A POLICY RESPONSE TO CONGRESSMAN JACK KEMP

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INTRODUCTION

This commentary sets out to critique the Kemp-Kasten bill[1] described by Congressman Jack Kemp in his recent *Journal of Legislation* article.[2] It will examine some of the problems with the current Federal income tax system, demonstrate that Kemp-Kasten retains many of the flaws of the present system, and address selected inequities contained in the Kemp-Kasten tax proposal.

Our present income tax system was enacted under authority granted to Congress by the 16th Amendment to the United States Constitution. That amendment permits taxation of "incomes, from whatever source derived."[3] While a coherent income tax system should have among its fundamental theoretical goals the measurement of income, and its taxation once and only once,[4] the present income system does not accomplish either of these two goals.

Instead, our income tax system consists of two conceptually distinct and conflicting systems whose net affect is to selectively tax certain types of income while preferentially exempting or moderating taxation on other forms of income.[5] The

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1. H.R. 777, 99th Cong., 1st Sess., 131 CONG. REC. H215 (daily ed. Jan. 30, 1985).
2. Kemp, *Federal Tax Law: The Need for Radical Reform*, 12 J. LEGIS. 1 (1985).
3. U.S. CONST. amend. XVI provides: "The Congress shall have the 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."

   Many definitions of the word "income" have been proposed. For purposes of this article "income" is defined as the sum of the increases in net worth which result from profit-seeking events (which implies subtraction of the costs of those transactions) plus the sum of the increases in net worth which result from events which are not necessarily profit-seeking in nature but which nevertheless produce an increase in net worth (which does not imply subtraction of the costs of these personal events except to the extent necessary to measure increases in net worth which actually result from events which are not profit-seeking in nature). For instance, a person who makes his living writing movie reviews could deduct the cost of going to the movies, while a recreational movie viewer could not. In contrast, a person who writes movie reviews as a hobby and who occasionally sells a review, but who has no realistic expectation of making a net profit over time, could deduct costs incurred in writing reviews but only to the extent of the amount of revenues generated by the reviews. *See* Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, at 228 (1979).
4. At the present time we do not tax either mere appreciation in value or imputed income. *Id.* Although these are economic income, they do not enter into "gross income" calculations under I.R.C. § 61(a) and therefore are not "taxable income" under I.R.C. § 63. This income is ignored by both the present system and by Kemp-Kasten. Despite the theoretical and practical significance of failure to consider this income for tax purposes, and despite the theoretical applicability of tax expenditure analysis to this income, the difficulties raised by the existence of these two forms of income will be ignored in the present analysis — just as they are ignored by the tax expenditure budget. *Id.* The normative starting point of both the present system and Kemp-Kasten for the time at which the income tax system should first take cognizance of income is when the income is realized.
5. *See* Surrey, *Tax Incentives as a Device for Implementating Government Policy: A Comparison with*

true income tax portion of the system has as its goals the accurate measurement of income and its taxation once and only once.[6] A secondary and conceptually distinct framework within the Tax Code establishes a system of subsidies, intended to implement a variety of social or economic policies.[7] This program of subsidies prevents the income taxation component of the present system from achieving its objectives.

The unsystematic interplay of the taxation and tax subsidy components creates three problems for the Federal tax system. First, selectively subsidizing some taxpayers by not collecting taxes otherwise due results in the imposition of a disproportionate tax burden on other taxpayers at the same income levels.[8] Second, this policy makes the system unnecessarily complex.[9] Third, the combination of these two components within a single system masks the tax subsidy element which annually aggregates at a level far exceeding the annual deficit.[10]

Direct Government Expenditures, 83 HARV. L. REV. 705-6 (1970) ("[t]he term 'tax expenditure' has been used to describe those special provisions of the federal income tax system which represent government expenditures made through that system to achieve various social and economic objectives").

6. S. SURREY, W. WARREN, P. MCDANIEL AND H. AULT, 1 FEDERAL INCOME TAXATION 239-241 (1972).
7. *Id.*; 1968 Sec'y Treas. Ann. Rep. on the State of the Finances 326-30.
8. It is this comparison which is the best conceptual genesis of the idea of the tax expenditure analysis.
9. *See* Surrey, *supra* note 5, at 731 ("the tax system is complex enough as it is, and to have a large number of tax incentives side by side with the provisions making up the structure of the tax itself can only cause confusion and a blurring of concepts and objectives").
10. Time and again subsidies have been passed by Congress which would not even be proposed if they had to be cast in the economically equivalent but more easily understood form of a direct outlay. *See* Surrey, *supra* note 5, at 272 ("it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured [as direct expenditures]. . ."). *See also* note 15, *infra*.

Some argue that the difference between the mechanics of giving a tax subsidy and one accomplished as a direct outlay is inherently significant. When one does not pay taxes which would otherwise be due, so the argument goes, one gets to keep one's own money; whereas when one receives a direct outlay, one is receiving someone else's money. For a person of this view, it might follow logically that a moral significance might be attached to the difference. Someone advancing this argument is unlikely to admit that a tax expenditure is a subsidy. A person advancing the argument would almost certainly object to my suggestion that what is involved is but a "difference in the mechanics." Nevertheless, by my phraseology, I certainly do mean that nothing more significant has happened than that the file has been papered differently, and that there is no substantive difference between the two forms of subsidy. I mean, in other words, that the only difference in the what of the event is in the mechanics.

The objection reflects several misunderstandings. It misses that the claim that the two mechanisms are equivalent is a fact, not a viewpoint. Stating that it is a fact is not itself an argument for or against either mechanism, nor is it an argument for choosing one mechanism over the other. It merely provides insight into what is happening for purposes of further analysis. The objection misses appreciation of the legal rights involved in the two mechanisms — that the person benefitting from the tax subsidy has as much right whatever the nature of the right, but neither more nor less right, to the benefit as the person receiving the direct outlay. Insofar as current law might be considered a normative standard for determining one's entitlement to a benefit, law can (and has) created entitlement of both varieties.

Underlying the objection may be implicit a view that individualistic man reaps from nature according to his just reward based on his idiosyncratic productivity. This eccentric view fails to understand the systemic basis of income and therefore of wealth in the United States today. If man at a very tender age crawls naked and alone into the forest and years later sallies forth from his now native environment with wagons, which he has built himself with his own inventiveness with axes and hammers which he has also built himself with his own inventiveness, drawn by beasts of burden which he has captured, tamed and trained himself, bearing the additional accumulations of wealth which he has stoutly and alone wrought from the world and amalgamated into his personal holdings, then the model would have some appeal. Claims based in moral philosophy, against him and his wealth from the needy people he meets (the need might relate to the costs of common defense, not just bread for the belly) might be available nonetheless, but are not necessary to deal with the objection. The man described does not exist. Income and therefore wealth in the United States today are systemically based, resulting from the interplay of innumerable aspects of the system pursuant to the rules on the basis of which income is made and therefore wealth is accumulated.

Personal responsibility for one's income and wealth as the norm is further bellied by the fact that

The Kemp-Kasten proposal eliminates many indirect subsidies[11] but retains a large majority.[12] Thus, while some specifics would change, the system would retain its dual taxation/subsidy structure. Moreover, while it would simplify the present tax system, Kemp-Kasten remains unnecessarily complex. Finally, while Kemp-Kasten may reduce the subterfuge in the present system, a large subsidy apparatus will continue to be obscured from the public, thus perpetuating many of the inequalities Congressman Kemp's bill purports to rectify.[13]

INCOHERENCE OF PRESENT LAW

"Tax expenditure" analysis is a powerful analytical framework for understanding the significance of a "tax incentive".[14] Congress often creates a tax incentive by abrogating tax liability on certain income. The failure to tax certain income, either by excluding the income or by allowing special deductions or credits against tax liability, promotes additional spending by taxpayers. This result is commonly referred to as a tax incentive. The resulting reduction in taxes is as

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much of the wealth in the United States today was inherited. If one thinks a person owns his property in an absolute sense, as if he is the source of his own underlying patent in land, for instance, one would have to object in principle to use of a power of eminent domain. I do not object to the use of the power of eminent domain, or to use of the taxing power.

At ground, the objection fails to accept the *if* clause as a given in the hypothetical: *if* one accepts the rate structure which does exist in the law as normative, then those on whom its burden falls with a lighter than anticipated touch are being subsidized — *when compared to* those who *are* paying tax pursuant to the rate structure. Despite all this, an attitude that there is such a difference could help explain the present state of affairs. *See* note 15 *infra* and accompanying text. As discussed in note 15 *infra*, there are differences in view regarding how best to measure the subsidies. Regardless, the comparison is accurate no matter which measurement methodology is followed. However, repeal of tax expenditures on my broad scale would not necessarily mean that the government would recoup an equivalent amount of money in receipts. *See Special Analysis G*, BUDGET OF THE UNITED STATES GOVERNMENT, FY 1985, at G15-G17.

11. *See* H.R. 777, *supra* note 1, §§ 201, 211, 228 (1985). The Kemp-Kasten proposal would eliminate only one-third of the subsidies of the present system. Kemp-Kasten would eliminate, for example, I.R.C. § 22 (relating to credit for the elderly and the permanently and totally disabled), § 23 (relating to contributions to candidates for public office), § 29 (relating to credit for producing fuel from a nonconventional source), § 30 (relating to credit for increasing research activities), § 116 (relating to partial exclusion of dividends received by individuals), § 124 (relating to qualified transportation furnished by employer), § 305(e) (relating to dividend reinvestment in public utilities), § 196 (relating to deduction for unused business credits), § 221 (relating to deduction for two-earner married couples).

12. The Kemp-Kasten proposal retains two-thirds of the subsidies of the present tax system, sometimes in modified form. For example, the following indirect subsidies would be retained: I.R.C. § 163 (relating to home mortgage interest), § 164 (relating to real property taxes), § 168 (relating to accelerated cost recovery), § 170 (relating to charitable contributions), § 213(a)(1) (relating to catastrophic medical expenses), § 408 (relating to treatment of IRAs).

An analysis of the dollar quantity of subsidies which would be retained by Kemp-Kasten should be a prerequisite to adoption of the proposal. The best basis on which to make the appropriate comparison is not completely obvious. A projected tax expenditure budget under Kemp-Kasten, using the proposal's nonsubsidy provisions as the baseline for comparison, is certainly called for. It would also be instructive, however, to see a projected tax expenditure budget reflecting the subsidies which would exist after adoption while using the normative provisions of present law as the baseline for comparison. To the extent all people received the same dollar subsidy from the latter tax expenditure budget, the "subsidies" could be ignored for the same reason it would be in any tax expediture budget. It is not really a subsidy. For example, the increase in the personal exemption deduction would be a candidate for such treatment. But a lowering of the rate brackets for only some people, or a lowering of the rate brackets more for higher income people than for lower income people, would produce a subsidy amount when viewed in relation to what the normative provisions of present law suggest are the appropriate tax liabilities. This is not the standard use of tax expenditure analysis. However, it would yield information important to appraising the Kemp-Kasten proposal, namely its results (at least when viewed in a static model comparison).

13. According to Surrey, "[m]ost tax incentives have decidely adverse effects on equity as between taxpayers on the same income level, and also, with respect to the individual income tax, between taxpayers on different income levels." Surrey, *supra* note 5, at 722.

14. *See* Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expeditures With Direct Governmental Assistance*, 84 HARV. L. REV. 352, 360-61 (1970).

much a subsidy as is a direct outlay of Federal money.[15]

Many tax deductions inhere in the idea of income because they are costs of securing income.[16] Elimination of these deductions would preclude accurate measurement of income.[17] Other deductions, however, are not costs of earning income. Their deduction is not required by the idea of income for they are not necessary to its measurement.[18] Their elimination is required in order to accu-

15. If a taxpayer in the 50% tax rate bracket receives a $10,000 deduction for interest payments made during a single year on his home mortgage, the taxpayer saves $5,000 in Federal income taxes. The $10,000 deduction makes his taxable income $10,000 less, and in the 50% rate bracket he pays 50% of $10,000, or $5,000 less in taxes. A person with the same level and types of economic income but without a mortgage does not receive the deduction and does not have his tax burden lowered by $5,000. The result, economically, is the same as if these two people paid the same amount of taxes, but only one received a subsidy check from the Federal Government for $5,000 as part of national housing policy. As Surrey notes "[t]he interplay is such that for any given program involving federal monetary assistance, the program may be structured to use the tax system to provide that assistance — where it will usually be called a tax incentive — or structured to use a direct government expenditure." *Id.* at 354.

The proper way to measure tax expenditures, it was formerly agreed, was to estimate the taxes not paid because of a special provision of tax law in all transactions qualifying for special treatment. In 1983, however, the Office of Management and Budget decided to express tax expenditures in terms of their "outlay equivalents" estimated in a way which produces results that are different from results expressed in terms of "revenue loss." Evolutions during this time period in the baseline for comparison used by the Office of Management and Budget for generating tax expenditure estimates are significant but not of central relevance here. The difference between the outlay equivalent estimates and the revenue loss estimates is that the former have been grossed-up to the pre-tax amounts an outlay would cost the Government on the assumption that the outlay would be taxable. The Government would, therefore, receive part of the outlay back in taxes. The revenue loss estimates are thought to be the amount of benefit to the taxpayer remaining if the outlay equivalent estimates were taxable. The revenue loss estimates reach directly the benefit to the taxpayer because taxes not paid are in fact not treated an income for tax purposes today. While there are good reasons for estimating outlay equivalents on the assumption of their taxability, I find it more meaningful for present purposes to think in terms of nontaxable outlay equivalents precisely because the revenue losses of the present tax subsidy system are in fact nontaxable. In other words, I find it more meaningful to think in terms of the revenue loss estimates. When I refer, in this article, to the direct outlay equivalent of a tax subsidy, I mean a direct outlay which is exempt from taxation. I am thereby putting tax subsidies and direct outlays on the same footing: if one is nontaxable then the other should be expressed in nontaxable terms as well.

The fiscal year 1985 Special Analysis G contains tables for both taxable outlay equivalents and nontaxable revenue losses. All tax expenditure figures used in this article are taken from the revenue loss table and are estimates for fiscal year 1985. *See generally Special Analyses G,* BUDGET OF THE UNITED STATES GOVERNMENT, FY 1985.

16. Those deductions fitting the "norm" in this context are those necessary to properly measure income. The Federal Tax Code does not define "income" though a common definition of the term specifies: "The gain derived from capital . . . [or] true increase in amount of wealth which comes to a person during a stated period of time." BLACK'S LAW DICTIONARY (5th ed. 1979) Section 212 of the Code permits the deduction from taxable income "all the ordinary and necessary expenses paid or incurred during the taxable year - (1) for the production or collection of income." I.R.C. § 212(1) (1982).

17. If you purchase candles for $40 and sell them for $100, your income is $60. It is not $100.

18. For example, deducting $20 (one half of the cost of the candles in note 17) before selling the candles, would artificially lower measured income from economic reality by $20. This allows the taxpayer to deduct a cost not yet incurred. The taxpayer will receive a subsidy for that year of $20 times the applicable rate bracket. This is precisely what happens in accelerated depreciation. *See* 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 15. The Senate Finance Committee described 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 law useful lives. The methods of cost recovery and recovery periods are the same for both new and used property.
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> 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 are in the 10-year class. Cer-

rately measure income.

Implicit in the characterization of the tax benefits from certain deductions as subsidies is the premise that the higher taxes which would have been paid but for the specially allowed deduction are an appropriate normative basis for comparison. That two people with the same economic income are not taxed the same means that one receives a subsidy when compared to the other.[19] If all taxpayers receive the same tax subsidies, the subsidy is no longer special but general. Under these circumstances, they become, in effect, adjustments in the rate table. The failure to collect particular taxes would benefit all taxpayers and would no longer constitute a subsidy.[20]

This tax expenditure analysis is applicable to all specially allowed exclusions,

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tain other long-lived public utility property ahs 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 undr 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 eligivle property and special rules relating to cost recovery for foreign assets, normalization requirements for public utility jproperty, 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.

19. The opposite comparison is also fair. In the text the person paying the *higher* amount in taxes is used as the basis for comparison. If, however, the person paying the *lower* amount is used as the basis for comparison, then it could be said that his more heavily taxed counterpart is being unfairly overburdened by an inappropriate level of taxes. This conclusion follows with equal validity from *its* starting point.

Which way one puts it is probably a test of attitude, not of logic. They have equal logical merit. Common to both analyses is that one person ends up with more money than the other by reason of different treatment by the Government. What they also have in common is that the basic notion of fairness for a tax system, that similarly economically situated people should be treated similarly, is violated, and that, accepting either level of tax as normative, income is not measured the same way and subjected to the same tax rate schedule once and only once. Either one taxpayer is undertaxed or the other is overtaxed. Both analyses therefore admit the principal point: the system does not achieve its theoretical objectives of measuring income and taxing it once and only once. The difference in perspective in how one reaches that conclusion is quite beside the point. Moreover, both analyses allow the conclusion that *if* the people were treated the same, and *if* the Government collected the same total taxes from the two people after equalization in treatment as it did before, then the present nominal rate structure could be lowered. As to the two taxpayers compared in note 15, *supra*, at present the Government collects a total of $5,000 (on the portion of income under discussion) from the two people — all of it from one and none from the other. The Government could instead collect a total of $5,000 from the two people by collecting $2,500 from each. Interestingly, this raises the theoretical possibility of considering what the progressive rate structure would be after elimination of tax expenditures and a resulting reduction in rates as the appropriate normative basis for comparison.

20. If the subsidy mechanism involved direct outlays rather than indirect tax expenditures, analysis similar to that contained in note 19, *supra*, would apply. The person receiving the direct outlay would have the same legal right, neither more nor less, to his subsidy as when received as a tax expenditure. When the same economic benefit is cast in this form it is less likely that anyone would quibble with use of the word "subsidy". But one could speak of the recipient as receiving his due entitlement under the law, and speak of his less fortunate counterpart who does not receive the direct outlay as being penalized.

deductions and credits,[21] most of which inure to the benefit of far fewer people than the home mortgage interest deduction. There are over 100 categories of these special subsidies contained in the estimated tax expenditure budget for 1985, totaling approximately $353 billion, of which something over $87 billion was to go to corporations and something over $266 billion was to go to individuals.

The subsidy mechanisms of the tax expenditure budget exempt certain income from measurement and therefore from taxation.[22] Thus, the inclusion of a tax subsidy component within the Tax Code results in an inevitable failure to achieve a true tax system's objectives. As a result, the present tax system is both progressive and regressive: many taxpayers at higher income levels are taxed at a higher rate than taxpayers at lower income levels but many taxpayers are taxed at an effectively lower rate than those with less income. Many taxpayers pay taxes at rates far lower than the nominal rate structure would suggest. For the purposes of graphic presentation of data relating to the rates of progressivity or regressivity in the present tax structure, two curves could adequately depict the average degree of progressivity or regressivity for each of these comparisons.[23] If charted on the same graph, these curves cross. When special tax expenditure provisions modify the rate of progressivity, the effective rate structure will differ from the nominal rate structure causing the point of intersection between the curves to shift.

The regressive effect of tax subsidies is heightened further since a higher income person receives a larger tax subsidy than a lower income person from the same amount of special exclusion or deductions.[24] In other words, higher income

21. *Special Analysis G*, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT FY 1985, G43-G48.

22. The discussion in note 19, *supra*, relating to a possible downward adjustment in rates as a correlative of elimination of tax subsidies is relevant here. Assuming the validity of the tax expenditure estimates for 1985, it is true that some taxpayers will pay over $350 billion extra in taxes to compensate for the revenue loss of over $350 billion in tax subsidies. But it does not necessarily follow that if tax expenditures were eliminated there would be a reduction in taxes of $350 billion. A general lowering of rates by enough to reduce revenues by $350 bilion would benefit those now disadvantaged, but it would also lower the nominal rates and therefore the tax burden of those now receiving the tax subsidies from what it would be if the tax subsidies were removed without lowering the rates. This second group, now on tax welfare, would pay substantially more in taxes than they do today, but not $350 billion more — precisely because of the hypothesized lowering of the otherwise applicable nominal rate structure.

It is likely that part, and possible that all, of the extra $350 billion in taxes that could be collected would be collected. There are many possible uses to which the money could be put besides a lowering of the tax rates. Less than two-thirds of the money would be required to eliminate the annual deficit of $200 billion. The remaining amount, a budget surplus in excess of $150 billion per year, could be used to retire the accumulated national debt.

A politically saleable package would likely involve a mixture of lower tax rates and deficit reduction. A careful consideration of the effect on the national and international economy is required prior to elimination of all tax subsidies. The tax effect of elimination of all tax subsidies would be an increase in taxes of $350 billion spread unevenly throughout the economy. Any sudden increase of this magnitude would have to be undertaken with care and might have to be phased in over a period of years. Such care should be exercised even though inadequate consideration was given to enactment of many of the tax subsidies. *See supra* note 10.

23. Assuming that such a line would be progressive in some degree, it would nevertheless, among other things, have averaged together the effect of the two crossing lines. It would therefore be a gross simplification.

24. *See* Surrey, *supra* note 5 at 720. *See also* Surrey & McDaniel, *supra* note 3, at 255. This can be seen by continuing the earlier example involving the home interest deduction. *See supra* note 15. The taxpayer in the 50% tax rate bracket was seen to save $5,000 in taxes from a $10,000 interest deduction. A person in the 25% tax rate bracket saves far less. The analysis becomes more complicated here, however, because a $10,000 deduction for such a person causes his rate bracket to change. Consider a married individual filing a joint return with taxable income for 1984 of $29,600 before consideration of the interest deduction. As the $10,000 deduction reduces taxable income by the first $5,000 (one half of the total deduction), $1,250 in taxes would be saved. This person then moves into the 22% tax rate bracket. The next $4,400 of the deduction would save $968 in taxes. The person then moves into the 18% tax rate bracket. The remaining $600 of the deduction would save $108 dollars in taxes. There-

taxpayers receive a larger subsidy for utilizing special deductions and exclusions because the taxpayer's per dollar tax reduction is greater. Furthermore, a higher income person can better afford to take advantage of special exclusions and deductions.[25]

Two elements, therefore, permit higher income people to benefit more from tax subsidies. First, as income increases each dollar of special exclusion or deduction results in a higher subsidy. Second, higher income people can better afford to engage in transactions involving special exclusions or deductions and economically they obtain higher per dollar benefit from a larger quantity of dollars. From a theoretical perspective, the aesthetic harmony of the fabric of the true income tax system has been shredded. From a practical perspective, the result is not fair or simple. A revenue raising system with such a vast, built-in spending apparatus is a contradiction.

THE KEMP-KASTEN PROPOSAL

The proposed Fair and Simple Tax Act of 1985,[26] the Kemp-Kasten bill, represents a significant departure from present law. While many provisions would change, only a few of the more revealing will be discussed here.

In place of the present series of nominally progressive tax rates,[27] Kemp-Kasten would substitute a single nominally flat rate of 24% for all individuals.[28] It would, however, have varying zero bracket amounts at levels higher than present law, making it in reality a progressive tax rate schedule.[29] Unlike present law, however, the proposal would accord special treatment to a portion of an individual's "employment income".[30] Kemp-Kasten excludes 20% of "employment income"[31] up to approximately $40,000, for an $8,000 maximum exclusion.[32]

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fore this person would save a total of $2,326 in taxes or less than half as much as his higher income neighbor. *See* I.R.C. § 1 (1982).

25. For example, a taxpayer in the 50% tax bracket may have a $10,000 interest deduction for purchasing a home. This deduction would reduce the taxpayer's liability by $5,000. This taxpayer in the 50% tax rate bracket might have a $10,000 home mortgage interest deduction. This is less likely for a person in the 25% tax rate bracket. If the lower income person pays only $5,000 in interest his taxes would be reduced by only $1,250. This is only one-fourth of the housing subsidy received by the higher income person.
26. H.R. 777, *supra* note 1.
27. For married individuals filing a joint return in taxable years 1985, the tax rate on taxable income above the zero bracket amount progresses from 11% of the excess over $3,400 up to $5,500, to 50% of the excess over $162,400 I.R.C. § 1(a)(3) (1982).
28. H.R. 777, *supra* note 1, § 101(a).
29. H.R. 777, *supra* note 1, § 112; I.R.C. § 63(d) (1982). The zero bracket amount corresponds to a standard deduction, or an amount of income allowed to be received tax-free. Under the current system the zero bracket amount exempts from taxation $2300 on an individual return, $3400 on a joint return and $1700 for a married individual filing separately. Kemp-Kasten changes the zero bracket amount to $2600 in the case of an unmarried individual, $3300 in the case of a joint return, and $1650 in the case of an married individual filing a separate return. *Id.*
30. H.R. 777, *supra* note 1, § 134. Kemp-Kasten defines "employment income" to include "wages, salaries, tips and other employee compensation" plus "net earnings from self-employment" plus amounts includible in income from "alimony or separate maintenance payments". *Id.* § 134(e)(1).
31. *Id.* § 134(d)(1).
32. The maximum amount of employment income that can be excluded from gross income is 20% of the FICA maximum wage base for the calendar year in which the taxable year of the taxpayer began. *Id.* § 134(b). The FICA maximum wage base for 1985 is $39,300. 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. In addition, there is a special rule for persons whose employment income is $10,000 or less and who are nevertheless wealthy enough to have "investment income", which is defined as any income "which is not employment income". *Id.* § 134(d). In this situation, up to $10,000 of investment income can be treated as employment income for purposes of obtaining the 20%-of-employment-income exclusion. *Id.* For a person with employment income, before consideration of this rule, of $10,000, the amount of investment income which could be treated as employment income would be 0.

Excluding 20% of income otherwise subject to a flat tax rate of 24% is the same as lowering the tax rate by 20%, resulting in an effective rate bracket of 19.2%. Kemp-Kasten's nominally flat rate of taxation is, then, in actuality, a progressive three-step tax rate schedule for workers. Congressman Kemp apparently does not really object to progressive income taxation, he just disputes particulars.

Kemp-Kasten would radically change the treatment of capital gains. Presently, capital gains, gains from disposition of capital assets, and Section 1231 assets, receive special treatment if held for more than 6 months.[33] A taxpayer with such gain may utilize a special deduction commonly known as the long term capital gain deduction.[34] Unlike deductions of costs, this deduction is measured with reference to gain; the bigger the gain, the bigger the deduction.[35]

The two most significant arguments advanced to justify this special treatment rest on the tax impacts of inflation and bunching of the long term gain in one year. The disposition of capital will ordinarily require that all realized income from that disposition be recognized in one year. Under a strictly progressive rate structure, income accrued from a capital disposition which reflected an appreciation in the value of the capital over several years would be aggregated and elevated to a higher tax bracket, thus subjecting it to higher rates of taxation than if it had been recognized as it accrued.[36] Under Kemp-Kasten, the difficulty of bunched income being thrown up into higher rate brackets would be obviated because the marginal tax rate for higher income is — except for the zero bracket — the same as it is for lower income.

In addition, the present system simply determines tax liability by calculating the difference between the purchase price and the selling price.[37] This system places no significance on the cause of the increase in price. Therefore, it is argued, the resulting nominal gain is attributable, in part, to inflation. In contrast, gain calculated in constant dollar terms, as allowed by Kemp-Kasten, would show only the real gain,[38] and the resulting figure would often be less than it is today. Under Kemp-Kasten, an asset's cost would be indexed for inflation.[39] Thus, after subtracting the indexed cost from the sales price, only real, or noninflationary, gain should remain. As a result, Kemp-Kasten eliminates the two major justifications for continuation of the present system's preferential treatment for long term capital gains. By indexing, the bill tends to reduce the absolute dollar increase in the

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For a person with employment income of 0, the amount of investment income which could be treated as employment income would be $10,000. It's a dollar for dollar sliding scale in between these two extremes. This rule could save $480 in taxes for an unemployed person living off $10,000 plus interest and dividends while he finds another job. It could do the same for a retired person living off investment income. It could also do the same for an idle wealthy person who would be more likely to have $10,000 in investment income. The person who would not benefit would be the unemployed person, or the retired person, who does not have enough investment income to be required to pay any taxes in the first place.

33. I.R.C. § 1232(a)(3)(A)(ii)(II)(1982).

34. *Id.* § 1202.

35. The deduction is for 60% of the gain, leaving only 40% of the gain subject to the basic taxing provision. *Id.* § 1202(a). The maximum tax rate for individuals today is 50%. *Id.* §1. But if only 40% of the gain is taxed, then even a person in the 50% tax rate bracket pays only 20% of the total gain in taxes.

36. Responses to this argument are available under the present tax system (such as the failure to tax imputed income, the failure to charge interest on the loan inherent in deferring taxation on appreciation in value until a realization event, and the fact that taxes are paid with inflated dollars), but the context would be completely changed with Kemp-Kasten's switch to a flat nominal rate structure.

37. I.R.C. § 1001 (1982).

38. H.R. 777, *supra* note 1, § 231.

39. *Id.* In the case of both mechanisms, indexing of basis and the switch to a nominally flat tax rate, the solution addresses the particular situation of a specific long term capital gain transaction far better than the crude rule of thumb presently employed in long term capital gain deduction.

asset's value, thus limiting tax liability.[40] In addition, by nominally taxing all income at the same marginal rate, Kemp-Kasten would alleviate the higher tax burden which would attend taxing all capital gains income at progressively higher marginal rates.

Having eliminated the major justifications for the preferential treatment, the Kemp-Kasten bill introduced as H.R. 6165 in the last session of Congress[41], would have repealed the long term capital gain deduction.[42] Curiously, the drafters of the most recent Kemp-Kasten bill have omitted the repeal provision for the long term capital gain deduction, although the bill retains a nominally flat tax rate structure[43] and the indexing of basis provision.[44] H.R. 777, instead, lowers the deduction from 60%[45] to 40%.[46] Ironically, this 40% of gain deduction, an elective alternative to the indexing of basis, represents a deduction for capital-derived income twice as large as that allowed for labor-derived income. Moreover, Kemp-Kasten limits the labor income exclusion to $8,000,[47] yet places no limit on the long term capital gain deduction.[48]

A comparative analysis of the exclusions or deductions individuals would receive at different income levels is revealing. A wage earner with $20,000 of employment income would get a $4,000 exclusion. The wage earner, however, must earn $40,000 in order to receive the maximum $8,000 employment income exclusion. In contrast, his wealthier neighbor would need only $10,000 of long term

40. While this approach does not consider the different rates of inflation in different assets, in different sectors of the economy, or in different regions of the country, it would nonetheless be a rather refined way of adjusting the gain in response to average inflation which has in fact occurred during the particular time period over which the asset has been held. While the length of time an asset has been held is central to both reasons for the present treatment of long term capital gain—the rate bracket bunching and inflation—Kemp-Kasten contains no holding period requirement as a prerequisite to indexing basis.
41. H.R. 6165, 98th Cong., 2d Sess., 130 CONG. REC. H9037 (daily ed. Aug. 10, 1984); S. 2948, 98th Cong., 2d Sess. 130 CONG. REC. S10,561 (daily ed. Aug. 10, 1984).
42. H.R. 777 *supra* note 1 § 232(b).
43. *Id.* § 101.
44. *Id.* § 231.
45. I.R.C. § 1202(a) (1982).
46. H.R. 777, *supra* note 1 § 232(c). Deducting 40% of your gain is still a very significant benefit. Furthermore, the gain would not be thrown up in the rate brackets.
47. *See supra* note 32, and accompanying text.
48. The modified long term capital gain deduction in Kemp-Kasten is elective and retains the six-month holding period requirement. Since indexing of basis under Kemp-Kasten would require no minimum holding period, but the modified long term capital gain deduction would, indexing would always be selected in an inflationary economy when the holding period requirement was not met. One would obtain the modified long term capital gain deduction by electing not to index the cost of the asset for purposes of calculating the gain. The election is for a taxable year, not for specific transactions. The obvious strategy for a person contemplating transactions for which inconsistent election decisions are indicated would be to split the transactions into separate years. Those transactions for which gain calculated with indexed basis would be less would be grouped into one year. No election would be made for that year and indexed basis would be used. Those transactions for which the remaining gain after the long term capital gain deduction would be less would be grouped together in the immediately preceding or following year. An election would be made for that year to not index basis and a long term capital gain deduction would be taken. The advantage for the taxpayer of having the option of choosing either indexed basis or a long term capital gain deduction is obvious, but the justification is unclear. The modified long term capital gain deduction does not appear to be merely a transition device. It has no expiration built into it and indexing on basis seems available for any qualifying transaction occurring after enactment of Kemp-Kasten for all gain attributable to inflation even though the inflation may have occurred prior to enactment. Rather, it grants preferential treatment for any transaction involving an asset for which appreciation in value proceeded at a pace of more than 250% of the applicable inflation rate. (100% of nominal gain divided by 40% of long term capital gain deduction yields 2.5 as a crossover point.) This would certainly include swiftly made gains and would seem to also include investments which are speculative in nature. Since indexing of basis under Kemp-Kasten would require no minimum holding period, but the modified long term capital gain deduction would, indexing would always be selected in an inflationary economy when the holding period requirement was not met.

capital gain to receive a $4,000 deduction. Similarly, the neighbor would receive a $16,000 long term capital gain on $40,000 income, and would continue receiving 40 cents for every additional $1 of long term capital gain without limitation. In an extreme situation, a wage earner making $40,000 would receive the maximum employment income exclusion of $8,000. If his wealthier neighbor realized $100,000 in long term capital gain, then his wealthier neighbor would receive a deduction of $40,000, equal to 100% of the wage earner's employment income. In addition, the wealthy neighbor will receive the benefit of his own employment income exclusion. Thus, if he has employment income, he will exclude up to $8,000 from the first $40,000.

The preceding comparative analysis of these two taxpayers reveals the Kemp-Kasten Bill's bias in favor of capital-derived income and the wealthy.[49] The tax rate bracket for the wage earner would be 19.2% on his first $40,000 of employment income.[50] His wealthier neighbor making $40,000 of employment income would also be in the 19.2% bracket. Both would be in the 24% bracket for additional employment income above $40,000.[51]. If the additional income took the form of long term capital gains, the marginal tax rate would fall to 14.4%.[52] Thus, Kemp-Kasten proposes two "flat" tax rates. The "flat" tax rate applicable to the wage earner really has two brackets: the first 19.2% followed by 24%. The wealthy neighbor, on the other hand, receives a rate of 14.4%. This is neither simple nor fair.[53]

EVALUATION OF KEMP-KASTEN

The first source of progressivity in the Kemp-Kasten tax structure, the zero bracket amount, would equally benefit all taxpayers at the same economic income levels. Therefore, there is no subsidy effect.[54] The second source of progressivity, the 20% exclusion for the first $40,000 of employment income is not a feature of the nominal tax rates. As an adjustment to the taxable base for taxpayers with one type of income, and not for all taxpayers at the same economic income level, it benefits only some taxpayers. Those taxpayers receive the benefit through a tax expenditure mechanism. This benefits workers, and since the tax benefit is eliminated for employment income above $40,000[55] higher income people do not benefit the most.

Moreover, the nominal rate structure's general flatness means that the tax benefit for each dollar of special exclusion or deduction remains constant throughout

49. I will ignore the zero bracket amount and personal exemption deductions, which would be available to both taxpayers, in the interest of simplicity.
50. *See supra* note 32 and accompanying text.
51. H.R. 777, *supra* note 1, § 101. It will be recalled that the 20% exclusion for the first $40,000 of employment income is the reason the nominal rate of 24% would be, in effect, 19.2% before it would jump to 24%. But with a 40% exclusion, the tax bracket for the recipient of long term capital gain would be 60% of the nominal rate. Thus, it would be a tax rate of 14.4%.
52. As discussed above the better-off taxpayer would more frequently benefit from this lower rate because he would have the capital with which to engage in long term capital transactions.
53. Due to the extent of long term capital gains transactions which occur, the total subsidy within the economy is large. The tax subsidy received on long term capital gain under Kemp-Kasten would be the amount of gain multiplied by 40% (the percent of gain allowed as a deduction), further multiplied by the 24% nominal rate bracket. This is precisely because 40% of the gain is the amount which is not subject to the nominal tax rate. For each $1 of long term capital gain, the subsidy is, therefore, 9.6 cents. For each $1,000, it is $96. For $10,000 it is $960. One must wonder what the reaction would be to this program if it were introduced in the form of a direct outlay.
54. The fact that the zero bracket amount is different for different categories of taxpayers in the Kemp-Kasten proposal, as it is under current law, provides the basis for arguing that the differences would have a subsidy effect but one too insignificant for concern here.
55. H.R. 777, *supra* note 1, § 134(b).

the income range over which it is allowed.[56] Kemp-Kasten, therefore, removes the progressive nominal rate structure as a mechanism for providing higher income taxpayers with larger tax subsidies. Yet reform could be better achieved by retaining the nominal rate structure while converting all special exclusions and deductions to tax credits.

Nonetheless, this is a positive change, moving the taxation system toward the theoretical underpinning of progressive taxation — taxation on the basis of ability to pay — *ceteris paribus*.[57] Of course, all other things are not equal. Kemp-Kasten removes progressivity itself from the nominal rate structure.[58] Kemp-Kasten's indirect retention of progressivity for most workers by manipulating their tax base conceals the flat portion of the nominal tax rate's principal effect: capital will not be taxed according to the ability to pay principle. Although Kemp-Kasten eliminates one source of the wealthy's receipt of larger subsidies from special exclusions and deductions by removing the progressive nominal rate structure, it retains other special exclusions, deductions and credits benefitting the wealthy. Furthermore, higher income taxpayers will still have more money with which to engage in transactions producing these special benefits. Indeed upper income taxpayers may still manipulate the tax system under the Kemp-Kasten proposal to avoid paying any taxes in a given year.[59]

Kemp-Kasten is not simple, and it violates the notion of fairness embodied in the idea of taxing people on the basis of their ability to pay.[60] Kemp-Kasten would continue a system based on the inability to pay. It stems from Kemp-Kasten's carryover of the twin problems of the present system — the failure to measure income and the failure to tax it once and only once. Kemp-Kasten's failure to retain a significantly progressive nominal rate structure increases the potential for regressive effective tax rates. Kemp-Kasten retains a vast spending apparatus built into the revenue raising system. The contradiction remains.

The reduction in the number, and possibly in the dollar effect, of subsidies given as tax expenditures is a positive feature of the Kemp-Kasten proposal. The removal of a significantly progressive rate structure as the nominal starting point is a negative. If these two changes, help shift the debate to the rate structure and away from tax incentives social or economic objectives, then Kemp-Kasten would have a beneficial net effect. Neutral or regressive taxation would be more palatable if achieved openly and notoriously.

The Kemp-Kasten proposal, however, attempts to shift discussion toward the rate without justification, since most tax subsidies would be retained. The rate

56. The benefit does not get larger as income increases since moving to a higher income level does not entail moving to a higher rate bracket.

57. The theoretical underpinning of a progressive tax rate structure is that a taxpayer pays taxes in an increasing proportion to his wealth. *See* R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 215-16 (1976).

58. Except for the zero bracket amount, the policy of taxation on the basis of ability to pay is removed completely from the nominal rate structure.

59. If a taxpayer realizes $100,000 in gain from sale of corporate stock held for seven months, even ignoring the zero bracket amount and personal exemptions, his tax liability would only be $14,400. A long term capital gain deduction of $40,000 would leave $60,000 subject to the 24% tax rate, for $14,400 of tax due and effective tax rate of 14.4%. This taxpayer has just received a special deduction of $40,000. He only needs additional special deductions of $60,000 to wipe out his taxable income and eliminate his tax liability. They would be readily available under Kemp-Kasten. If this "taxpayer" paid $40,000 in mortgage interest he would have his special deduction and his tax liability would be eliminated. This is not taxation on the basis of ability to pay—it is not taxation at all. It is welfare for the wealthy. Since higher income people will be better able to achieve a lower effective tax rate by virtue of the capital which is, or is becoming, available to them, it is theoretically possible that the effective rate structure under Kemp-Kasten would be regressive overall. It would undoubtedly be so for many, many people.

60. *See* J. PECHMAN, FEDERAL TAX POLICY 52 (1971).

structure emphasized in justifying the proposal — as under the present Code — is nominal only. The actual, effective rates of taxation achieved under Kemp-Kasten are no more obvious from reading Congressman Kemp's article and bill than they are upon reading current Federal income taxation law. While the specific provisions of law are explicit in the bill, the overall economic effects, pursuant to the proposal or under present law, are not widely understood. People think in terms of tax rates as they find them stated, in tables and schedules, or as a flat rate. They do not think in terms of *effective* tax rates after taking tax subsidies into account. The tax expenditure budget is a part of the official budget of the United States, but how many Americans know of it?[61]

Congressman Kemp maintains in his article that tax burdens on the various income classes would be the same as they are today.[62] He also claims that workers will pay less taxes under his proposal.[63] It is difficult to see how both can be true. He also claims his proposal will raise as much in revenues as the present system.[64] It *cannot* all be true.

I wish to emphasize that theoretical policy analysis is not the principal basis on which to judge the Kemp-Kasten proposal. It should be judged primarily on the basis of its projected results as generated by econometric models used in comparison with today's results. Limiting my analysis to what falls within the four corners of the two documents I have considered, H.R. 777 and Congressman Kemp's article, it is unclear to me which set of results I would prefer. If I could vote today, I would vote against Kemp-Kasten. But I would vote against the present system of taxation as well.

61. A projected tax expenditure budget estimating the results under Kemp-Kasten, and preferably comparing those results with the status quo, is not, as far as I am aware, yet available.
62. Kemp, *supra* note 2, at 16.
63. *Id.* at 15-16.
64. *Id.* at 16.