest marginal rates.[9] The current tax system requires that the top one-quarter of income earners pay about seventy-five percent of all income taxes.[10] The disproportionate weight of this tax burden has encouraged widespread tax avoidance: legally in the form of tax sheltering, and illegally in the form of tax evasion.

Today, over half of our national income is exempt from taxation.[11] Congress created this problem by granting preferential tax treatment in the form of deduc-

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Given this level of sophistication and complexity, it is not surprising that over 6 million taxpayers pay commercial firms to complete even the simplified return. *Id.* at 3.

Statistics reflecting the physical bulk of the Tax Code itself and interpretative materials are amazing. The general laws of the United States are codified in 50 different titles, and are published in approximately 180 volumes. The Internal Revenue Code fills 14 of these volumes and occupies 14 inches of shelf space. The 1981 Economic Recovery Tax Act amended 89 sections of the Tax Code. To explain these changes, the Joint Committee on Taxation published a 411 page booklet. *Id.* at 4.

6. *See* D. McCarthy, Citizen's Choice National Commission on Taxes and the IRS 6 (1981).
7. *Id.* at 7.
8. *Id.*
9. At that time, 88% of all taxpayers paid marginal rates of 20-22 percent, 10% paid rates ranging from 23%-31% and a very small number paid over 32%. By 1979, however, 45% of American taxpayers paid marginal tax rates greater than 23%, and 18% of this nation's taxpayers paid marginal tax rates exceeding 32%. R. Hall & A. Rabushka, The Flat Tax 23-24 (1984).

Distribution of Tax Returns By Marginal Tax Rate, Calendar Years 1961, 1969, and 1979*

		(percent)	
Marginal Tax Rate	1961	1969	1979
0-14	0.00	9.59	10.06
15-19	0.00	16.97	24.70
20-22	87.80	9.38	19.94
23-31	10.04	57.48	27.36
32-72	2.15	6.57	17.93
73-91	0.01	0.02	0.00
Total	100.00	100.00	100.00

*Includes only tax returns with positive tax liability

Source: Eugene Steuerle and Michael Hartzmark, Individual Income Taxation 1947-1979 Nat'l Tax J. (June 1981)

10. Hall & Rabushka, *supra* note 9, at 9.
11. *Id.* at 11.

tions, credits or exemptions for over 100 special economic activities.[12] Our tax policies discourage those business and investment decisions intended solely to produce maximum economic benefit and promote decisions primarily intended to provide tax shelter.[13] Sheltering income from taxation is an industry that consumes a growing share of the nation's talent and wealth. There are 50,000 to 60,000 tax lawyers in our country.[14] Experts estimate that taxpayers pay $25 billion to support the income-sheltering industry.[15] In addition, the economy suffers greatly when those tax advisors recommend investment and business decisions based on tax advantages, rather than on income production. The aggregate economic loss associated with income-sheltering and lost taxable income due to tax-motivated investment decisions amounts to approximately $100 billlion annually.[16]

Illegal tax evasion compounds the problem of the poor revenue performance which plagues our tax system.[17] As is true with tax avoidance by income sheltering, illegal tax evasion predominates among upper income earners.[18]

Compliance Costs

The cost of complying with the tax laws compounds the problems of economic inefficiency in the current tax system.[19] The aggregate costs attributable solely to the inefficiency of our current tax laws are exceedingly high, particularly in light of our relatively low tax base.[20]

Equity

The national mood of discontent with the tax system is based not only on an awareness of the system's inefficiencies, but also on the perception that the system is fundamentally unfair to many taxpayers. Historically, the concept of tax fairness or equity has meant equal treatment of equally situated citizens. This interpretation rests on the constitutional principle that it is illegal to discriminate among equal classes of taxpayers by imposing substantially differing tax liabilities.[21] Under current law, however, a wide variety of deductions, exemptions, and tax loopholes preclude the equitable distribution of tax liability among income earners. To illustrate some of the problems which any proposed tax revision must rectify, the following sections will examine the factors producing existing inequities.[22]

12. *Id.*
13. *Id.*
14. *Id* at 28.
15. *Id.* at 24.
16. R. HALL & A. RABUSHKA, *supra* note 1, at 13.
17. According to the IRS, the United States Treasury Department lost $29 billion in 1973, $87 billion in 1981, and will lose an estimated $120 billion in 1985 to illegal evasion. *Id.* at 10. Furthermore, these amounts do not include unreported income from drugs, prostitution, and gambling which have been estimated to aggregate another $10 billion in lost taxes. *Id.*
18. According to the IRS, only two percent of wage earners fail to report income. *Id.* Unreported income from interest and dividends, on the other hand, is 16%; from capital gains, 22%; from self-employment income, 40%, and from rents and royalties, 50%. *Id.*
19. Compliance costs, including both the costs of filing and the cost of purchasing tax advice, probably exceed $35 billion. *See* R. Hall & A. Rabushka, *supra* note 1.
20. According to Hall and Rabushka, lost economic output resulting from inefficient tax-motivated investment may exceed $100 billion. Tax evasion may cost another $120 billion in lost revenues.
21. U.S. CONST., amend. XIV.
22. *See* 131 CONG. REC. S885 (daily ed. Jan. 31, 1985) for the author's further discussion of these principles in the context of introducing S. 321.

In-Kind Income

One major source of taxpayer frustration regarding inequity derives from the knowledge that substantial income escapes taxation altogether. Much of this untaxed income may be characterized as "in-kind" and includes such items as noncash fringe benefits,[23] non-monetary transfer payments such as food stamps,[24] subsidized medical care,[25] and income received through barter exchange.[26] It is difficult to quantify or to capture these types of incomes. Consequently, the income which would otherwise be realized from the transfers of goods and services in these untaxed transactions is lost to the "underground economy."[27] The Treasury Department estimates that between $240 to $400 billion a year travels in this "underground economy" and escapes taxation.[28] Hall and Rabushka theorize that the underground economy has flourished partly because bracket creep has increased the marginal tax rate of many families from 25% or 30%, to 50%.[29]

The Marriage Penalty

The current tax system also is perceived as unfair for imposing a penalty on married taxpayers. Graduated rate income taxes which treat married couples as one unit are not marriage neutral. Marriage neutrality could be accomplished either by making the tax proportional rather than progressive, or by taxing individuals rather than couples.[30]

Since flat rate tax proposals tend to be proportional in imposing tax liability, most of these proposals closely approximate or even achieve marriage neutrality. The alternative remedy — taxing individuals rather than couples — theoretically would accomplish the same goal. This remedy, however, would increase the tax system's complexity. To be effective, this approach would require allocation of investment income and deductions between spouses. Moreover, if the tax imposed on individuals remained progressive, it might result in different tax liabilities for married couples with identical aggregate incomes, depending on the allocation of income between the spouses.

The two-earner deduction enacted in 1981 only partially addresses these marriage neutrality problems.[31] That provision reduces the marriage penalty, but does not eliminate the inequity in all cases. In addition, it increases the complexity of the Tax Code.

Separation of Corporate and Individual Income Taxes

The existing tax law distinguishes between corporate and individual income. This distinction results in inequitable tax liability among individual taxpayers. The rationale underlying the distinction is, however, economically suspect. All corporate income ultimately is accounted for either as consumption by individuals, for example, wages paid to employees or as an increase in the value of share-

23. I.R.C. § 123(a) (1982).
24. Rev. Pub. 711-425, 1971-72 C.B. 26.
25. Rev. Rul. 70-341, 1970-2 C.B. 112.
26. *See generally The Underground Economy's Hidden Force*, BUS. WEEK, April 5, 1982.
27. *Id.* at 64-70.
28. *See* INTERNAL REVENUE SERVICE, DEP'T OF TREASURY, ESTIMATES OF INCOME TAX UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS (1979).
29. R. HALL & A. RABUSHKA, *supra* note 1, at 7-9.
30. Marriage neutrality would be the equal taxation of incomes regardless of marital status. Presently, couples are taxed as a single unit. *See* I.R.C. § 22(a) (1982).
31. I.R.C. § 22(a) (1982). Prior to 1981, a couple with a combined income of $30,000 paid a tax penalty of $2,166. However, § 221(a) reduces the tax penalty to $606. *See* S.REP. NO. 144, 97th Cong., 1st Sess. 29-32 (1982).

holders' claims. Consequently, corporate tax payments allocate to the Government resources that otherwise would be distributed to shareholders or other individuals for present or future consumption. Similarly, after-tax corporate income is either distributed as dividends or retained by the corporation and reinvested. If the income is distributed to shareholders, the income is subject to double taxation — once at the corporate level[32] and again at the individual shareholder level.[33] If the corporation retains income as earnings, shareholders will pay tax on the appreciated value of the stock in the form of capital gains when the stock is sold.[34] In contrast, business income earned by partnerships and sole proprietorships is taxed only once, as income to the individual owner.[35]

The Code's treatment of business is frequently criticized because it taxes some corporate income at high rates and thus, artificially distorts business decisions.[36] Many economists argue that current tax laws discourage the distribution of corporate earnings as dividends.[37] Integrating the corporate and personal taxes would end the double taxation of dividends, thereby eliminating the incentive to accumulate income within corporations. Additionally, the integration of corporate and personal taxes would improve tax equity by relating the effective tax rate on corporate income to the circumstances of individual taxpayers.

Corporate Tax Burden Differentials

Under existing laws, different industries face significantly different tax burdens.[38] On the one hand, some capital income is taxed heavily because it is indexed to inflation or because it is taxed under both the corporate and individual income taxes. On the other hand, much capital income is taxed slightly, if it is taxed at all.[39] The average tax rate on real capital is low. In 1979, only about 30% of net real capital income was reported on individual tax returns.[40] Corporate and individual real capital income taxes together totaled about 28% of the nation's net real capital income.[41]

The distorting effects of current tax laws produce a wide disparity of tax burdens among different industries.[42] The effective tax rate ranges from a low of 14%

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32. I.R.C. § 311(a) (1982).
33. *Id.* § 301(c)(3)(A).
34. *Id.*
35. *Id.* § 61(a).
36. *See, e.g.*, Thuronyi, *The Taxation of Corporate Income: A Proposal for Reform*, 2 AM. J. TAX POL'Y 109, 110 (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 job creation and generally burdens corporate activities." *Id.*
37. *See, e.g.*, J. PECHMAN, COMPREHENSIVE INCOME TAXATION 81 (1977).
38. In 1982, for example the tax rates were 4.1% for railroads and 15.6% for the utilities while high-tech industries paid much higher rates such as 26.4% for producing computers and office equipment and 21.9% for instrument manufacturing. *See* Auerbach, *Corporate Taxation in the United States*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 468 (1983). *See also* note 42.
39. CONGRESSIONAL BUDGET OFFICE, REVISING THE TAX 24 (1983).
40. *Id.*
41. *Id.*
42. TAX RATES FOR U.S. CORPORATIONS BY INDUSTRY

U.S. INDUSTRY	U.S. TAX RATE ON U.S. INCOME
Aerospace	−0.6
Beverages	20.5
Broadcasting	8.9
Chemicals	−17.7
Computers and office equipment	26.4
Construction	15.9
Electronics, appliances	14.3

for oil extraction to a high of 31% for the trade industry.[43] These differentials occur because depreciation allowances in the tax laws — the Accelerated Cost Recovery System is the most obvious example — do not correspond to true economic depreciation rates.[44] The investment tax credit and a failure to index income to inflation also cause differential tax burdens.[45] One leading commentator has concluded that "implementation of a broad based income tax, including integration and inflation adjustments, would go far to free capital to seek its place in investment without distortion by tax preference."[46]

THE FLAT RATE TAX REFORM PROPOSAL

Congress currently is considering several different proposals for comprehensive tax reform and simplification.[47] All of the proposals under consideration share a common goal: broadening the tax base.[48] The proposals differ only in

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Financial institutions	−3.8
Food Processors	31.6
Instruments	21.9
Insurance	−6.3
Investment companies	21.3
Metal products	30.2
Paper and wood products	36.1
Petroleum refining	18.2
Pharmaceuticals	32.7
Retailing	20.4
Rubber	39.0
Soaps and cosmetics	33.3
Telecommunications	1.6
Tobacco	36.3
Transportation	
Railroads	4.1
Trucking	36.9
Utilities (electric and gas)	15.6
Wholesalers	36.1
Average, All Companies	16.1

Source: Joint Committee on Taxation

43. *Id.*
44. I.R.C. § 168 (1982).
45. *Id.* § 46.
46. Musgrave, *Tax Reform or Tax Deform*, 8 EASTERN ECON J. 143 (1981).
47. *See, e.g.*, the Bradley-Gephardt tax proposal. S. 1421, 98th Cong. 1st Sess., 129 CONG. REC. S7838-45 (daily ed. June 8, 1983) (introduced by Sen. William Bradley, (D-N.J.)); H.R. 3271, 98th Cong. 1st Sess. 125 CONG. REC. H3846 (daily ed. June 9, 1983) (introduced by Rep. Richard Gephardt, (D-Mo.)). *See also* the Kemp-Kasten tax proposal H.R. 777, 99th Cong. Sess., 131 CONG. REC. H215 (daily ed. Jan. 30, 1985).
48. The Bradley-Gephardt proposal, *supra* note 47, would shrink the current tax brackets from 15 levels to 4, and limit allowable deductions to a handful. The Bradley-Gephardt plan is referred to as a comprehensive individual income tax proposal. Bradley and Gephardt retain the following provisions of the Internal Revenue Code.
 -The 'zero bracket amount', which would be increased from $3400 to $4600 for joint returns.
 -The taxpayer exemption which would be increased from $1000 to $1500 for single returns, from $3,000 to $7,000 for joint returns, and from $1,000 to $1,750 for heads of households. Each additional exemption is $1,000.
 -Employee business expenses.
 -Home mortgage interest.
 -Charitable contributions.
 -State and local income taxes and real property taxes.
 -Exclusion for social security and veterans benefits.
 -Exemption of interest on general obligation bonds.
 For a further discussion of Bradley-Gephardt *see* Gephardt, The Fair Tax Act: A Plan for a Simple, Fair and Economically Rational Tax, 12 J. LEGIS 129 (1985). The Kemp-Kasten proposal, *supra* note 47, is sometimes considered a "progressive flat tax" because it combines a single flat tax rate with a progressive tax base. It retains deductions for mortgage interest, real property taxes, charitable contributions, and catastrophic medical expenses. At the same time, it reserves a consumption

their approaches to achieve this end. Those tax reform measures which would enlarge the tax base by eliminating many, if not all, of the deductions, exclusions, exemptions, and credits in the present tax system are the most likely to succeed. Broadening the tax base in this way would allow a new tax system to raise levels of revenue comparable to (or exceeding) existing revenue levels but with lower marginal tax rates for most, if not all, taxpayers.

Principles of the Deconcini Flat Tax Bill

On January 31, 1985, I introduced Senate Bill 321. The bill would amend the Internal Revenue Code of 1954 by implementing a flat rate tax system. My bill is designed to restructure the Federal tax laws governing both personal and corporate income tax.

A sound tax policy must satisfy three major interests. First, the tax system must produce adequate revenue to fund government expenditures at an acceptable level. Second, the system must minimize, to the greatest possible extent, the tax burden on those least able to bear it. Third, the tax system must promote economic efficiency in investment by eliminating those provisions which tend to encourage tax-motivated, economically irrational investment decisions.

The proposed legislation is based on the scholarly analysis of Stanford economists Robert Hall and Alvin Rabushka. This legislation is designed to restore proper economic incentives and to eliminate the disincentives and distortions in the current Internal Revenue Code. The bill is based on four principles:[49]

1. All income should be taxed only once and as close as possible to the source;
2. All income should be taxed at the same low marginal rate, 19%;
3. The poorest households should pay no tax;
4. All tax returns should be simple enough to fit onto a single page.

Single Taxation

Under S. 321, the current separate personal and corporate income taxes would be replaced by a business tax and an individual compensation tax. The business tax levies against business owners all taxes which may be owed on business income, without regard to allocation of that income. Enactment of this provision will eliminate one of the major sources of inefficiency in the current tax system: the avoidance or evasion of income tax on interest and dividends.[50] Under this flat tax scheme, all businesses are treated alike, whether corporate or noncorporate. All face a 19% tax on business income, defined as business receipts minus the cost of "business inputs."[51]

based tax by retaining current tax treatment for IRA's and Keoghs, general obligation and municipal bonds, private pension plans and social security, and home ownership.

Provisions for workers, the poor, families with children and senior citizens include: 1) doubling the personal exemption to $2,000; 2) doubling exemption for the elderly and the blind; 3) increased zero bracket amounts; 4) a new exclusion for 20% of employment income to about $40,000. There is a 25% tax rate on taxable income. Tax indexing is retained. *See* Kemp, *Federal Tax Law: The Need for Radical Reform* 12 J. LEGIS 1 (1985).

49. *See* R. HALL & A. RABUSHKA, *supra* note 1, at 32.

50. In 1981, unreported income from dividends was 16%. Unreported income from interest ran to 16% which explains why the I.R.S. sought, unsuccessfully, to require banks to withhold a portion of the interest payments and those found to the treasury. *See* R. HALL & A. RABUSHKA *supra* note 9, at 29.

51. *See* S. 321, § 103, 99th Cong. 1st Sess. 131 CONG. REC. S883 (daily ed. Jan. 1985). Business inputs include the cost of purchase of goods, services, and materials for the business. *Id.* at § 103(a). In computing this amount, the cost of goods or materials purchased would be the actual amount paid, whether or not the goods are resold during the year purchased. *Id.* at § 103(b)(1). The cost of inputs

The proposed business tax is essentially a comprehensive withholding tax on all forms of income except wages, salaries, and pensions. As structured, however, the business tax affects income only once. It abolishes the practice of double taxation of dividends.[52] Moreover, by eliminating business deductions for interest payments and dividends[53] the business tax captures taxes that currently escape taxation.[54] The business tax simply captures the tax on interest income and dividend income before those payments are dispersed to individuals. A business may file any number of tax returns for its subsidaries provided all business receipts are reported in the aggregate and that all business inputs are reported on only one return.[55] When a business has a negative taxable income, this amount may be carried forward to offset taxes in future years.[56]

Under S. 321, individuals would be taxed on an individual basis at a flat rate of 19% on all compensation for labor and services,[57] less their personal allowance and dependent exemption.[58] If the compensation does not exceed the personal allowance, the individual pays no tax. Personal allowances would be indexed to the Consumer Price Index (CPI) and would rise by the proportional increase in the CPI from the beginning to the end of the immediately preceding year.[59] This indexing would prevent inflation from depreciating the benefit of the personal allowance over a period of years.[60]

Interest, dividends, and capital gains would not be taxed at the individual level because businesses would already be taxed for these amounts. Similarly, employer-provided fringe benefits such as health and life insurance, meal plans, and other forms of in-kind income would not be taxed to individuals, but would be taxed to businesses as nondeductible expenses.[61] Under the current version of the bill, however, no personal deductions would exist for mortgage interest,[62] other consumer interest,[63] property taxes,[64] income taxes,[65] other local taxes,[66] charitable contributions,[67] or medical expenses.[68]

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brought into the United States would be the market value of the input. Reasonable business travel expenses would also be included as a business input. *Id.* at §103(b)(3).

52. Corporate profits may currently be taxed at 46%, I.R.C. § 11(b)(5)(1982); at rates up to 50% if distributed as dividends, *id.* § 301(c)(1); or at 20% if capital gains, *id.* § 302.
53. S. 321, *supra* note 51, at § 103(b).
54. *See supra* note 50 and accompanying text.
55. *Id.* at § 203(c). "A business may file any number of business tax returns for its various subsidiaries or other units provided that all business receipts are reported in the aggregate, and provided that each expense for business inputs is reported on no more than one return." *Id.*
56. S. 321, *supra* note 51, at § 203(d). When business taxable income is negative, the negative amount may be used to offset positive taxes in future years. The amount carried forward from one year to the next is augmented according to an interest rate equal to the average daily yield on three month treasury bills during the first year. There is no limit to the amount on the deduction of the carry forward.
57. S. 321, *supra* note 51, at § 202.
58. S. 321 provides large personal allowances:

Married Taxpayers Filing Jointly	$9000
Head of Household	$8000
Single Taxpayers	$4500
Each Dependent	$1800

Id.

59. *Id.*
60. S. 321, *supra* note 51, at § 201(b). Each year personal allowances rise by the proportional increase from the beginning to the end of the immediately preceding year of the Consumer Price Index.
61. S. 321, § 202.
62. I.R.C. § 163 (1982).
63. *Id.* § 163(b).
64. *Id.* § 164(a)(1).
65. *Id.* § 164(a)(3).
66. *Id.* § 164(a).
67. *Id.* § 170(b)(1).
68. *Id.* § 213(a).

Single Rate

Taxing all income at the same percentage rate solves many of the problems that currently plague existing tax laws. Under the current system, individuals rarely fail to consider tax consequences when they choose the form in which they receive income. Consequently, taxpayers devote an enormous amount of creative time and money to minimizing tax burdens. The costs of tax avoidance go far beyond the fees paid to attorneys, tax-shelter syndicators, and accountants.[69] A tax-avoiding investor often selects otherwise undesirable investments with high risk or low return.[70] Few rational individuals would contemplate such investments absent the current tax system. Significantly, the worst consequence of allowing so much income to escape taxation is the very high tax rates applied to the reduced tax base to generate revenues. The result of these Code-induced distortions is clear: too few pay too much.[71] The flat rate tax under Senate Bill 321 is intended to eliminate these inequities and inefficiencies by imposing equal tax rates on all income.

Limiting Burdens on the Poor

Limiting the tax burden on the poor is the third principle of Senate Bill 321. Other tax proposals such as a Federal sales tax or a value-added tax on businesses make all citizens, both rich and poor, pay equivalent amounts of tax on their income used for consumption.[72] Any proposed tax plan should follow the example of the current Federal tax system by attempting to avoid taxing the truly poor.[73] Minimizing the tax liability of the poor, however, does not mandate graduated tax tables with high marginal rates for middle and upper income families. The irrationally high marginal tax rates imposed by the current graduated tax rate system have provided the impetus for revenue leakage in the form of tax shelters and tax avoidance schemes.[74] A flat rate tax applied to all income above a set personal allowance provides progressivity without creating unreasonable differences in tax rates.

Those not familiar with the operation of flat rate tax strategies have criticized flat rate tax proposals as not being progressive. Such criticism, however, is unwarranted. A tax system is progressive when it garners an increasing proportion of a

69. *See* INTERNAL REVENUE SERVICE, *supra* note 28; Gutman, *The Subterranean Economy*, FIN. ANALYSIS J. 26 (Nov.-Dec. 1977). The size of the underground economy has been estimated to be $250 billion per year.

70. *See, e.g.*, Thuronyi, *supra* note 36, at 109-10 (1983) Thuronyi claims:

> [O]ur system for taxing corporate income distorts the economy and plays mischief with corporate financial decision. The corporate income tax encourages corporate takeovers, distorts investment, discourages job creation and generally burdens corporate activities . . . [t]he tax system favors debt financing relative to new equity issues. Because interest payments are fully deductable by the corporate borrower, the interest, unlike the return on equity capital, is taxed only once, in the hands of the investor.

71. Average and marginal tax rates for selected income groups from 1954 to 1983 based on unpublished Treasury Department data, are presented in the *Statistical Abstracts of the United States* 329 (1984). According to Joseph A. Pechman, the present system is grossly unfair to wage earners as compared to those who receive their income from business activity. J. Pechman, FEDERAL TAX POLICY 290-92 (4th ed. 1983). Indeed, the failure of business operators to pay their lawful obligation is one reason why tax rates remain so high and wage earners are so heavily burdened.

72. *See* R. HALL & A. RABUSHKA, *supra* note 9, at 41, 120 (1985). *See also* Kemp, *supra* note 48, at 3; J. PECHMAN, *supra* note 71, at 5.

73. The levels of income at which taxation begins are, for example, for single persons: $3,300 ($1,000 personal exemption plus $2300 zero bracket amount); for married persons filing joint returns: $5400 ($2000 personal exemption plus $3400 zero bracket amount); with two children: $7400 ($4,000 personal exemption plus $3400 zero bracket amount) I.R.C. § 6012(a)(1) (1982).

74. *See supra* notes 11-18 and accompanying text.

taxpayer's income as that person's income rises.[75] Critics who allege that a flat rate tax destroys progressivity falsely assume that only a set of graduated marginal tax rates ensures that the rich pay more income in taxes. Progressivity can be achieved without resort to graduated tax rates. A flat rate tax plan that combines a reasonably calculated personal allowance exclusion for taxpayers and their dependents with a flat tax on the remaining income generates an overall progressive income tax system.[76]

Simplification

Simplicity is the last of the four basic principles underlying the S. 321 tax plan. The proposed tax revision is intended to alleviate substantially the hopeless complexity of existing tax laws.[77] Simplified tax forms and tax laws also preserve the system's integrity. Complicated forms invite opportunities to escape paying taxes and diminish confidence in government. Senate Bill 321 would eliminate much of

75. For example, consider three families with incomes of $10,000, $20,000, and $30,000. Suppose these families paid taxes of $500, $2,000 and $4,500 respectively. The first family would have paid 5% of its income in taxes, the second family 10%, and the third family 15%. These payments illustrate the concept of progressivity: those with larger incomes pay a higher share of that income in taxes than do those with smaller incomes.

76. The three hypothetical families mentioned in note 74 illustrate the progressivity of a flat tax. Assuming each family has one employed spouse and two children, the tax liability of each family is as follows:

Family	Income	Tax	Net % paid
1	$10,000	0	0%
2	$20,000	$1,406	7.03%
3	$30,000	$3,306	11.02%

The first family pays no taxes because the family's personal allowance of $12,600 ($9,000 for married taxpayers filing jointly and $3,600 for the two dependent children) exceeds the family's income. The second family must pay $1,406 in taxes (19% times the excess of the family's income over the family's personal allowance of $12,600), and the third family must pay $3,306 in taxes (19% times the excess of the family's income over the family's personal allowance of $12,600). Extrapolating this calculation demonstrates that families with higher incomes do pay a larger proportion of their income in taxes.

77. For example, the Treasury Department estimates that the public spent 613 million hours in 1977 filling out Federal tax forms, or about three hours for every man, woman, and child in the country. At an estimated average cost of $27 for each professionaly prepared tax return, the aggregate dollar value of professional tax preparation may approximate $2.3 billion a year.

the existing complexity by allowing taxpayers to file their returns on a simple, postcard-sized form.[78]

Investment Incentives

The proposed flat tax system eliminates the tax burden disparities[79] facing different industries under the current tax laws, which resulted from complex rules and schedules for depreciating capital investments. The flat tax proposal provides

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78.

HALL-RABUSHKA SIMPLIFIED FLAT-RATE TAX FORM

Form 1	**Individual Compensation Tax**	**1982**
[illegible]	Last name	Your social security number
[illegible]		Spouse's social security no.
[illegible]	Your occupation ► / Spouse's occupation ►	

1	Compensation as reported by employer	1	
2	Other wage income, including pensions	2	
3	Total compensation *(line 1 plus line 2)*	3	
4	Personal allowance		
	(a) ☐ $6200 for married filing jointly	4(a)	
	(b) ☐ $3800 for single	4(b)	
	(c) ☐ $5600 for single head of household	4(c)	
5	Number of dependents, not including spouse	5	
6	Personal allowances for dependents *(line 5 multiplied by $750)*	6	
7	Total personal allowances *(line 4 plus line 6)*	7	
8	Taxable compensation *(line 3 less line 7)*	8	
9	Tax *(19% of line 8)*	9	
10	Tax withheld by employer	10	
11	Tax due *(line 9 less line 10, if positive)*	11	
12	Refund due *(line 10 less line 9, if positive)*	12	

On the other side of the postcard, a business entity would file a form similar to the one reprinted below.

Form 2	**Business Tax**	**1982**
Business Name		Employer Identification Number
Street Address		County
City, State, and ZIP Code		Principal Product

1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2(a)	
	(b) Wages, salaries, and pensions	2(b)	
	(c) Purchases of capital equipment, structures, and land	2(c)	
3	Total allowable costs *(sum of lines 2(a), 2(b), 2(c)*	3	
4	Taxable income *(line 1 less line 3)*	4	
5	Tax *(19% of line 4)*	5	
6	Carry-forward from 1981	6	
7	Interest on carry-forward *(14% of line 6)*	7	
8	Carry-forward into 1982 *(line 6 plus line 7)*	8	
9	Tax due *(line 5 less line 8, if positive)*	9	
10	Carry-forward to 1983 *(line 8 less line 5, if positive)*	10	

79. *See* Kemp, *supra* note 48, at 7. *See also* R. HALL & A. RABUSHKA, *supra* note 9, at 72; Auerbach, *Corporate Taxation in the United States*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 451, 466 (1983).

investment incentives by adopting the principle of expensing investment. This principle allows a 100% deduction for capital investment as a "business input."[80] With this simple device S. 321 eliminates the complicated depreciation schedules of existing law.[81]

This proposal is both simple and economically efficient. Investment is channeled to those areas of greatest economic return, rather than to areas of greatest tax advantage. Capital formation is stimulated by taxing consumption. Expensing investment is simply a consumption tax: a tax on what individuals take out of the economy rather than a tax on what individuals invest into it. Analysts estimate that income expensing should increase growth in capital stock by 3.2%.[82]

Expensing investment would also abolish a sizeable proportion of the double taxation on savings. Presently, individuals pay tax on their personal income and again pay tax on interest received when saved income earns a return. A tax system allowing investment expensing would eliminate the tax on interest, and hence the double taxation of saved income. Elimination of the interest deduction by the borrower of the saved income ensures that the return to savings is taxed. This proposal would raise the ratio of capital stock to GNP from 3.0 to 4.4 and could result in a 4% increase in the GNP within seven years.[83]

Fairness: Taxes on Wages and Salaries

Adopting a fair tax reform measure is of paramount importance. To be fair a tax system must adhere to the principles of horizontal as well as vertical equity in allocating the tax burden. A flat or uniform tax satisfies both these requirements, as it imposes a tax burden on each taxpayer in direct proportion to his income. As incomes double, triple, or increase tenfold, tax obligations increase at equivalent rates. Moreover, elimination of hundreds of legal tax loopholes ensures that those higher income earners will pay a higher percentage of income in tax than do lower income taxpayers. In addition, the high personal allowance embodied in my tax bill insulates the poor from taxation entirely.[84] Finally, my tax reform bill dramatically limits the taxation of wages and salaries.[85]

Present laws fail to adequately tax business income. Tax revenue from corporate income was only $44 billion in 1983.[86] Additionally, tax revenue from all non-wage income for 1983 was only $30 billion.[87] Thus, total revenue from business-derived income equaled only $74 billion in 1983.[88] On the other hand, the

80. S. 321, *supra* note 51, at § 104.
81. *See* Auerbach, *supra* note 38, at 467 (1983).
82. R. HALL & A. RABUSHKA, *supra* note 9, at 73. *See also* Auerbach, *The Efficiency Gains from Dynamic Tax Reform*, 24 INT'L ECON. REV. 1, 81-100 (1983).
83. R. HALL & A. RABUSHKA, *supra* note 9, at 92.
84. *Id.* at 32-33.
85.

Earnings	Current Tax	Flat Tax
$ 5,000	0	0
10,000	$258	0
15,000	882	$456
25,000	2,374	2,356
35,000	4,355	4,256
50,000	8,189	7,109
80,000	17,574	12,806

This table compares the taxes that a family of four would pay under existing law with the taxes that same family would pay under my tax bill. The table shows that taxpayers at every income level will pay less under the flat tax than they would pay under existing law.

86. R. HALL & A. RABUSHKA *supra* note 9, at 73, 120.
87. *Id.*
88. *Id.*

tax revenue from wages under the personal income tax was $260 billion.[89] These revenue levels vividly illustrate that wage earners shoulder a disproportionately heavy tax liability in comparison to business owners: 15% for wage earners versus 11% for business owners.[90] Assuming a tax of 19% on earnings in excess of the personal allowance under Senate Bill 321, the average net tax rate on wages would approximate 12%.[91] The corresponding tax rate on business income would be exactly 19%, resulting in the capture of an additional $55 billion in business tax revenue.[92]

Interest Rates and Housing

By abolishing both the taxation on interest received and the deduction on interest paid, a flat tax should lower interest rates. The current high interest rates are partially supported by the taxation of earned interest and the deduction for interest payments.[93] In order to offer savers rates high enough to offset the cost of taxes paid on interest received on savings, lenders must charge higher interest rates to borrowers. Similarly, borrowers are willing to accept higher interest rates because they can deduct the cost of borrowing — that is, the interest paid on the loan. Once these tax deductions and payment requirements are abolished and market forces prevail, borrowers and lenders should agree on a lower interest rate, a rate that is not artificially elevated by tax laws. The S. 321 tax reform proposal could result in a 20% reduction in the interest rate.[94] An interest rate reduction of this magnitude would stimulate the housing industry enough to offset any adverse effect which the elimination of the mortgage interest deduction may have.[95]

CONCLUSION

Any undertaking as extensive as tax reform is exceedingly complex, with widespread consequences for all Americans. An undertaking of this magnitude must carefully be analyzed at every step in the legislative process. I firmly believe that Senate Bill 321, however, represents the best tax reform measure currently before Congress. It is clearly the simplest of the pending bills, it offers the lowest marginal tax rate of the major tax proposals, and with the increase in the personal exemptions it can also make the claim of being the fairest. A good tax system must be efficient, equitable, and simple. The 19% flat rate tax satisfies each of these criteria better than any other proposal currently under consideration.

89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. I.R.C. § 163(a) (1982) allows a deduction on all interest paid or accrued within the taxable year of indebtness. I.R.C. § 61(a)(4) defines gross income to include interest. Section 128 excludes interest to a maximum level; for 1985, 15% of net interest is excluded up to $3,000 ($6,000 on a joint return).
94. *See* R. HALL & A. RABUSHKA, *supra* note 9, at 83.
95. *See id.* at 82.