

COMMENTARIES

THE ECONOMICS AND POLITICS OF TAX REFORM: A COMMENT ON CONGRESSMAN KEMP'S ARTICLE

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INTRODUCTION

Recently, Congressman Jack Kemp (R-NY) correctly observed that "the Tax Code needs fundamental and complete reform . . . [because it] has earned a reputation of being 'soft on the rich'. . . [and] is unfair to the poor."¹ Congressman Kemp's accurate diagnosis is, unfortunately, not matched by an equally sound prescription for reform. His flat rate tax proposal, which incorporates supply-side economics, threatens to merely redistribute wealth from the middle class to the upper class.

This comment will begin by analyzing the tax burdens on the various taxpayer groups under the current tax scheme. The comment will then consider the current tax system and Congressman Kemp's proposal from the standard of tax fairness. Third, the comment proposes a progressive rather than flat-rate tax structure, and shows the inequities inherent in the Kemp flat-tax proposals. Finally, the comment will discuss many of the problems within the current system, which Congressman Kemp's legislation would retain.

THE CURRENT DISTRIBUTION OF THE TAX BURDEN

A recent study by Joseph Pechman examines the impact of *all* taxes on the overall distribution of the tax burden.² The Pechman study considers the impact of the personal income tax as well as payroll, property, sales, and excise taxes. Such a comprehensive approach more accurately describes the distribution of the tax burden. Pechman's analysis illustrates two major characteristics of the current tax system. First, the middle class pays less as a percentage of their income than the rich or the very poor.³ Second, income earned labor income is taxed more than income obtained from the return on capital.⁴ Table One displays the total effective tax rates by family income group.⁵ Under the the current tax system, the lowest income groups pay the highest tax, 32.5%, while the highest in-

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1. Kemp, *Federal Tax Law: The Need For Radical Reform*, 12 J. LEGIS. 1, at 2-3 (1985).

2. J. PECHMAN, *WHO PAID THE TAXES: 1966-1980* (1985).

3. See *infra* note 5.

4. For example, labor is taxed more than capital gains, interest income, dividends or rental income.

5. Pechman determined how much the typical taxpayer in each income class would pay in property tax, sales and excise tax, what their share of the corporate income tax, individual income tax, and payroll taxes would be. He adds the tax rates to obtain the total tax rate for each income group.

come group pays only 31% of their income in taxes. Since the current tax rate only fluctuates between 20.3% to 32.5%, the Tax Code is already effectively flat.

Table Two describes the decline in the proportion of total tax liability paid by corporations.⁶ Between 1960 and 1982, the payroll tax share of Federal revenue rose sharply while the share of corporate income fell.⁷ As a result, workers pay relatively more taxes than owners of capital. The payroll tax consists mainly of FICA (Social Security tax) which is assessed equally between employers and workers. Employers can shift their share of the tax to consumers by raising prices, or to the workers by lowering wages. Thus, an employer's ability to shift the tax burden to others means the statutory incidence and actual incidence can differ, and workers are likely to pay more of the payroll tax than firms.

The corporate income tax is assessed on corporate profits. Presumably, an increase in corporate profits will be allocated to executive salaries, corporate spending, and shareholder dividends. Thus, a decrease in corporate profits will decrease all three. Moreover, in 1982, the top 0.5% of households, ranked by income, owned most of the total supply of corporate stocks and bonds.⁸ Thus, when the taxes paid by corporations decrease relative to the taxes paid by workers, the tax burden shifts from corporations and wealthy households to lower income taxpayers.

Furthermore, the tax law provisions that reduced the corporate income tax not only shifted the tax burden to labor but also increased the unemployment rate. The investment tax credit⁹ and the accelerated depreciation allowance¹⁰ constitute the major tax breaks for firms and capital-owning households. Both provisions

Table One: Effective Tax Rates* by Income Group

Family Income (annual income in thousands)	Effective Total Tax Rate
0-5	32.5
5-10	20.3
10-15	20.5
15-20	21.5
20-25	22.7
25-30	23.2
30-50	24.5
50-100	26.5
100-500	27.3
500-1000	27.1
1000 and over	31.0

Source: J. PECHMAN, WHO PAID THE TAXES: 1966-1980 (1985).

*The tax rate is the sum of the effective payroll tax (assumes workers pay all), sale and excise, property taxes, personal income tax rates and corporate income tax (assumes all property owners pay the tax).

Table Two: Federal Budget Receipt by Major Source: 1960-1982

Source	1960	1970	1982	% change (60-82)
Individual Income Tax	44.0%	46.9%	47.6%	+8.1%
Payroll	15.9	23.3	39.9	+151.9
Corporation Tax	20.2	17.0	7.5	-62.8
Excise Tax	12.6	8.1	6.9	-42.1
Customs, estate taxes	2.9	3.2	2.3	-20.6

Source: US BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1983-84, 248 (1982).

7. *Id.*

8. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1982-83, 449 (1981).

9. I.R.C. § 46 (1982).

10. *Id.* §168.

lower the cost of capital relative to other types of investments, such as research and development and labor intensive production.

ELEMENTS OF FAIRNESS

Economic fairness in a tax setting is a vague and malleable concept.¹¹ It is difficult to define "fairness" in the allocation of tax liability among the various segments of a highly pluralistic society. Inevitably, however, any structural modification of the tax system must address this threshold question. Congressman Kemp's discussion fails to address the issue squarely. Instead, Kemp assumes that a fair tax is one which imposes the same tax rate on all persons regardless of income. The Kemp view holds that a flat rate tax of 24% is more equitable than a progressive rate structure.¹² He relies on a standard, but erroneous indicator of fairness to defend his flat tax. Implicit in his argument is the assumption that a flat tax system produces equal sacrifice because there is a "constant marginal utility of money." Stated simply, Congressman Kemp presumes that a one percentage decline in the retained income of a wealthy individual will be reflected in the same amount of hardship or sacrifice as a one percentage decline in the retained income of a poor person.

Fortunately, Congressman Kemp's actual proposal modifies this theoretical premise somewhat to reflect empirical observation. His proposed flat tax system recognizes that lower income individuals experience a greater hardship than upper income families when income declines¹³ and, therefore, recommends an increased zero bracket¹⁴ and greater personal exemptions.¹⁵ Further, he suggests an additional 20% income exclusion.¹⁶ The Kemp proposal returns to Kemp's theoretically "fair" allocation of the tax burden at higher income levels. The result suggests some diminution in the marginal utility of money up to some threshold income level, beyond which income level the utility of money remains constant. The foundation for such a view, however, remains unclear.

Once an individual's income exceeds a specified threshold, the Kemp proposal taxes 24% of income from each and every taxpayer. Thus, returning to the theoretical premise, if taxpayer A has a taxable income of \$8000 and a tax liability of \$240 for every additional \$100 in income, this tax payer is assumed to experience the same detriment from the loss of income as does taxpayer B who has a taxable income of \$240 for each \$100 in income and a tax liability of \$25,000. Taxpayers A and B will not make the same sacrifices when they are taxed. The \$240 paid may mean that taxpayer A might not visit a doctor this year, purchase no new clothes or birthday presents, undertake no car repairs.

Another way to evaluate sacrifice is to consider the source of the income that is taxed. In order for the loss of income to be equal, the income used to pay the tax should have been acquired at an equal cost to the taxpayer. The personal cost of obtaining a dollar through a return on property ownership is generally different than the cost of acquiring a dollar through a return on labor. To the extent that these costs differ, property income should be taxed either more or less heavily than labor income to accurately reflect equal sacrifice.

11. See Heller, *Assessing the Reagan Economic Program* in SUPPLY SIDE ECONOMICS, 70-79 (R. Fink ed. 1982)

12. Congressman Kemp states: "Tax reformers who equate high marginal tax rates with equity understand neither human nature nor the nature of incentives." Kemp, *supra* note 1, at 5.

13. Kemp, *supra* note 1, at 3-4.

14. H.R. 777, 99th Cong., 1st Sess., 131 CONG. REC. H215 (daily ed. Jan. 30, 1985), § 112.

15. *Id.* § 111.

16. *Id.* § 134.

Table Three indicates that higher personal income levels correlate with higher percentages of income derived from property ownership.¹⁷ Because of this discrepancy in the sources of income, taxing wealthy and low income individuals at a uniform rate cannot be "fair" even within Mr. Kemp's restrictive definition of the term.

THE PROGRESSIVE TAX ALTERNATIVE

A tax system with a progressive rate structure,¹⁸ extracts equivalent sacrifices from each taxpayer. Such a scheme would satisfy the "fairness" test. The current Tax Code as written, though not as implemented, encompasses such a progressive tax structure. The Tax Code, like other progressive tax systems, rests on principles which recognize a diminishing marginal utility of money. Essentially, these systems acknowledge that the value of money decreases relative to the amount available.¹⁹ Similarly, a progressive tax system should rest on the presumption that money earned through labor requires more sacrifice than money earned for property ownership. Thus, it taxes the latter more heavily.

Unfortunately, Congressman Kemp has not set out to create a tax system which is "fair." Rather, he has set out to create a tax system which promises a "larger economic pie."²⁰ Jack Kemp believes that the present progressive marginal tax rate system "damages economic growth."²¹ The Kemp plan fails to impose equal sacrifices on all taxpayers; instead, it allows the affluent to retain a larger share of their income. His hope is that they will use their income to invest in productive capital and foster economic growth.²²

The Kemp analysis relies on supply-side economics. This theory prompted the 1981 tax cuts, which dramatically reduced the tax burden for the upper income families and corporations by adopting provisions such as the accelerated depreciation allowance and investment tax credits.²³ Supply-side economics posits that tax reductions for wealthy individuals and corporations will induce swift, substantial increases in overall economic activity.²⁴ Supply-siders originally predicted that such increased economic activity would generate so much income

17. Table Three: Sources of Taxable Income by Income Size, 1976 and Percentage Distribution of Households by Income Percentage of Taxable Income Derived from:

Taxable Income Group*	Wages and Salaries**	Property
Under 10,000	87%	13%
10,000-20,000	89	11
20,000-30,000	89	11
30,000-50,000	77	23
50,000-100,000	58	42
100,000-200,000	51	49
200,000-500,000	38	62
500,000-1,000,000	23	76
1,000,000 or more	12	88

Source: H. WACHTEL, LABOR AND THE ECONOMY 169 (1984)

* In 1981, 95% of all households in the United States have incomes under \$58,554. U.S. BUREAU OF THE CENSUS, MONEY, INCOME AND POVERTY STATUS OF FAMILIES AND PERSONS IN THE UNITED STATES: 1981, SERIES P-60, No. 134 at 11 (March 1982)

** Business and professional self employment, farm ownership, partnership, capital gains, dividends, rent, interest, and royalties.

18. That is, one in which the percentage at which income is taxed rises with income.

19. See J. ARONSON, PUBLIC FINANCE 70-79 (1982).

20. Kemp, *supra* note 1, at 24.

21. *Id.* at 8-9.

22. *Id.* at 22.

23. See *supra* notes 9-10 and accompanying text.

24. See generally J. WANNISKI, THE WAY THE WORLD WORKS (1978); J. KEMP, AN AMERICAN RENAISSANCE (1979); and G. GILDER, WEALTH AND POVERTY (1981).

that, despite the tax cut, the Federal budget would be balanced by 1984.²⁵

Supply side theory presumes a highly positive correlation between taxpayers investment decisions and their marginal tax rate. Yet economic studies in the corporate context repeatedly have shown that anticipated sales, among a myriad of other variables, are more important to a firm's investment decision than are tax rates.²⁶ The 1981 tax cuts did not take place in an economic vacuum. Many industries in 1981 faced unique problems which discouraged increased investment. Most of these problems were unanticipated and, therefore, were not included in the supply-siders calculations. As a result, the reduction in tax rates in 1981 did not induce new investment. It merely enhanced profits for many corporations. This increase in corporate earnings has resulted in an unprecedented flurry of corporate merger and acquisition wars. Old capital has used the revenue provided by the tax cut to buy old capital.²⁷ After examining the supply-side program, Nobel Laureate Economist James Tobin concluded that reducing taxes for businesses and wealthy households would not promote investment. Tobin noted: "The only sure results of supply-side policies are redistributions of income, wealth and power — from government to private enterprises, from workers to capitalists, from poor to rich."²⁸

THE DISTRIBUTIONAL IMPACT OF KEMP-KASTEN

Congressman Kemp suggests that the Kemp-Kasten bill "assures that all taxpayers pay their fair share."²⁹ This bold claim must be examined carefully to assess the "fairness" of the allocated shares. The principle provisions of the Kemp-Kasten bill can be divided into three factors: 1) deductions; 2) tax exemptions; and 3) marginal tax rates. The proposed legislation would greatly streamline the personal income tax. At the same time, however, the proposal would retain certain economic preferences, as reflected in the bill's deductions. These deductions include mortgage interest payments³⁰ and property taxes on residential property,³¹ charitable contributions,³² catastrophic medical expenditures,³³ individual retirement accounts,³⁴ Keogh plans,³⁵ interest paid on municipal bonds³⁶ and derived from pension plans,³⁷ social security³⁸ and home ownership.³⁹ Similarly, the tax is streamlined by the exemptions which are included in the Kemp-Kasten plan. These include increasing the personal exemptions from \$1,000 to \$2,000⁴⁰ and increasing the zero tax bracket amount.⁴¹ Both of these recommen-

25. *Id.*

26. See a review of these studies in Hulten, *Tax Policy and the Investment Decision*, 2 AM. ECON. REV. 236-41 (1984).

27. It should be noted that some suggest that the current recovery can be traced to the supply-side policy. The data clearly indicates that the recovery was led by an increase in demand fueled largely by the government's largest peacetime deficit. See ST. LOUIS FEDERAL RESERVE BANK, *MONETARY TRENDS*, February 1985.

28. J. Tobin, *Supply-Side Economies: What Is It? Will It Work?*, in *VIEWPOINTS ON SUPPLY SIDE ECONOMICS* 138 (T. Hailstones, ed 1982).

29. Kemp, *supra* note 1, at 1015.

30. I.R.C. § 25 (1982).

31. *Id.* § 163.

32. *Id.* § 170.

33. *Id.* § 213(a)(1).

34. *Id.* § 219(a).

35. *Id.* § 404(a)(2).

36. *Id.* § 103.

37. *Id.* § 404(a)(9).

38. *Id.* § 86.

39. *Id.* § 163.

40. H.R. 777, *supra* note 14, § 111.

41. *Id.* § 112.

dations enjoy wide political support since they improve equity and reduce administrative costs.⁴² In addition to these exemptions, the Kemp-Kasten plan provides an extra \$2,000 exemption for the aged and the blind⁴³ and creates a new exemption equal to 20% of the wages, salaries and self-employed income for incomes below \$40,000.⁴⁴ After these deductions and exemptions have been taken, the flat rate of 24% is applied to taxable income.⁴⁵

Table Four estimates the redistributive effects of various deductions and exemptions of the Kemp-Kasten plan and compares it to other current tax proposals.⁴⁶ As the table illustrates, Kemp-Kasten favors high income households over middle income households, despite its attention to low income. To estimate the distribution of taxes among families, the payroll tax rate and personal income tax rate are added. As one can see, the current law has the least progressive schedule. In fact, the tax rate goes down between income levels \$60,000 and \$120,000. The Kemp-Kasten plan also taxes households with incomes around \$60,000 more as a percentage of their income than those around \$120,000. The Bradley-Gephardt bill is the most progressive, although rates are slightly higher at all income levels.

THE NEED FOR TAX REFORM

Few question the need for tax reform; the tax code presupposes periodic revisions. As the economy changes, all aspects of the personal and corporate income tax must be reexamined to determine if incentives and preferences are consistent with public policy. Historically, this reexamination occurs about every decade. The time for tax reformation is ripe.

Every deduction is reflected in an alteration of relative cost of some activity to which the deduction is directly or indirectly related. If markets function as predicted, this change in relative cost should induce a change in economic behavior. Take for example the case of homeownership. A number of special homeownership incentives have been incorporated into the tax code; these include, mortgage interest⁴⁷ and property taxes⁴⁸ deductions, a roll-over provision for those who sell their homes,⁴⁹ and tax credits for weatherization.⁵⁰ Any decision regarding revision to the Tax Code requires principled and well-reasoned determinations as to whether these tax inducements remain desirable in 1985. Consider tax credits for

42. Administrative costs are lowered because the level of exempted income reduces the number of taxpayers who find it profitable to itemize their tax returns. Since fewer taxpayers itemize, less Internal Revenue resources must be devoted to auditing these returns.

43. H.R. 777, *supra* note 14, § 111(1).

44. *Id.* § 134. This provision defines "employment income" to include "earned income" as defined in I.R.C. § 36 (c)(2) (1982).

45. *Id.* § 1.

46. Table Four: "The Distribution of Tax Rates* of the current Tax Code, Bradley-Gephardt, the Treasury Department proposal, and Kemp-Kasten for 5 hypothetical taxpayers at 5 income levels."

Annual Income Level	Current Law	B-G	Treasury	K-K
\$15,000 (married)	12.75	13.15	10.35	8.15
\$30,000 (married & itemizer)	15.55	16.35	15.45	14.33
\$60,000 (married & itemizer)	18.29	18.56	17.52	17.91
\$120,000 (married with capital gains income)	14.39	22.06	18.20	17.44
\$1,000,000 (married with capital gains income)	24.42	21.92	18.65	17.93

* Tax Rate is the sum of the individual income tax rate and the FICA tax rate.

For incomes of \$60,000 and below we assume all incomes are from wages and salaries. The income level of \$120,000 is assumed to be composed of 33% capital gains, 16.33% interest and dividends, and 50% in wage and salaries. The income level of \$1,000,000 is assumed to be composed of 40% capital gains, 40% interest and dividends, and 20% in wages and salaries.

47. I.R.C. § 163 (1982).

48. *Id.* § 164.

49. *Id.* § 1034.

50. *Id.* § 23.

weatherization expenditures. At the height of the energy crisis, weatherization was an important public policy goal. That policy, however, is today of limited utility and leaves vast tax sums uncollected.

Kemp-Kasten would sweep away many tax inducements related to a wide variety of economic activities. Congressman Kemp claims that "one bold stroke" will disarm special interests and garner broad public support.⁵¹ But his plan does not disarm all special interests nor is it neutral in its effects on special interests. For example, his plan lowers the business capital gains tax from 28% to 20%.⁵² In contrast, the Bradley-Gephardt plan, raises the tax on capital gains to 30%.⁵³ The Kemp-Kasten depreciation provision expands the type of activity, like oil drillings, that can be depreciated and allows all capital to be depreciated faster than under current law.⁵⁴ Kemp-Kasten will save corporations billions by lowering the effective tax rate across industries from 25% to 23%.⁵⁵ The Kemp-Kasten bill would decrease the tax burden on corporations while encouraging business to invest in capital rather than employ workers.

The Kemp-Kasten bill retains the provisions of the current Tax Code that encourage U.S. companies to operate abroad.⁵⁶ By liquidating and then selling its subsidiaries, instead of selling the subsidiaries directly, conglomerates can completely avoid capital gains taxes.⁵⁷ In a recent case, a corporation avoided paying \$50 million of capital gains taxes in this manner.⁵⁸ In addition, a recent increase in the use of "installment sale contracts" have allowed developers, corporations, and wealthy individuals to defer taxes causing the Federal Government to lose an estimated \$6 billion in taxes.⁵⁹ The use of this loophole can be expected to increase but none of the tax reform proposals in Washington mention it.

Not only does Kemp-Kasten increase the tax favoritism towards business, Kemp-Kasten furthers the present penalties on workers. Income received by injured workers through Worker's Compensation will be taxed under Kemp-Kasten.⁶⁰ Further, the child care exemptions will be eliminated.⁶¹ Instead of closing loopholes, the Kemp-Kasten bill shuts the door on the progressive tax rate concept.

CONCLUSION

Despite the rhetoric which accompanied the bill's introduction, Kemp-Kasten neither closes the most egregious existing loopholes nor achieves an equitable allocation of tax liability. Instead the bill merely closes some loopholes in order to accommodate the effective redistribution of tax liability away from upper income taxpayers. The Kemp-Kasten tax reform proposal recommends a tax structure that reduces the tax liability of the affluent and increases the tax burden of those who can least afford it. The proposed tax is, therefore, not fair nor will it fulfill its promise to provide a larger economic pie.

51. Kemp, *supra* note 1, at 24.

52. H.R. 777, *supra* note 14, § 232(a)(1).

53. H.R. 800, 99th Cong., 1st Sess., § 241 131 CONG. REC. H215 (daily ed. Jan. 30, 1985).

54. H.R. 777, *supra* note 1, § 301.

55. CONGRESSIONAL BUDGET OFFICE, A COMPARATIVE ANALYSIS OF FIVE TAX PROPOSALS (prepared by J. Gravelle) 13 (1984).

56. I.R.C. §§ 27, 901-08 (1982).

57. *Id.* § 332.

58. BUS. WEEK, Jan. 14, 1985, at 166.

59. Crock, *One More Loophole That The Treasury isn't Tackling*, BUS. WEEK, January 14, 1985, at 17.

60. H.R. 777, *supra* note 14, § 211(1). This section would repeal I.R.C. § 104 (1982).

61. H.R. 777, *supra* note 14, § 201(1). This section would repeal I.R.C. § 21 (1982).