FLAT-RATE TAX

HEARINGS

BEFORE THE

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UNITED STATES SENATE

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FLAT-RATE TAX

THURSDAY, SEPTEMBER 30, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m. in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Long, Baucus, and Bradley.

Senator LONG. This hearing will come to order. The chairman and the others will be along in due course. The chairman asked me to call the meeting together or to call it to order at least.

Our first witnesses, I am pleased to say, will be a panel consisting of Mr. Joseph Pechman, director of Economic Studies program, The Brookings Institution; Mr. Rudolph E. Penner, resident scholar of American Enterprise Institute; Mr. Robert E. Hall, professor, Department of Economics, Stanford University. We are very proud to have you gentlemen, and would be very pleased to have you proceed.

I suppose, Mr. Pechman, you ought to go first since your name appears first on the list.

STATEMENT OF JOSEPH PECHMAN, DIRECTOR, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. PECHMAN. Thank you very much, Mr. Chairman. I prepared a statement for the committee, but it is rather lengthy, and I am going to summarize it.

Senator LONG. We will print your entire statement for all three of you. And we will ask you to summarize it for the record.

Mr. PECHMAN. I would also like to say that this testimony was prepared with my colleague, Karl Scholz, who is sitting behind me. Mr. Scholz prepared the quantitative data and is coauthor of the statement.

The point of my testimony is not to support any particular plan. The purpose is to give to the committee some basis for making judgments about the trade-off between broadening the tax base and reducing the tax base. I think it is unnecessary at this stage, after 2 days of testimony, to emphasize that, if you broadened the tax base and pruned the unnecessary deductions under the income tax, you could use the revenue to reduce the tax rates very, very substantially. You would simplify the tax system and the tax return, and also improve horizontal equity.

I will take these things for granted, and now turn to the tables that we prepared to help the committee understand the nature of the changes that we are talking about.

If you will turn to table 6, you will see the outline of six different plans, ranging from the most comprehensive tax plan to plans that have been recommended both inside and outside of Congress.

Senator LONG. What page is table 6 on?

Mr. PECHMAN. This is table 6 at the end of the testimony.

Senator LONG. OK, sir.

Mr. PECHMAN. The list also includes as plan two, a flat tax plan. All of these plans yield the same amount of revenue. And all of them approximate the distribution of tax burdens by income classes, except that we have increased the personal exemptions and the zero bracket amounts so that by the year 1984, the threshold at which people will pay tax will be increased to the estimated poverty line income.

Senator LONG. Would you just give us an illustration of using that table to illustrate how it works out? Just pick whatever bracket you think would be most typical of one group, and then the other group. Two groups.

Mr. PECHMAN. Well, to do that, we will have to turn to table 8. Table 8 answers your question.

Senator LONG. Table 8.

Mr. PECHMAN. Table 8 gives you the figures by income classes. Table 6 describes the plans.

Senator LONG. Where is table 8? Oh, here it is.

Mr. PECHMAN. As you can see from table 8, the tax burden under present law increases to a maximum 26.4 percent, in the second highest income class of $500,000 to $1 million.

Senator LONG. That's just a bunch of numbers. I haven't studied it previously. What line are you looking at?

Mr. PECHMAN. I'm looking at the first column.

Senator LONG. Yes.

Mr. PECHMAN. And that shows the percentage——

Senator LONG. Present law.

Mr. PECHMAN. Present law. The people with income below $5,000 pay seven-tenths of 1 percent of their income in tax. People at the $25,000 level——

Senator LONG. What percent did you say?

Mr. PECHMAN. Seven-tenths of 1 percent.

Senator LONG. I'm with you now.

Mr. PECHMAN. On $25,000, they pay 10 percent.

Senator LONG. Yes, sir.

Mr. PECHMAN. And at $1 million, they pay 23 percent of their income. This is the tax on their total income, including incomes that are not now taxed. That includes capital gains. Now plan one is a plan that would tax all income in full, and it gives very few deductions. The only deductions we allow are deductions for unusual medical expenses and casualty losses in excess of 10 percent of income.

That plan, because it broadens the tax base so much, permits you to reduce the tax rates from the presently scheduled 11 percent to 50 percent in 1984 to 9 percent at the bottom and 28 percent at the top. Now with that plan, as you can see, we do reduce tax burdens in the lower income classes somewhat. And then we approximate the tax burdens of the upper income classes pretty well. The total tax yield of the plan, of course, is the same as under present law—12 percent of total expanded income.

Now as you move across to the right of the table, you get plans with more generous deductions, and more exclusions. For example, in plan three we provide deductions for State and local property taxes and income taxes. And we also provide more generous deductions for interest payments and so on.

The message of these plans is that as you increase the generosity of the deductions, you have to increase the tax rate to get the same yield. So that under plan three, for example, the rates go, from 11 to 30, instead of from 9 to 28. And under plan four, from 12 to 30, and so on.

Plan two is the flat tax plan. This has the same tax base as plan one except that, instead of the graduated rate structure, we choose a rate which turns out to be 17 percent. That's applied to all taxable income. As you can see, that also yields the same total revenue as does present law. The basic point is that above $35,000 of income, in this case, the tax burden is lower than under present law tax. And it's higher below that.

In other words, the point that you were quoted on in the press, Mr. Chairman, that a flat tax redistributes the tax burden to the poor- and middle-income classes is well taken.

I'll stop there, and then respond to questions.

Senator LONG. Well, let's hear from the next witness.

[The prepared statement of Joseph A. Pechman and John Karl Scholz follows:]

Brookings Institution

Economic Studies Program

Comprehensive Income Taxation and Rate Reduction

by

Joseph A. Pechman and John Karl Scholz*

Statement Prepared for the Senate Finance Committee, September 30, 1982

Congress and every administration in recent years have paid lip service to the objective of tax simplification, but the income tax has become more and more complicated with the passage of every revenue act. The 1981 inome tax return (Form 1040) contained, in addition to a two-page initial summary, 9 separate schedules and 35 supplementary forms for detailed reporting of income receipts, deductions, and credits. The 1981 form listedeight adjustments that were allowed in arriving at adjusted gross income and eight tax credits. In 1960, there was only one adjustment to calculate adjusted gross income and

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one tax credit. The tax law and the tax return form were made even more complicated by the new tax preferences added in the 1981 tax act. There is no question that income tax reporting has become both aggravating and costly. Public opinion polls invariably report that millions of taxpayers feel that they cannot cope with income tax reporting and must pay for assistance in the preparation of their returns.

The source of the complexity is the attempt by Congress and most administrations to do too much with the income tax. Whether it is promotion of jobs, energy saving, or incentives to work, save and invest, the normal reaction is to add a special deduction or credit to the income tax to help achieve the allegedly urgent social objective. Every such departure from the normal structure of the income tax leaves its mark on the tax return and imposes additional burdens of record-keeping for the taxpayer. The practice violates the principle that people with the same income should pay the same tax, narrows the tax base, and requires unnecessarily high marginal tax rates on the constricted base to raise the revenues needed from the income tax.

The obvious solution is to simplify the tax law by repealing all the special provisions and starting all over again. In the past, the forces arrayed against simplification through the elimination of tax preferences have been much too powerful to permit any progress to be made in this way. But the idea of tax simplification has reappeared in recent months, as Congress has finally recognized that the public is fed up with the present income tax.

The idea is to tax all incomes without any exclusions, personal deductions (except for those like unusual medical expenses and casualty losses which reduce ability to pay) or tax credits; the increased tax base would then be used to reduce tax rates across the board. Taxpayers would simply add up their income sources, subtract their personal exemptions and their unusual expenses, and calculate their tax liability from a tax table or the schedule of tax rates.

The idea of a simplified, broad-based income tax has been supported recently by those who are interested in converting the income tax to a "flat tax." The base of the flat tax would be the same as the broad-based tax just described. The only difference is that a single tax rate (between 15 and 20 percent, depending on how broad the base would become) would be substituted for a graduated rate schedule.

This paper provides estimates of (1) the extent to which the federal individual income tax has been eroded by the exclusions, deductions, and exemptions which are not essential for effective income taxation, (2) how much tax rates could be reduced if the unnecessary exclusions, deductions, and exemptions were removed, and (3) the differences in the distribution of tax burdens under the flat tax as compared with a graduated rate schedule. The estimates are for calendar year 1984, when the 1981 tax act becomes fully effective.

These estimates come from an income tax file developed by the Internal Revenue Service, which contains all the tax information from a random stratified sample of 155,000 tax returns for the year 1977. The file was projected to 1984 on the basis of published tax return data for 1979 and changes in income and prices assumed in the official budget estimates from 1979 to 1984. The calculations were made by a tax calculator developed by the Brookings Tax Project, which reads information from tax returns and computes adjusted gross income, taxable income, and taxes after credits.[1]

The Comprehensive Income Tax Base

A comprehensive income tax base would conform as closely as possible to an economic concept of income. In addition to adjusted gross income as presently defined in the Internal Revenue Code, we have assumed that income under a comprehensive tax would include capital gains in full, interest on newly issued state and local bonds, interest on life insurance savings, one-half of social security benefits,

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1. The provisions of the 1981 tax act were incorporated into the tax calculator on the basis of assumptions that were described in John Karl Scholz, "Individual Income Provisions of the 1981 Tax Act," Setting National Priorities: The 1983 Budget (Brookings, 1982), Appendix A, pp. 251-62).

railroad retirement benefits, workman's compensation, unemployment insurance and veteran's payments. All dividends, one-third of premiums paid by employers for their employee's health insurance[2] and all premiums paid for life insurance are also included. In addition, the 1981 savings provisions are repealed and the major tax preference items on the minimum tax form[3] are made subject to the regular income tax.

When the federal tax actually paid is related to adjusted gross income modified to include these receipts (expanded AGI), the effective rate of tax under the 1984 rate schedule turns out to be a relatively low percentage of income at all income levels. It rises from an effective rate of 0.7 percent on incomes below $5,000 to 10.0 percent on incomes between $25,000 and $35,000, to a maximum of 26.4 percent on incomes between $500,000 and $1,000,000 (table 1). For all tax returns, the effective rate averages 12.0 percent of expanded AGI.

Once the income concept for the comprehensive tax is established, it is necessary to select the deductions and personal exemptions considered necessary for personal income taxation. In the comprehensive tax plan used in this paper itemized deductions are

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2. This is an estimate of the portion of premiums in excess of $150 per month per employee. This is the limit often proposed as a practical compromise between full taxation of employer-paid health insurance premiums and the present exemption of all such premiums.

3. These preference items include accelerated depreciation and depletion.

limited to: medical and casualty deductions in excess of 10 percent of expanded adjusted gross income; interest paid up to the amount of investment income reported on the tax return; and the presently allowed miscellaneous itemized deductions (which are mainly deductions related to the earning of labor or investment income). Taxpayer and dependent exemptions were increased to $1,750,[4] the special exemptions for age and blindness were eliminated, and the zero bracket amount was increased to $4,000 for all returns. The personal exemptions and zero bracket amount were chosen to relieve from tax individuals and families with incomes below the estimated poverty lines in calender year 1984. One rate schedule is used by all taxpayers;[5] to alleviate the so-called marriage penalty on two-earner couples, a deduction from adjusted gross income of 25 percent of the earnings of the spouse with the lower earnings (earnings not to exceed $50,000) is allowed. Finally, all tax credits are eliminated.

In 1984 total AGI of all taxpayers will amount to $2,308 billion under present law. Under the comprehensive income tax plan, adjusted

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4. Heads of households receive an additional $1,750 exemption in lieu of a child care credit.

5. Married couples filing separate returns have a separate rate schedule with one-half the bracket widths as the basic schedule. Consequently married couples filing separate returns have a zero bracket amount of $2,000. To avoid having two rate schedules and two zero bracket amounts, married couples could be required to file joint returns.

gross income would rise to $2,529 billion, an increase of $221 billion or 10 percent (table 2). Taxable income would rise from $1,547 billion to $1,752 billion, an increase of $205 or 13 percent. Transfer payments constitute the largest increase in adjusted gross income and taxable income, though excluded capital gains, interest on life insurance, and premiums paid by employers for employee insurance also contribute significant amounts. If taxed at 1984 rates these additions to the tax base would raise income tax revenues by $86 billion, or over 25 percent; or, alternatively rates could be reduced by an average of 22 percent to produce the revenues estimated under present law.

The effect of adopting the comprehensive tax plan differs markedly among tax units at different income levels. While almost 70 percent of the total increase in taxable income accrues to taxpayers with incomes of $35,000-$100,000 (see table 3), the largest percentage changes in taxable income occur at the bottom and top of the income scale. By increasing the personal exemptions and the zero bracket amount, the taxable income for taxpayers reporting less than $5,000 is virtually eliminated. In contrast, the expansion of the tax base increases taxable income by 54 percent for taxpayers with incomes of $500,000-$1,000,000 and by 97 percent for those with incomes of $1,000,000 or more.

As already noted, the changes in income subject to tax, deductions, exemptions, and credits would increase 1984 tax revenues by $86 billion assuming present tax rates remained unchanged. On average, as a consequence of the increased exemptions and zero bracket amount, taxpayers with incomes below $20,000 would pay less tax than under present law. Above this level, average tax liabilities would increase by 13.4 percent for incomes of $25,000-$35,000, 38 percent for incomes of $50,000-$100,000, and 93 percent for incomes above $1,000,000 (table 4).

Table 5 shows the average rate changes possible under a comprehensive income tax while still maintaining the revenues yielded under present law and preserving the present distribution of tax burdens by income class. Rates below $20,000 would have to be increased, while those above $20,000 would be reduced. At the highest income level, rates could be approximately halved without altering average tax burdens.

Alternative Comprehensive Tax Plans

All or part of the increased revenue that would be collected under the comprehensive income tax can be viewed as a reserve to be used for general tax rate reductions. This section explores ways in which tax rates might be reduced and the implications of such reductions for the distribution of tax burdens at various income levels and for different types of filers.

To illustrate the ways a comprehensive income tax might be designed, six alternative tax plans are presented. Each of these plans, with the exception of plan six, will yield approximately the same amount of revenue that would be collected in 1984 under the Economic Recovery Tax Act of 1981. The rates were chosen to approximate the present law average effective tax rates in each income class above $20,000 as closely as possible.[6]

Descriptions of the base, deductions, and exemptions for the six tax plans are given in table 6, Table 7 describes the rate structures that would be used for each plan. Plan 1 is equivalent to the comprehensive tax plan previously described. The rate schedule for this plan would range from 9 percent on the first $5,000 of taxable income over the zero bracket amount to 28 percent for those with taxable income exceeding $70,000 (see footnote 5). This graduation is achieved in seven taxable income brackets. The zero bracket amount for plans 1 through 5 is $4,000.

Plan 2 is a flat rate plan with adjusted gross income, deductions and exemptions that are identical to plan 1. Since two-earner couples cannot be pushed into higher tax rate brackets after they marry, plan 2 has no two-earner deduction. The flat rate required to yield the same

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6. To keep taxpayers with incomes below the poverty line off the income tax rolls, the increase in personal exemptions plus the zero bracket amount below $20,000 was not offset by rate increases.

revenue as present law under plan 2 is 17 percent.

Plan 3 allows considerably more generous deductions, while maintaining the same adjusted gross income base as plans 1 and 2. In addition to medical expenses, casualty losses and interest paid deductions, plan 3 allows deductions for contributions, state and local property and income taxes, mortgage interest and child care.[7] The two-earner deduction is retained. Since total tax revenue is to be maintained and more generous itemized deductions are being allowed, marginal tax rates must be increased. The rate schedule for plan 3 ranges from 11 percent on the first $5,000 of taxable income above the zero bracket amount to 30 percent above $70,000. Again there are seven taxable income brackets.

Plan 4 reduces the AGI base further by continuing the exclusions for interest paid on all state and local bonds, social security benefits, workman's compensation and veteran's payments. Plan 4 has the same deductions and exemptions as does plan 3. Since the tax base is reduced by the more generous exclusions, the marginal rates for plan 4 are higher still. They range from 12 percent in the lowest taxable income bracket to 30 percent in the $50,000 and over bracket. This graduation is achieved in six taxable income brackets.

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7. The child care deduction is the same as the amount on which the child care credit under present law is based. Since a child care deduction is provided, the additional $1,750 exemption granted to heads of households in plans 1 and 2 is eliminated.

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Plan 5 has the same exemptions, deductions, and AGI base as plan 4, but it retains the present treatment of persons with different marital and family statuses. Thus plan 5 has four rate schedules - one each for married couples, single taxpayers, heads of households and married couples filing separate returns. The two-earner deduction is reduced to the present 10 percent of the earnings of the spouse with the lower earnings (with an earnings cap of $30,000). Each marginal rate schedule rises from 12 percent in the lowest bracket to 30 percent in the highest ($100,000 in the joint return schedule). This graduation is achieved in seven brackets.

Plan 6 reduces the AGI base further by retaining the present law exclusions for all savers certificates, investment in IRA and Keogh plans, and nonitemizers charitable contributions. It allows the same itemized deductions as plans 3, 4 and 5. Plan 6 provides a $1,500 taxpayer exemption and a $1,000 dependent exemption (and an additional $250 for heads of households), and has no special deduction for two-earner married couples. There is a two-tier rate structure: a rate of 14 percent applies to taxable income, and a surtax ranging from 6 to 14 percent applies to adjusted gross incomes. The surtax begins above $25,000 for single taxpayers and $40,000 for married couples. The zero bracket amount is $2,300 for single returns and $4,600 for joint returns.

The application of a surtax to adjusted gross income instead of taxable income under plan 6 means that the effect of the the personal deductions and exemptions would be partially eliminated for those subject to the surtax. In addition, the combined zero bracket amount and exemptions are not enough to insure that taxpayers with incomes below the poverty line will not pay tax in 1984. Finally, plan 6 yields $15.7 billion less revenue than does present law.[8]

Table 8 shows the effective rates of tax under present law and under each of the alternative tax plans. Plans 1, 3, 4, 5 and 6 generate effective rates in the various income classes that look very similar to the present rates, except for the lowest income classes where taxes are cut under plans 1, 3, 4 and 5 by the increased personal exemptions.

The flat tax plan, plan 2, is the least progressive of the tax plans by a wide margin and would generate much larger deviations of proposed tax burdens from present ones than any other plan. On average, the effective rates of tax would be higher under plan 2 than under present law for all income classes between $10,000 and $50,000. Those at the highest income levels would enjoy substantial savings.

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8. Plan 6 has been proposed by Senator Bill Bradley of New Jersey and Congressman Richard A. Gephart of Missouri. The shortfall in individual income tax revenue under this plan would be recovered by developing a special tax on pension funds or by changes in the corporate tax.

For example, under present law the average tax paid by taxpayers with incomes between $500,000 and $1,000,000 is approximately $175,000; under plan 2 the average for this income group falls to 105,000, a reduction in tax liability of almost 40 percent. For taxpayers with incomes of $1,000,000 or more, the average tax reduction is $153,000, or about 30 percent (table 9).

Even when coupled with substantial rate reductions, comprehensive tax revisions of the type discussed in this paper would increase the tax burdens of taxpayers who benefit from preferential provisions under present law while reducing the tax burdens of those who do not benefit from them. Tables 10 through table 15 give detailed estimates of the percentage and magnitude of the tax changes under these comprehensive tax proposals, by marital status and income classes. In all plans, except the flat tax plan, 75-80 percent of the taxpayers would have tax cuts or tax increases of less than $100 or less than 10 percent of their previous tax liability. Plan 2 would raise the tax liability more than 10 percent and more than $100 for almost 40 percent of the taxpayers. As mentioned earlier, these tax increases would fall disproportionately on taxpayers earning less than $50,000.

Under most plans (the flat tax excluded), average tax liabilities of single people will fall, while average tax liabilities of married couples (especially one earner couples) will rise. But plan 5 results in significantly less redistribution among different marital statuses than do the other plans. This is a consequence of the retention of the present law rate schedules for each marital status in plan 5. Since it generates $15.7 billion less revenue than the other plans, plan 6 would on the average reduce taxes in all income classes except the $1,000,000 and over class and the $5,000-$15,000 class and for every marital status except heads of households.

Summary

If unnecessary exclusions, deductions and exemptions were removed from the federal individual income tax, tax rates could be reduced by an average of 22 percent in 1984, while exempting all individuals and families with incomes below the poverty line. Depending on the definition of income and the choice of deductions, a graduated rate structure that ranged from 9-12 percent to 28-30 percent would closely reproduce the present distribution of tax burdens. However, the flat tax would do considerable violence to the distribution of tax burdens. It would reduce average tax liabilities for all income classes over $50,000 and increase average tax liabilities below $50,000. At the very top of the income scale, the flat tax would reduce average tax liabilities by 30 to 40 percent. All the plans would increase horizontal equity, simplify the tax law, and ease compliance and administration.

Table 1. Distribution of Expanded Adjusted Gross Income and Federal Individual Income Tax by Income Classes, 1984

Dollar amounts in millions

		Individual income tax	
Expanded AGI class[1]	Expanded AGI[1]	Amount	Percent of Expanded AGI
$0-5,000	$33,331	$247	0.7
5,000-10,000	96,747	3,890	4.0
10,000-15,000	166,791	10,032	6.0
15,000-20,000	206,256	15,906	7.7
20,000-25,000	220,917	20,016	9.1
25,000-35,000	483,559	48,192	10.0
35,000-50,000	603,939	68,974	11.4
50,000-100,000	538,433	83,573	15.5
100,000-500,000	220,638	50,838	23.0
500,000-1,000,000	18,979	5,006	26.4
1,000,000 and over	21,869	5,042	23.1
All Classes[2]	2,598,465	311,742	12.0

1) As defined in Plan 1, Table 1

2) Includes negative adjusted gross incomes

Table 2. Adjusted Gross Income, Taxable Income, and Tax Liability Under Present Law and Under a Comprehensive Income Tax, 1984

In millions

Item	Adjusted Gross Income	Taxable Income[1]	Tax Liability[2]
Present law	$2,308,304	$1,547,338	$311,742
Plus:			
Personal exemptions[3]	---	-154,691	-32,951
Personal deductions[4]	---	158,406	63,581
Excluded capital gains	54,041	51,502	19,740
Transfer payments[5]	127,679	112,817	24,298
Insurance[6]	63,504	61,839	17,711
Dividend exclusion	2,049	1,979	599
Other items[7]	15,557	14,398	4,480
Two-earner deduction[8]	27,331	27,158	7,794
Equals: Expanded AGI	2,598,465	1,820,746	416,994
Plus:			
Comprehensive law two-earner deduction[9]	-69,300	-68,841	-19,596
Equals: AGI under Comprehensive law	2,529,165	1,751,905	397,398

1. Does not include zero bracket amounts

2. Under present rates

3. Increased exemptions described in Plan 1, Table 6

4. Includes the effects of eliminating the deductions for state and local taxes, charitable contributions, interest paid in excess of investment income, and medical expenses and casualty losses below 10 percent of income. The zero bracket amount was also increased to $4,000.

5. Transfers include 50 percent of social security benefits, workman's compensation, unemployment benefits and veteran's payments.

6. Includes interest on life insurance policies, one-third of employer provided health insurance and all of employer provided life insurance.

7. Includes state and local bond interest, accelerated depreciation, depletion, sick pay, all savers interest, and nonitemizers charitable contributions.

8. 10 percent of the earnings of the lower earning spouse.

9. 25 percent of the earnings of the lower earning spouse (Plan 1, table 6).

Table 3. Change in the Tax Base Under a Comprehensive Income Tax, by Income Classes, 1984

Dollar amounts in millions

Expanded AGI class[1]	Taxable income: Comprehensive law[1]	Taxable income: Present law	Change in taxable income[2]	Percent distribution of change[2]	Percent change in taxable income[2]
$0-5,000	$36	$2,163	-$2,127	-1.0	-98.3
5,000-10,000	16,900	31,396	-14,496	-7.1	-46.2
10,000-15,000	68,247	75,193	-6,946	-3.4	-22.1
15,000-20,000	109,614	111,422	-1,808	-0.9	-1.6
20,000-25,000	133,395	130,772	2,623	1.3	2.0
25,000-35,000	317,868	294,326	23,542	11.5	8.0
35,000-50,000	435,393	375,305	60,088	29.4	16.0
50,000-100,000	435,468	355,351	80,117	39.2	22.5
100,000-500,000	196,502	149,371	47,131	23.0	31.6
500,000-1,000,000	17,692	11,497	6,195	3.0	53.9
1,000,000 and over	20,790	10,542	10,248	5.0	97.2
All Classes[3]	1,751,905	1,547,338	204,567	100.0	13.2

1. As defined in Plan 1, Table 6

2. Reductions result from the increase in personal exemptions

3. Includes negative adjusted gross incomes

Table 4. Tax Liabilities Under Present Law and Under a Comprehensive Income Tax, by Income Classes, 1984

Dollar amounts in millions

	Tax liability				
Expanded AGI class[1]	Comprehensive tax[1]	Present law	Change in tax liability[2]	Percentage distribution of tax change[2]	Percentage change in tax liability[2]
$0-5,000	$4	$247	-$243	-0.3	-98.4
5,000-10,000	2,027	3,890	-1,863	-2.5	-47.9
10,000-15,000	9,052	10,032	-980	-1.1	-9.8
15,000-20,000	15,743	15,906	-163	-0.2	-1.0
20,000-25,000	20,836	20,016	820	1.0	4.1
25,000-35,000	54,637	48,192	6,445	7.5	13.4
35,000-50,000	87,210	68,974	18,236	21.3	26.4
50,000-100,000	115,013	83,573	31,440	36.7	37.6
100,000-500,000	74,923	50,838	24,085	28.1	47.4
500,000-1,000,000	8,199	5,006	3,193	3.7	63.8
1,000,000 and over	9,753	5,042	4,711	5.5	93.4
All Classes[3]	397,398	311,742	85,656	100.0	27.5

1. As defined in Plan 1, Table 6

2. Reductions result from the increase in personal exemptions

3. Includes negative adjusted gross incomes

Table 5. Average Tax Rate Changes Possible to Maintain a Constant Yield Under a Comprehensive Income Tax, by Income Classes, 1984

Dollar amounts in millions

	Tax liability		
Expanded AGI class[1]	Comprehensive tax	Present law	Average rate reduction possible (percent)
$0-5,000	$4	$247	-6075.0
5,000-10,000	2,027	3,890	-91.9
10,000-15,000	9,052	10,032	-10.8
15,000-20,000	15,743	15,906	-1.0
20,000-25,000	20,836	20,016	3.9
25,000-35,000	54,637	48,192	11.8
35,000-50,000	87,210	68,974	20.9
50,000-100,000	115,013	83,573	27.3
100,000-500,000	74,923	50,838	32.1
500,000-1,000,000	8,199	5,006	38.9
1,000,000 and over	9,753	5,042	48.3
All Classes[2]	397,398	311,742	21.6

1. Expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

Table 6. Alternative Tax Plans

	AGI	Deductions	Exemptions	Other Deductions	Rates
Plan 1	Expanded AGI[1]	Medical and casualty in excess of 10 percent of AGI, miscellaneous itemized deductions, interest not to exceed investment income	$1,750 per capita plus an additional $1,750 for heads of households	25 percent of earnings of spouse with lower earnings (earnings up to $50,000)	9 to 28 percent, $4,000 zero bracket amount
Plan 2	Same as Plan 1	Same as Plan 1	Same as Plan 1	None	17 percent, $4,000 ZBA
Plan 3	Same as Plan 1	Contributions, state and local property and income taxes, medical in excess of 10 percent of AGI, child care, mortgage interest, nonmortgage interest not to exceed investment income, miscellaneous itemized deductions	$1,750 per capita	Same as Plan 1	11 to 29 percent, $4,000 ZBA
Plan 4	Plan 1 excluding state and local bond interest, social security benefits, workman's compensation and veterans payments	Same as Plan 3	Same as Plan 3	Same as Plan 1	12 to 30 percent, $4,000 ZBA
Plan 5	Same as Plan 4	Same as Plan 3	Same as Plan 3	Plan 1 at 10 percent with earnings cap of $30,000, same as present law	12 to 30 percent, $4,000 ZBA, 4 schedules
Plan 6	Plan 4 plus present IRAs, all savers and charitable exclusions	Same as Plan 3	$1,500 for taxpayer $1,000 for dependent, and an extra $250 for heads of households	None	14 to 28 percent, $4,600 ZBA for joint returns and $2300 for single returns

1. Expanded AGI is adjusted gross income as defined in the Internal Revenue Code modified to include sick pay, all savers interest, nonitemizers charitable contributions, excludable dividends, interest on life insurance, excluded capital gains, all unemployment benefits, state and local bond interest, 50 percent of social security benefits, workman's compensation, veterans payments, tax preferences reported on the minimum tax form, one-third of employer provided health insurance, employer provided life insurance, 1981 IRA provision rescinded.

Table 7. Present Marginal Tax Rate Schedule and Schedules for Alternative Comprehensive Tax Plans by Taxable Income Classes

Present law: Taxable income [1]	Present law: Rates [2]
$0-2,100	.11
2,100-4,200	.12
4,200-8,500	.14
8,500-12,600	.16
12,600-16,800	.18
16,800-21,200	.22
21,200-26,500	.25
26,500-31,800	.28
31,800-42,400	.33
42,400-56,600	.38
56,600-82,200	.42
82,200-106,000	.45
106,000-159,000	.49
159,000 and over	.50

Taxable income [1]	Plan 1 Rates [3]	Plan 2 Rates [3]	Plan 3 Rates [3]	Plan 4 Rates [3]	Plan 5 Rates [2]
$0-5,000	.09	.17	.11	.12	.12
5,000-10,000	.15	.17	.16	.16	.15
10,000-20,000	.18	.17	.19	.20	.19
20,000-30,000	.21	.17	.21	.23	.22
30,000-50,000	.24	.17	.26	.28	.24
50,000-70,000	.26	.17	.28	.30	.27
70,000-100,000	.28	.17	.30	.30	.27
100,000-150,000	.28	.17	.30	.30	.30
150,000 and over	.28	.17	.30	.30	.30

Plan 6 [4]

Basic tax: 14%

Surtax for joint returns: [5]

$40,000-55,000	6%
$55,000-65,000	11%
$65,000 and over	14%

1. Taxable income above the zero bracket amount
2. Schedule for married persons filing joint returns. Separate schedules apply to single persons and heads of households.
3. One rate schedule used by all taxpayers. Married couples with two earners receive a deduction of 25 percent of the lower earner's earned income (see Table 1).
4. Basic tax applies to taxable income above zero bracket amount; surtax applies to adjusted gross income
5. Surtax applies to adjusted gross income. Surtax for single persons begins at $25,000 with the same bracket sizes and rates as the surtax for joint returns.

Table 8. Effective Tax Rates Under Present Law and Under the Comprehensive Income Tax Using Alternative Plans, by Income Class, 1984

Rates in percent

		Plan[1]					
Expanded AGI class[2]	Present law	1	2	3	4	5	6
$0-5,000	0.7	0.0	0.0	0.0	0.0	0.0	0.6
5,000-10,000	4.0	1.6	3.0	1.9	1.7	1.7	4.3
10,000-15,000	6.0	4.2	7.1	4.9	4.2	4.5	6.2
15,000-20,000	7.7	6.5	9.2	7.2	6.4	6.8	7.7
20,000-25,000	9.1	8.3	10.6	8.9	8.4	8.8	8.7
25,000-35,000	10.0	10.0	11.8	10.4	10.3	10.6	9.8
35,000-50,000	11.4	12.4	13.0	12.3	12.5	12.6	10.9
50,000-100,000	15.5	16.3	14.2	15.8	16.4	15.5	14.1
100,000-500,000	23.0	22.1	15.4	21.2	21.6	20.6	21.0
500,000-1,000,000	26.4	25.4	15.9	24.1	24.2	24.0	24.5
1,000,000 and over	23.1	26.4	16.2	24.7	24.7	24.7	25.3
All Classes[3]	12.0	12.0	11.9	12.0	12.0	11.9	11.4

1. As defined in Table 6

2. As defined in Plan 1, Table 6

3. Includes negative adjusted gross incomes

Table 9. Total and Average Tax Liabilities Under Alternative Comprehensive Income Tax Plans, by Income Classes, 1984

Total liability amounts in millions

	Tax liability							
Expanded AGI class[1]	Total	Average	Total	Average	Total	Average	Total	Average
	Present law		Plan 1		Plan 2		Plan 3	
$0-5,000	$247	$20	$3	$0	$6	$1	$4	$0
5,000-10,000	3,890	301	1,538	119	2,886	223	1,870	145
10,000-15,000	10,032	750	7,079	529	11,770	880	8,246	617
15,000-20,000	15,906	1,342	13.397	1,130	19,068	1,609	14,878	1,255
20,000-25,000	20,016	2,034	18,324	1,862	23,418	2,380	19,756	2,008
25,000-35,000	48,192	2,968	48,390	2,981	56,902	3,505	50,412	3,105
35,000-50,000	68,974	4,736	74,976	5,148	78,371	5,382	74,235	5,098
50,000-100,000	83,573	9,902	87,918	10,416	76,492	9,063	84,897	10,058
100,000-500,000	50,838	36,679	48,802	35,210	34,043	24,562	46,724	33,711
500,000-1,000,000	5,006	174,039	4,825	167,736	3,023	105,105	4,576	159,096
1,000,000 and over	5,042	513,605	5,777	588,489	3,538	360,423	5,409	551,009
All Classes[2]	311,742	3,073	311,029	3,066	309,517	3,051	311,007	3,066
	Plan 4		Plan 5		Plan 6			
$0-5,000	$4	$0	$0	$0	$184	$15		
5,000-10,000	1,660	128	1,657	128	4,178	323		
10,000-15,000	6,942	519	7,512	562	10,376	776		
15,000-20,000	13,159	1,110	14,103	1,190	15,839	1,336		
20,000-25,000	18,593	1,890	19,521	1,984	19,267	1,958		
25,000-35,000	49,733	3,063	51,491	3,171	47,230	2,909		
35,000-50,000	75,528	5,186	76,309	5,240	65,941	4,528		
50,000-100,000	88,193	10,449	83,503	9,893	75,943	8,998		
100,000-500,000	47,731	34,438	45,450	32,792	46,392	33,471		
500,000-1,000,000	4,592	159,636	4,547	158,065	4,658	161,955		
1,000,000 and over	5,411	551,196	5,394	549,493	5,539	564,237		
All Classes[2]	311,545	3,071	309,486	3,051	295,549	2,913		

1. As defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

Table 10. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 1, 1984

Marital Status or income group[1]	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
	Percentage	Average amount	Percentage	Average amount	Percentage	Average amount	Average amount
Single Individuals	15.5	$1,038	34.8	-$15	49.6	-$551	-$117
Heads of Households	9.4	1,512	26.3	-25	64.3	-677	-299
Married Couples	33.1	1,549	33.8	-51	33.0	-1,175	108
One Earner	39.6	1,643	33.8	-13	26.6	-1,303	299
Two Earner	27.9	1,442	33.9	-82	38.2	-1,103	-47
$0-5,000	0.0	0	91.4	-9	8.6	-137	-20
5,000-10,000	8.9	208	26.5	6	64.5	-313	-182
10,000-15,000	23.8	377	9.5	-15	66.7	-463	-221
15,000-20,000	28.2	559	7.6	-18	64.1	-574	-212
20,000-25,000	27.9	720	15.0	-16	57.1	-648	-172
25,000-35,000	30.8	973	30.8	-38	38.4	-717	12
35,000-50,000	40.5	1,403	44.5	-28	14.9	-963	412
50,000-100,000	36.5	2,846	43.0	-121	20.3	-2,357	515
100,000-500,000	30.6	13,305	22.7	-655	46.7	-11,548	-1,468
500,000-1,000,000	41.4	62,239	10.3	-1,258	48.3	-69,394	-6,303
1,000,000 and over	60.0	234,396	10.0	-3,772	30.0	-211,868	74,884
All Classes[2]	24.5	1,410	33.7	-34	41.8	-816	-7

1. Incomes classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

Table 11. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 2, 1984

	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
Marital status or income group[1]	Percentage	Average Amount	Percentage	Average Amount	Percentage	Average Amount	Average Amount
Single Individuals	24.9	$784	41.7	-$41	33.4	-$441	$31
Heads of Households	17.7	834	31.5	-31	50.7	-604	-168
Married Couples	50.1	1,151	33.7	10	16.1	-3,890	-47
One Earner	43.5	1,227	36.1	-17	20.3	-3,834	-251
Two Earners	55.5	1,103	31.7	35	12.8	-3,961	118
$0-5,000	0.0	162	91.7	-9	8.3	-137	-20
5,000-10,000	18.4	300	20.5	-8	61.1	-215	-78
10,000-15,000	38.9	591	27.2	-60	32.9	-251	130
15,000-20,000	48.9	743	27.1	-52	24.0	-344	267
20,000-25,000	51.0	862	29.8	24	19.2	-524	346
25,000-35,000	60.2	1,020	30.8	-3	9.0	-848	536
35,000-50,000	53.6	1,374	37.5	68	8.9	-1,302	645
50,000-100,000	23.2	2,484	31.5	-173	45.3	-3,005	-839
100,000-500,000	16.4	6,664	8.0	-109	75.6	-17,457	-12,117
500,000-1,000,000	10.3	26,710	20.7	-2,361	69.0	-102,673	-68,934
1,000,000 and over	10.0	83,950	30.0	-8,473	60.0	-254,040	-153,181
All Classes[2]	37.6	1,040	37.0	-16	25.4	-1,602	-22

1. Incomes classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

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Table 12. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 3, 1984

	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
Marital status or income group[1]	Percentage	Average Amount	Percentage	Average Amount	Percentage	Average Amount	Average Amount
Single Individuals	17.9	982	39.4	-30	42.7	-483	-43
Heads of Households	9.8	1,326	28.1	-35	62.0	-613	-260
Married Couples	32.2	1,392	37.0	-16	29.4	-1,326	44
One earner	39.9	1,488	37.0	-16	23.1	-1,542	231
Two earners	25.9	1,273	39.6	-53	34.4	-1,208	-107
$0-5,000	0.0	105	91.4	-9	8.6	-136	-20
5,000-10,000	11.2	230	24.7	10	64.1	-287	-156
10,000-15,000	26.3	440	13.1	-6	60.6	-410	-134
15,000-20,000	30.4	639	13.4	-25	56.3	-493	-87
20,000-25,000	31.5	754	25.2	-61	43.3	-573	-26
25,000-35,000	34.1	927	41.1	-34	24.8	-666	137
35,000-50,000	37.3	1,303	49.7	-8	13.0	-927	361
50,000-100,000	27.9	2,837	46.5	-149	25.6	-2,216	157
100,000-500,000	25.9	13,645	16.2	-723	57.9	-11,015	-2,968
500,000-1,000,000	39.3	56,410	7.1	-1,721	53.6	-69,832	-14,943
1,000,000 and over	50.0	210,076	10.0	-4,079	40.0	-209,430	37,404
All classes[2]	25.0	1,265	38.2	-34	36.8	-844	-7

1. Incomes classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

Table 13. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 4, 1984

	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
Marital status or income group[1]	Percentage	Average Amount	Percentage	Average Amount	Percentage	Average Amount	Average Amount
Single Individuals	5.4	1,850	43.5	-15	51.0	-411	-156
Heads of Households	13.1	1,184	36.3	-9	50.6	-456	-79
Married Couples	29.9	1,375	43.2	-2	26.8	-1,188	92
One Earner	35.6	1,490	42.5	4	21.9	-1,353	235
Two Earners	25.3	1,243	43.8	-6	30.8	-1,093	-24
$0-5,000	0.0	0	91.5	-9	8.5	-136	-20
5,000-10,000	1.3	237	33.5	2	65.2	-270	-173
10,000-15,000	5.2	295	21.6	5	73.2	-338	-231
15,000-20,000	11.9	394	20.6	-12	67.4	-409	-232
20,000-25,000	20.5	508	32.2	-41	47.3	-498	-145
25,000-35,000	32.3	729	45.1	-7	22.6	-610	95
35,000-50,000	43.7	1,113	48.6	66	7.7	-883	450
50,000-100,000	33.9	2,608	52.5	-70	13.6	-2,205	547
100,000-500,000	27.0	13,725	19.5	-739	53.5	-10,843	-2,241
500,000-1,000,000	39.3	56,623	7.1	-2,002	53.6	-69,500	-14,403
1,000,000 and over	50.0	210,627	10.0	-3,927	40.0	-209,559	37,591
All classes[2]	18.9	1,416	43.0	-8	38.1	-697	-2

1. Increases classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negatice adjusted gross incomes

Table 14. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 5, 1985

	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
group[1]	Percentage	Average amount	Percentage	Average amount	Percentage	Average amount	Average amount
Single Individuals	11.4	1,139	42.1	8	46.5	-319	-15
Heads of Households	14.8	1,108	35.9	10	49.3	-444	-51
Married Couples	28.8	1,220	45.2	9	26.0	-1,436	-19
One earner	25.7	1,426	46.6	-10	27.7	-1,573	-73
Two earners	33.1	1,082	44.0	25	24.7	-1,312	25
$0-5,000	0.0	0	91.4	-9	8.6	-140	-20
5,000-10,000	1.4	193	32.7	4	65.8	-268	-173
10,000-15,000	10.8	222	15.7	0	73.5	-289	-188
15,000-20,000	18.4	345	17.8	-35	63.8	-328	-152
20,000-25,000	23.0	521	40.0	-45	37.0	-410	-50
25,000-35,000	36.3	728	47.9	47	15.7	-540	203
35,000-50,000	45.5	1,050	50.2	134	4.3	-955	504
50,000-100,000	22.4	2,765	53.4	-118	24.2	-2,337	-8
100,000-500,000	24.0	13,437	13.3	-630	62.6	-11,233	-3,887
500,000-1,000,000	39.3	55,496	7.1	-2,193	53.6	-70,451	-15,974
1,000,000 and over	50.0	209,427	10.0	-4,191	40.0	-210,516	35,888
All classes[2]	20.5	1,200	43.2	8	36.2	-751	-22

1. Incomes classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

Table 15. Changes in Tax Liability Under a Comprehensive Income Tax by Marital Status and Income Groups, Plan 6, 1984

	Increases of more than $100 and 10 percent		Changes of less than $100 or 10 percent		Decreases of more than $100 and 10 percent		
group[1]	Percentage	Average amount	Percentage	Average amount	Percentage	Average amount	Average amount
Single Individuals	14.2	890	69.4	-29	16.4	-699	-8
Heads of Households	25.3	863	65.9	-8	8.8	-624	159
Married Couples	20.7	1,237	43.2	-93	36.0	-1,486	-319
One earner	18.4	1,447	37.9	-73	43.7	-1,499	-417
Two earners	22.6	1,099	47.6	-106	29.8	-1,471	-240
$0-5,000	1.0	128	98.6	-6	0.4	-141	-5
5,000-10,000	10.6	338	82.5	-2	6.9	-175	22
10,000-15,000	24.7	293	57.6	-30	17.7	-167	26
15,000-20,000	27.5	376	38.3	-46	34.2	-267	-6
20,000-25,000	24.1	530	39.4	-63	36.5	-491	-76
25,000-35,000	24.9	712	45.4	-70	29.7	-690	-59
35,000-50,000	17.2	1,123	47.8	-138	35.0	-960	-208
50,000-100,000	14.6	3,142	26.0	-269	59.4	-2,178	-904
100,000-500,000	26.8	13,271	15.2	-659	57.9	-11,524	-3,208
500,000-1,000,000	41.4	56,131	10.3	-2,390	48.3	-72,839	-12,084
1,000,000 and over	60.0	207,109	10.0	-1,801	30.0	-221,433	50,632
All classes[2]	18.3	1,093	55.2	-53	26.4	-1,254	-160

1. Incomes classified by expanded adjusted gross income as defined in Plan 1, Table 6

2. Includes negative adjusted gross incomes

STATEMENT OF RUDOLPH G. PENNER, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, D.C.

Senator LONG. Mr. Penner.

Mr. PENNER. Thank you very much, Mr. Chairman. I'm grateful for this opportunity to testify.

I interpret the discussion about flat taxes as indicating a profound dissatisfaction with the complexity of our current tax system. And I am delighted that this debate is occurring because we shall have a pressing need for new revenues over the next few years. I hope that the fundamental issues raised by the flat debate will lead us to raise those revenues in an efficient, equitable and simplified manner.

I would like to select only a few issues for discussion this morning. Others are noted in my prepared testimony.

In moving toward fundamental tax reform one of the first issues that we have to consider is what do we want as the base of our tax system. Should it be consumption? Should it be income?

There are, I think, both philosophical and pragmatic reasons for favoring consumption. Hobbes made the point many years ago that it is fairer to tax people on what they extract from our society as is roughly measured by their consumption, as opposed to what they contribute to our society, which is very roughly measured by their income.

But pragmatically, I think that consumption taxes lead to great simplification. One of the great problems of our system as it exists today in an inflationary environment is that it is extremely difficult to measure the return to income from capital accurately. Inflation erodes depreciation allowances, creates false capital gains in equity and inventories and so on. And, of course, makes nominal interest rates far too high as a measure of income, whether they are deducted by borrowers or added to taxable income by a lender.

Theoretically you could solve all of these problems with some sort of complicated indexing scheme, but it would be so complex as to be not practical in my view.

The other issue that I think we have to confront is how progressive should our tax system be. It's a bit curious that the term "flat tax" these days is being applied to systems of various degrees of progressivity. But I think the main point to be made is whatever your political values with regard to progressivity and redistribution, we do not need the huge number of narrow tax brackets that we have today to attain today's effective degree of progressivity. Indeed, it could be very closely approximated with three brackets. Widening the brackets, I think, is a very important thing to do because it reduces a large number of problems. It does not eliminate them, but it does ameliorate problems like those raised by the marriage penalty. It makes averaging less of a problem. It makes lumpy capital gains less of a problem. So I believe that if the only thing that came out of the flat-tax debate was a significant widening of the brackets, it would have served a very useful purpose.

One of the issues we must confront in tax reform—and I would like to see more public debate on it—is how we treat families of different size. In the time since World War II, there has been rather dramatic changes in our tax system in a direction that treats large families less and less generously relative to small families. Now having an average family myself, I don't have strong feelings one way or another on the issue. But it is curious to me that this rather fundamental change in values has occurred without public debate.

But as we talk about tax reform, I think the very most important point was the one emphasized by Mr. Pechman. That is to say, as we search for revenues over the next few years, it will be far superior to search for those revenues by finding ways of broadening the tax base. Whether we are talking about consumption as the base or income as the base, the main point is that high marginal tax rates create inefficiencies in our economy. The inefficiencies are more severe if a complex series of deductions, exclusions and so on means that the marginal rates on different activities differ greatly. So as we search for revenues, the general principle, of course, should be that we should go for base broadening measures as opposed to marginal tax rate increasing measures.

Thank you very much.

Senator LONG. Thank you.

[The prepared statement of Rudolph G. Penner follows:]

THE FLAT TAX

RUDOLPH G. PENNER
American Enterprise Institute

I would like to thank the committee for this opportunity to testify.

The testimony reflects my own personal opinions and does not necessarily reflect the views of the staff, advisory panels, officers, or trustees of the American Enterprise Institute.

I have analyzed what I regard to be the main issues in the flat tax debate in the accompanying article, "The More or Less Flat Tax" and I would like to submit it for the record.

the AEI economist

American Enterprise Institute for Public Policy Research

August 1982

The More or Less Flat Tax

Rudolph G. Penner

Introduction

The other day I heard a politician say that he strongly favored a "progressive, flat tax." I was not sure whether he was intent on murdering our language or our tax system. The latter may be a noble goal, but the truth is that the term "flat tax," which has recently become as popular as motherhood, is being used to describe a great variety of very different tax proposals put forth by individuals with very different goals and ideologies.

Nevertheless, our tax system is badly in need of reform, and though the debate over a flat tax is confusing, it is one of the most healthful to occur in decades of continual discussions of tax policy. Although the various proposals differ radically, they all share a few crucially important characteristics. All would reduce the large number of deductions, credits, and special exemptions that now riddle our income tax system and make it incomprehensible to most taxpayers. This would greatly expand the tax base and thereby allow a significant reduction in marginal tax rates without losing revenue for the government.

The Current Income Tax System

There was a time when public opinion polls showed that taxpayers felt that the property tax was our "most unfair" tax. Recently, it has lost its title to the income tax. That is disturbing because the personal income tax is the most important revenue source for the federal government, contributing over 45 percent of total revenues in 1982. Moreover, the normative notion that tax burdens should vary with income has long been widely accepted by tax theorists. It has only recently been challenged in a major way by a few who would substitute consumption for income as our main tax base. Certainly, consumption tax proponents have not yet made a major impact on public opinion, and the unpopularity of the present income tax is not explained by a desire to replace income as the major base of taxation.

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Public opinion polls are not good at uncovering explanations for their results, and I can only speculate about the reasons for the revolt against the income tax. It is probably significant, however, that a growing number of deductions and exemptions has created an enormous discrepancy between definitions of income that would typically be used by economists—or laymen, for that matter—and the definitions used for income tax purposes.

Personal income as defined in the national income accounts is not exactly the income concept that would be used in a true income tax system (because, among other things, it excludes capital gains), but it provides a readily available, reasonably accurate standard for making comparisons with the base of the present income tax. In 1982, personal tax liabilities will equal only about 11 percent of total personal income despite marginal tax rates ranging from 12 to 50 percent. The reason for this apparent anomaly is that adjusted gross income (AGI), the income concept appearing in tax law, will equal only about three-quarters of personal income. Taxable income, the tax base remaining after exemptions and deductions are subtracted from AGI, is, in turn, only about three-quarters of AGI, or less than 60 percent of total personal income.

The gap between the income concepts used for tax purposes and a concept appropriate for measuring economic well-being not only is very large, it also varies greatly among individuals with the same income and among individuals with different incomes. Of course, some of the gap between economic income and AGI

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was created in the name of fairness. Legislators considered it appropriate to deduct things like moving expenses and alimony payments in computing AGI. But other important exclusions were created originally for administrative convenience, such as the social security exclusion, and others were created to get people to do "good" things, such as save for their retirement. When everything is added up, the link between any fair concept of income and AGI becomes quite obscure, and it is understandable that fairness is no longer considered to be a characteristic of the tax system.

There are many other important problems. The design of the current system makes it look as though we could never make up our minds about the desirability of progressivity. If one looks only at the rate structure, the system appears to be highly progressive. Rates extend from 12 percent at low income levels to 50 percent at the top. Generous exemptions and a zero bracket also add greatly to the progressivity of the system in the lower half of the income distribution, and we even have a small negative income tax for wage-earning families with children. The exclusions, tax shelters, and deductions that riddle the tax system are, however, used to a greater degree by the upper-income groups than by the lower-income groups even though all have access to some benefits. The net result is that effective tax rates rise much more slowly with income than would be expected if one looks only at the rate structures. This is true on the average, though many upper-income people pay the tax the rate schedule suggests.

To some degree this reflects political hypocrisy. We pretend to have a more progressive system than actually exists. But it also reflects some ambivalence toward the notion that income should be the main tax base. Many of the so-called loopholes involve capital income of one kind or another, and upper-income groups receive relatively more of their income from capital. Special provisions reducing burdens on capital income would not be called loopholes if consumption was the main tax base. Many experts think that consumption would, in fact, be a fairer and more efficient base. Consumption is a better measure of immediate well-being, and a consumption tax would act as less of a deterrent to saving and investment. Our system has been moving rapidly to exclude more and more capital income, and one might say that we were moving rapidly toward a consumption base except that there has been no significant attempt to tax a higher proportion of the consumption that is now excluded, for example, that financed by untaxed transfer payments such as social security.

The best one can say about the system is that it is a hodgepodge. What's more, it is an incomprehensible hodgepodge. Few understand why they bear the exact tax burden that emerges once they complete their returns, but they do understand that whatever the burden, it can be either less or greater than that faced by others who appear to be of equal economic status.

Where individuals have some choice over the forms in which they receive income, few actions are taken without considering the tax consequences. An enormous amount of creativity is devoted to minimizing tax burdens, but even in those rare cases in which fairly well off people avoid taxation altogether, they do not avoid being burdened by the tax system. It costs money to avoid taxes. The costs go far beyond the fees paid to lawyers, tax-shelter syndicators, and accountants. A tax-avoiding investor must often accept undesirable investments with high risk and low expected rates of return. No one would contemplate such investments in the absence of the tax system.

Perhaps the worst result of allowing so much income to escape taxation is that very high tax rates have to be applied to the taxable income that remains. Since people who get most of their income from wages usually find it difficult to exploit special tax advantages, work effort is especially discouraged. Some capital income bears a very high positive tax rate, such as the return to an investment in stock, which bears both corporate and personal income tax burdens; some bears a zero tax rate, such as municipal bonds; and some bears a negative tax rate, such as the typical tax shelter in oil drilling or rental housing. As a result, the allocation of our capital stock becomes enormously inefficient.

Marginal tax rates not only are high, but now rise quickly as income rises because the real value of the width of tax brackets has been allowed to shrink significantly over time, as politicians were not willing to adjust fully for the inflation of the 1970s. This has intensified a number of problems that would be less severe with wider brackets. Our efforts to mitigate each of the problems have further complicated the system. A second earner in the family, for example, is likely to push the family into much higher marginal tax brackets, and the whole system often imposes a so-called marriage penalty; that is, married couples pay more than two single individuals earning the same aggregate income. We have responded with a new deduction for two-earner couples. It may be meritorious, but it greatly complicates tax forms without entirely solving the problem. The marriage penalty would still exist if tax brackets were wider, but in most cases it would be much less severe. The narrow brackets also intensify the tax penalty on those whose incomes vary from year to year. We have responded with income averaging, but the resulting special tax form almost defies human understanding.

The complexity, the high marginal rates, and the notion that the system is unfair undoubtedly encourage illegal tax evasion. Many believe evasion is growing rapidly. Reliable information on the issue is extremely difficult to gather, but if those hints of growing evasion are valid, the implications could be severe. Our system crucially depends on voluntary compliance. If that begins to break down, the system may become unstable. Once cheating attains a certain level, the whole system will quickly become completely unenforceable—a situation that now exists in many countries of the world.

Given the problems described above and many others that were not mentioned, it is little wonder that people are searching for a better system. The only surprise is how rapidly the notion of some sort of flat tax has become popular. A few months ago the term was seldom used. Now it is the talk of the country.

Flat Tax Proposals

There are now at least ten legislative proposals related to the flat rate. As already noted, they vary greatly, and some are anything but flat. Several of the proposals leave most of the design details to the secretary of the Treasury, so it is difficult to know what would eventually emerge.

Hardly any proposals coming from the Congress, academia, or concerned citizens impose an absolutely flat tax. Even the purest versions generally provide a generous basic exemption in order to ease the burden on low-income groups. Some variants would, however, be less progressive than today's tax system, while others, such as that introduced by Senator Bill Bradley and Representative Richard A. Gephardt, would have more than one tax bracket and would more or less duplicate the effective progressivity of the current system. In fact, the Bradley-Gephardt bill would somewhat increase tax burdens above $60,000 of income.

The purest flat tax proposals allow no deductions from income. Others, such as the Bradley-Gephardt bill, retain homeowner and charitable deductions in order to enhance their political appeal.

One of the most detailed pure proposals was designed by Alvin Rabushka and Robert Hall of Stanford University. All businesses would be treated alike whether corporate or noncorporate and would face a 19 percent tax on cash flow. All business costs would be deductible, including expenditures on investment. Interest would be considered a return to capital and would not be deductible. The individual would also face a 19 percent tax on all compensation for labor services after deducting a $5,000 exemption for married couples, $3,000 for singles, and $600 for each dependent. The receipt of interest, dividends, and capital gains would not be taxed at the individual level, since business income was already taxed once. The complete system is equivalent to a somewhat progressive wage or compensation tax because of the ability to expense capital investment. Expensing makes the before- and after-tax rates of return to capital equal if tax rates remain constant over the life of the investment. Every $100 of investment reduces tax liabilities by $19. In essence government pays 19 percent of the cost of the equipment, but then gets back 19 percent of the return when it levies future taxes. The investor bears 81 percent of the after-tax cost of the investment and receives 81 percent of the proceeds. Pension contributions by the employer or employee are part of taxable income; that is, they are paid out of after-tax income, but withdrawals from the system and the return to pension investments are not taxed. With tax rates constant over time, this is equivalent to allowing the deduction of pension contributions but then taxing withdrawals when they occur. In both cases before- and after-tax rates of return to contributions are equal. Social security would be treated as though it was a private pension plan.

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The wage or labor compensation tax favored by Hall and Rabushka is very similar to a consumption tax. In fact, if all labor income is consumed and all capital income is saved, wage and consumption taxes are identical. Although this assumption does not hold exactly, there are strong tendencies in that direction.

Issues Raised by a Flat Tax

Income versus Consumption as the Tax Base. As previously noted, a growing number of tax experts favor basing the tax system on consumption rather than on income. As Hobbes noted three hundred years ago, it seems fairer to tax people on what they withdraw from the common resources pool, as is roughly measured by their consumption, than to tax them on their contribution to the pool, as is roughly measured by their income. A consumption tax would also be more favorable to savings and investment than an income tax, and at first sight, it appears to be more efficient. That is not absolutely certain, however, because it is not known whether a consumption or an income tax interferes more with work effort.

"Most observers believe, however, that if a flat rate system is to have any chance of political success, homeownership deductions must remain. This is unfortunate. It is hard to think of any good economic reasons for such deductions, and, in fact, favoring housing over business investment greatly distorts the allocation of the nation's capital stock."

Perhaps the most persuasive pragmatic argument for consumption taxation pertains during periods of significant inflation. In the presence of inflation it is virtually impossible accurately to measure the income from capital. Interest rates embody inflationary premiums that do not reflect true income for lenders or appropriate deductions for borrowers because they only compensate for the erosion in real value of those debt instruments denominated in money terms. Similarly, inflation erodes the value of depreciation allowances based on original cost and creates false capital gains on inventories and equity investments. In theory, these problems can be handled through indexing, but the resulting tax system would be so complex as to be impractical.

Many worry, however, that consumption taxation would result in the accumulation of great quantities of wealth by high-income groups. Some, who nevertheless favor the consumption tax for pragmatic and efficiency reasons, believe that it should be accompanied by significant wealth, gift, and inheritance taxes. Depending on the nature of those taxes, the system could then become much more complicated and less conducive to savings and investment.

Although a consumption tax is very similar to a wage tax in its effects on resource allocation and income distribution, a consumption tax probably has more appeal politically, for it appears to be more equitable. The Hall-Rabushka labor compensation tax could be easily converted into a consumption tax with very few modifications.

Marital Status and Family Size. Since all flat tax systems involve some type of significant basic exemption, it is necessary to decide how to treat married couples, heads of households, singles, and dependents. Some marriage penalty remains under the Hall-Rabushka plan because married couples receive a basic allowance of $5,000 while two single people filing separately would each get $3,000. But because all pay the same low marginal tax rate, the marriage penalty does not create the same work disincentives for secondary workers that the current system creates. Under the Hall-Rabushka variant, married couples could be allowed to file separately, but then multi-worker families would pay less tax than single-worker families with the same total income. The problem could be resolved by setting the single exemption at one-half the exemption for married couples. With only one tax rate, single individuals could no longer complain that they were being badly discriminated against vis-à-vis one-earner couples. That leaves open the question whether single heads of households should receive special status or should be treated like single individuals plus getting the standard exemption for dependents. Hall and Rabushka provide a basic allowance for heads of households only slightly lower than that given married couples.

The exemption provided for dependents is only $600 in the Hall-Rabushka system. Because that is lower than today's $1,000 exemption, larger families would bear a somewhat higher relative tax burden than they now do, all other things being equal. That would continue the trend that has prevailed since World War II of treating large families less and less generously. Whether this trend is appropriate is largely a matter of social values.

Simplicity. The greatest appeal of the flat tax is its simplicity. The elimination of deductions, exemptions, and special credits greatly shortens the tax form; makes taxpayer compliance simpler; and makes it easier to administer the system. Hall and Rabushka claim that their tax form would fit on a postcard. All of the laws governing corporations and capital gains could be eliminated, and with only a basic allowance and a single rate, there would be much less need to worry about things like averaging and reducing any marriage penalty that remained.

An income tax variant of the flat tax would, however, be considerably more complex than the Hall-Rabushka consumption variant. It would become necessary to define depreciation, inventory profits, and so forth, which could become very complicated if there was any attempt to adjust for inflation. With a single, low tax rate, it would, however, be less important to accord capital gains special treatment, and that whole complex body of tax law could be eliminated.

Although a flat tax system would be very much simpler than our present system, tax lawyers and accountants would not necessarily become extinct. There would still be plenty of problems. It would still be hard to differentiate between business expenses and personal consumption. The IRS would still have to decide how vigorously to pursue compensation paid in-kind through complex fringe benefit arrangements. It is crucially important to note, however, that taxpayers have much less incentive to game the tax system when they are faced only with a single, low marginal tax rate.

The Degree of Progressivity. All of the variants of the flat tax system now being proposed possess some degree of progressivity. Where there is only one tax bracket the progressivity comes from the basic allowances and exemptions. Under the Hall-Rabushka approach, for example, a couple with two children would face an average tax rate of 7.2 percent on $10,000 of wage income, a rate of 13.1 percent at $20,000, and a rate of 16.6 percent at $50,000. The rate gradually approaches 19 percent as income rises.

Additional progressivity can be obtained by adding a surcharge at high income levels or by having several tax brackets. Today's complex tax rate structure, however, with a multitude of brackets and rates, is not necessary to achieve today's level of progressivity. The U.S. Treasury's *Blueprints for Basic Tax Reform* (1977) showed that the distributional efforts of today's tax system could be obtained with basic allowances and only three very wide tax brackets as opposed to the twelve brackets now appearing on joint returns. As already noted, wider brackets greatly reduce the problems posed by averaging, lumpy capital gains, and the marriage penalty.

"Whatever happens to the rest of the tax system, the charitable deduction is likely to remain."

Some element of these problems remains, however, with more than one tax bracket. Further, with several brackets it is necessary to ask whether it is worth indexing the system to eliminate bracket creep. This question also applies to the basic allowances and exemptions in a single rate system, but with few brackets it becomes less important.

And, of course, the presence of several brackets with higher and higher marginal rates does create additional work disincentives in both the consumption and income variants of the system and savings and investment disincentives in the latter. The question of distribution versus efficiency is as old as the study of economics, and I shall not here pursue all of the scientific and philosophical questions raised in discussions of this trade-off. Applying the label "flat tax," however, to some highly progressive variations on the theme suggests that the American psyche is thoroughly ingrained with some notion of progressivity.

Deductions. It seems as inconsistent to discuss deductions in a flat rate system as it does to discuss progressivity. Most observers believe, however, that if a flat rate system is to have any chance of political success, homeownership deductions must remain. This is unfortunate. It is hard to think of any good economic reasons for such deductions, and, in fact, favoring housing over business investment greatly distorts the allocation of the nation's capital stock. This is true even under a consumption tax approach since business capital would face a zero tax while housing gets a negative tax or tax subsidy.

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But the politics of the issue are crystal clear. Out of 93 million returns filed in 1979, 26 million taxpayers itemized, and 21 million deducted home mortgage interest. While, at first sight, it may appear that homeowners using the deduction do not account for a large portion of the total, many nonitemizers are part-time workers with low income. Those who use the deduction tend to be in the solid middle class, which exercises enormous political clout.

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The issue of charitable deductions is harder to decide on its merits. While retaining this deduction constitutes a significant departure from the flat rate concept, it is generally agreed that charitable activities should be encouraged and that attempting to do this on the expenditure side of the budget would leave too much decision making in the hands of bureaucrats and politicians. Hence, whatever happens to the rest of the tax system, the charitable deduction is likely to remain.

Long-run Economic Impacts

Efficiency. Probably enough has been said about economic efficiency, but it is hard to emphasize the issue too strongly. High marginal tax rates or the taxes paid on *extra* work effort or savings are destructive of economic efficiency. Almost anything that can be done to broaden the tax base and lower those rates will be to the nation's benefit. Moreover, it is important that the taxpayer face the same marginal tax rates on different types of economic activity. Otherwise, effort is diverted from activities that are most productive from the point of view of the nation as a whole. Of course, such distortions have been rationalized in the past by the notion that private returns do not necessarily reflect the social worth of activities. I know of no tax expert, however, who thinks that we have generally done a good job of identifying activities with positive or negative social worth, and most would gladly scrap the current system in order to let private rewards prevail.

Because various investments and occupations are taxed so differently under the current tax system, a flat tax approach would involve a vast reallocation of the nation's resources. Our current system is so complex that it is impossible to forecast the characteristics of this reallocation with any certainty. This very fact will make people hesitant to adopt the new system. It is possible, however, to identify a few industries that receive especially generous tax incentives and that would almost certainly lose productive resources under a flat rate approach. These include oil drilling and other extractive activities, timber growing, and rental housing. Ordinary corporate activities that do not get special advantages should prosper with the elimination of double taxation. Among the occupations that would prosper from any reductions in progressivity are those with variable income and those that involve long periods of education but high income during shortened careers, such as medical specialties. People in such occupations tend to be heavy users of tax shelters, but, as noted earlier, tax shelters are often costly. High-income groups that receive most of their income in the form of wages would benefit relative to high-income capitalists since the latter now find it easier to avoid taxes.

Distribution of Income. The proponents of a single rate flat tax system face a difficult political situation. In each income class there would be some gainers and some losers. Those with many deductions would lose, and those with few deductions would gain. The typical plan involves tax increases on the majority of the middle class, though in most cases the increase would be fairly small. Of the small number of people with incomes above $100,000, the vast majority would receive large tax cuts.

The point is illustrated in figures 1 and 2, which consider joint returns and assume a flat rate of 20 percent on all AGI with a $5,000 basic allowance and a $600 exemption. Figure 1 considers the $20,000 to $30,000 income class in 1979. The bars illustrate the number of taxpayers paying different average tax rates. The wide range of average tax rates among taxpayers in similar circumstances provides evidence of the inequity prevalent in our current system. There are 12.7 million taxpayers in the income class. Fifty-seven percent of them face an average tax rate of 12 to 15 percent. In a flat rate system, over 80 percent would be concentrated in a similar range between 12.6 and 16.7 percent. The "typical" flat rate would be 15.3 percent based on $25,000 of income and 1.5 dependents. Under 1979 law, 80 percent in this class paid less than 15 percent of their income in taxes. Under a flat tax it would be highly unusual for a family in this income class to face an average tax rate less than 12 percent, but under 1979 law almost 40 percent of families had average rates below 12 percent. That is, almost 40 percent would pay more under the flat tax than they now do. Only 4 percent of the taxpayers paid over the 16.7 percent maximum tax possible under the flat rate.

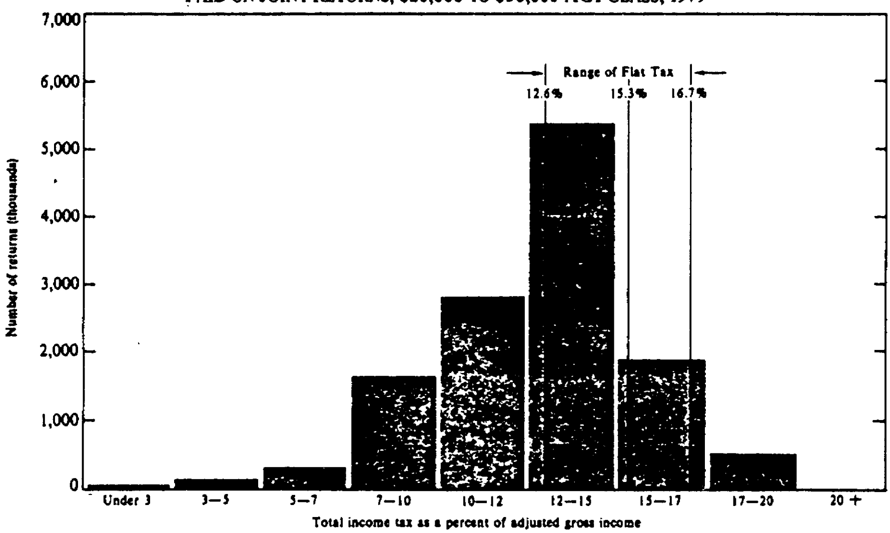
In contrast, figure 2 shows the situation facing those in the $100,000 to $200,000 income class. There are only 323,000 returns in this group. Over 90 percent would have paid more in 1979 than the maximum 19.5 percent possible under a flat rate. Almost 15 percent paid more than twice the maximum flat rate.

Of course, many who advocate a pure flat rate regard the progressivity of our current system as immoral and believe the general taxpayer would accept much less income redistribution. Moreover, they believe that efficiency gains would more than compensate the losers in the middle- and lower-income classes. It has never been easy to sell this trickle down theory, and it is not surprising that the flat rate proposals of moderate Democrats such as Bradley and Gephardt retain considerable progressivity and further protect the bulk of the middle class by retaining homeowner deductions. Nevertheless, I do not believe that one should completely rule out the possibility that the middle class would accept some tax increases in return for a much simpler system and one that treats equals more equally. Middle class taxpayers might even be convinced that considerable efficiency gains would follow, although they are undoubtedly too sensible to swallow the vastly exaggerated claims of the more enthusiastic supply siders.

Transition Problems

The overnight implementation of any of the flat tax proposals would seriously shock the economy as well as many individuals. Many, such as homeowners, have been induced to make certain investments by privileges under existing tax laws; if those privileges, which often imply negative tax rates, were eliminated, they would suffer substantial capital losses. Bankruptcies

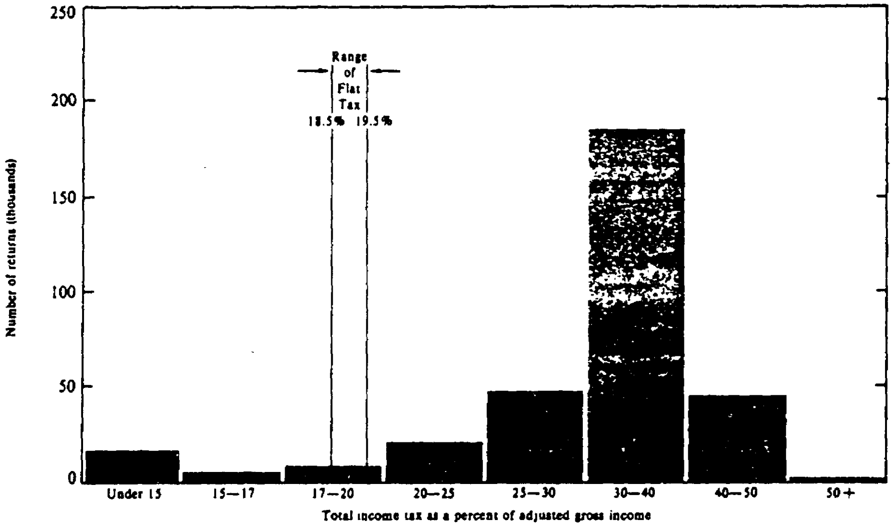
FIGURE 1: AVERAGE TAX RATES
PAID ON JOINT RETURNS, $20,000 TO $30,000 AGI CLASS, 1979



NOTE. The low end of the flat tax range assumes $20,000 of income and four dependents. The high end assumes $30,000 of income and no dependents. The range will include well over 80 percent of all taxpayers under the flat tax described in the text. Most taxpayers outside the range would pay less than 12.6 percent in taxes because they had more than four dependents or losses carried forward from previous years. The 15.3 percent rate is computed for $25,000 of income and the average of 1.5 dependents.

SOURCE. Internal Revenue Service, *Statistics of Income, 1979.*

FIGURE 2: AVERAGE TAX RATES
PAID ON JOINT RETURNS, $100,000 TO $200,000 AGI CLASS, 1979



SOURCE. Internal Revenue Service, *Statistics of Income, 1979.*

would soar among the losers. Other investors would find tax rates lowered considerably, and they would enjoy substantial gains.

The consumption variant of the flat tax creates other problems. In the Hall-Rabushka variant, it would be necessary to decide whether asset sales by businesses should be included in taxable cash flow even though they were purchased out of after-tax income under the old system. Theoretically such sales should not be taxed, but sales of assets where acquisition was deductible under the new law should be taxed. Thus, there should ideally be two classes of assets, and this complicates an otherwise simple system.

Many other problems would emerge, and I think it is clear that the new system would have to be phased in slowly. Phase-in rules are bound to be complex, and our tax system could become very much more complicated before it becomes simpler.

Conclusion

One has to be overjoyed that a tax reform as appealing as a movement toward a flat tax has become a matter of public debate. Such tax reform faces formidable political opposition from the myriad of special interest groups that gain from the inordinate complexity of the present system. Perhaps the strength of that opposition will be overwhelming, and there is little chance of major tax reforms in the foreseeable future. But if the debate does nothing more than nudge marginal tax reforms in the direction of broadening the tax base and lowering marginal rates, it will have provided an immensely valuable public service.

Our tax system, however, has become a mess because politicians wanted to do all things for all people. There are few of us who do not benefit from one special provision or another. It may be time to make a deal. We might all agree to give up our special advantages in the interest of obtaining a more simple, efficient, and equitable system. We know that there will be net winners and losers, but one advantage of having a hopelessly complex system is that we are not sure who they will be. Tax reform might be sold as a giant lottery that, unlike most lotteries, is clearly a positive sum game.

STATEMENT OF ROBERT E. HALL, PROFESSOR, DEPARTMENT OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CALIF.

Senator LONG. Next we will hear from Mr. Robert Hall from Stanford, Department of Economics, Ph. D., and professor, senior fellow at the Hoover Institution, Stanford, Calif. A very fine organization.

Mr. HALL. Thank you, Mr. Chairman.

Alvin Rabushka and I are the authors of what we believe to be the only fully developed flat tax proposal. We see hundreds of remarks to the effect that there are numerous flat tax proposals circulating in Washington, but I think it is fair to say that there are only two fully developed proposals in circulation today. One is the Hall-Rabushka plan, and the other is Bradley-Gephardt, which is fully developed but is not a flat tax, as Senator Bradley would be the first to tell you.

Senator LONG. Senator Bradley, did you hear what he said?

[No response.]

Senator LONG. Say that again. [Laughter.]

Say it again.

Mr. HALL. In my mind, there are two well-developed tax reform proposals circulating in Washington. One is the Hall-Rabushka plan and the other is the Bradley-Gephardt. The Bradley-Gephardt, although it is fully developed, is not a flat tax.

Senator BRADLEY. That's right. [Laughter.]

Mr. HALL. The statement that I have submitted gives extensive details about the proposal, and I will not attempt to summarize them. I have circulated our two tax forms, each on a post card—the business tax form and the individual compensation tax. Those by themselves explain a lot about the system. I have many extra copies here.

The thing I would like to stress about the structure of our tax reform proposal is that it gives attention to the business side of taxation, as well as to the personal side. In other words, we have proposed replacing the personal income tax with a flat marginal rate, a progressive tax, but one which has only a single marginal rate, a marginal rate of 19 percent. That replaces the personal income tax. But we also take care of the very severe problems of taxation that exist today in the area of business taxation.

The combined tax rate of the corporate income tax and the personal income tax can be 60 or 65 percent under the current system, and we regard that as the single largest defect of the current tax system.

Senator LONG. Could I just interrupt you here for a moment?

Mr. HALL. Sure.

Senator LONG. And I will let you have more time at the end to make up for it. You have got a well-written statement, and I haven't done justice to it. I am going to take it off and study it carefully before we vote on this matter. But during the recess, I will have an opportunity to do justice to all these statements that have been made, including these three witnesses, which is one good reason why now and then we ought to have a little time off to think rather than to just be under constant pressure like we are up here where we can't do justice to some of these things.

But you have one as gross revenue from sales. Two is a liable cost. Now that would just appear as one line. But doesn't that entail a great deal of paperwork to arrive at that figure? In other words, just because they are on a post card-sized thing—but don't you have to do a lot of paperwork to arrive at allowable cost?

Mr. HALL. Businesses, in all circumstances, have to maintain accounting records which would include information like the gross revenue from sales. There is no suggestion that businesses can survive without accounting.

Senator LONG. I don't want to brag about the fact that I have to file a complicated tax return and get audited every year. I don't want to brag about that. I'm not particularly proud of it or happy about it. But it seems to me as though when I take the forms—even what I mail in now. What I am mailing in, the Government part, looks about like what I am holding up here. Let's say about 8 or 10 pages. But the tax return looks like that and many more. A whole big pile of paper. All kind of stuff. And all kind of work that I don't do. Most of it, I have people do for me, but it costs me good money to do all that. And I think that is true of most people. Now is that going to be eliminated? For example, that one item there—a liable cost. Doesn't that entail a great deal of bookkeeping to arrive at that figure?

Mr. HALL. It certainly does. And as I say, the only tax rate that would eliminate the Government's interest in accounting would be a zero tax rate. As soon as we try to collect any revenue from businesses, then businesses have to be required to maintain accounts. And it is quite true that each line of the business tax return is the summation of information that appears in the accounting records. That's inescapable in any tax system.

But I would stress that computing something like the gross revenue from sales is a very simple computation. It is simply adding up some unambiguous numbers that come from the accounting record. It's nowhere near as complex, for example, as the computation of depreciation, which is a requirement of the current tax system. You will notice that there are no depreciation accounts required on form 2. Rather, there is a single very appropriate investment incentive; namely, the immediate deduction of investments. So there's a great deal of simplification even though, as you say, the fact that businesses file a post card is the tip of the iceberg as far as what records they have to maintain.

Now what I would like to do in my remaining time is just to cover a few specific points about the flat tax. In particular, the accounts that I have heard of these hearings have suggested that there has been a great deal of criticism and very little support for the flat tax.

Now in the first place, I think one of the key issues that has been discussed is the question of the relative treatment of higher income and middle-income taxpayers.

Let me start by being very clear that any flat-tax proposal, in particular the Hall-Rabushka proposal, results in a reduction of taxation for successful Americans. Anyway you do that arithmetic, the conclusion emerges that putting a 19-percent tax rate on higher income families gives them relief from the much higher tax rate that they are paying today.

Now the question in evaluating flat tax is whether the set of economic effects that go with the relief of taxation of successful Americans is something we like or something we don't like. My fundamental belief is that the revitalization of the American economy, which is something that we all stand for, will almost inevitably have to be led by successful Americans. And that the treatment of success in this country is something that we are going to have to rethink. And that the heavy penalty on success that the tax system imposes today is just too much. It is causing successful people to divert their attention from what they really should be doing, which is starting new businesses, cranking up new ideas, by the extremely heavy tax that we put on those activities.

As I say, a representative tax rate for somebody who has a good idea, starts a corporation and finally cashes in, under the current tax system, is something like 60 or 65 percent. On the other hand, the tax system today subsidizes tax shelter activities. No wonder you find so many successful people or people who could be successful moving into tax shelters rather than putting their energy into places where it would be economically more justified.

Another point is housing. The analysis that appears in the paper, I hope, will convince you that there is no threat to housing from the elimination of mortgage deductions. The elimination of interest deductions, as a general matter, will lower interest rates by more than enough to offset the effect of the loss of deductions. There is no threat whatsoever from the flat tax of the type we have proposed to the housing industry.

Finally, the treatment of the poor is revealed, I think, by most calculations not to be a problem under our type of proposal. The distributional consequences are the middle class versus upper income. All tax systems embody progressive treatment of the poor. And that's certainly true of ours. We do not ask the poor to pay taxes. There is a generous personal allowance in our proposal which insures that at the lower end of the income distribution we are doing justice to the concept of progressivity.

Well, my impression is that Washington is giving a cool reception to the flat tax. But that's not true of the rest of the Nation. I think it's significant that I am one of the few witnesses here who is not part of the Washington establishment, and I see the flat tax from a very different point of view from the people in this town. In the Nation as a whole, people are disgusted with the existing tax system. And they are ready to start over. And they don't take a narrow, self-interested view of tax reform. They are interested in what is good for the Nation, and not just preserving the advantages that they get from some existing provision of the tax system. So I would encourage this committee not to take a narrow review of tax reform, but rather to consider the possibility of starting over.

Senator LONG. Thank you.

[The prepared statements of Robert E. Hall and Alvin Rabushka follow:]

A Simple Income Tax with Low Marginal Rates

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Revised September 1982

A more complete presentation of this material will appear in **Low Tax, Simple Tax, Flat Tax**, to be published by McGraw-Hill in early 1983.

Form 1 — Individual Compensation Tax — 1982

Your occupation ▶
Spouse's occupation ▶

1 Compensation as reported by employer	1	
2 Other wage income, including pensions paid directly by employer	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	

Form 2 — Business Tax — 1982

1 Gross revenue from sales	1	
2 Allowable costs		
(a) Purchases of goods, services, and materials	2(a)	
(b) Wages, salaries, and pensions paid to employees	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	

Despite recent progress in lowering rates, the American tax system remains a disgrace, in dire need of simplification and reform. It is inordinately lengthy, filling volumes of tax codes, complicated by hundreds of credits, exemptions, and special provisions. Many taxpayers require expensive professional help to fill out their tax returns correctly. Each act of the Congress further complicates the system. Political promises of real simplification and reform of the tax system remain unfulfilled.

The tax system consists chiefly of the personal income tax, the corporate income tax, and the payroll tax for social security. The personal income tax has steeply progressive rates, rising to a maximum marginal rate of 50 percent under the new tax law. The income base to which these progressive rates are applied has steadily eroded over the years through a wide variety of exclusions, deductions, and exemptions to the point where it now constitutes no more than half of total national income. The personal income tax discourages savings. Income is first taxed when earned and again when savings earn interest. Even worse, the returns to savings put into the corporate sector are taxed twice, once as corporate profits, and again at the household level when dividends are paid. A growing chorus of criticism contends that the current system attenuates individual incentives to work, save and invest. For many taxpayers, saving a dollar in taxes is worth twice as much as earning another dollar in income.

Prior to the twentieth century, federal revenues, comprising about 3 percent of GNP, were largely collected from customs duties. With the adoption of the Sixteenth Amendment in 1913 and the payroll tax in the 1930s, federal revenues have grown to consume 22 percent of GNP. Escalating inflation in the 1970s pushed growing numbers of taxpayers into high tax brackets that twenty years ago were meant only for the very rich. Costly side effects have begun to surface.

Scholarly research, along with Internal Revenue Service reports, reveals widespread evidence of tax evasion on interest, dividend, and other forms of household or professional income. Tax shelters are now a commonplace feature of the financial landscape. Estimates of the underground economy range from several tens of billions to several hundred billion dollars. In the eighteenth century, customs duties exceeding 100 percent made England into a nation of smugglers. Today, marginal tax rates of 50 percent from the personal income tax, 46 percent from the corporate tax, and 14 percent from the payroll tax are converting Americans into tax avoiders and channeling their investments into tax shelters. The current system fosters contempt for the law, simultaneously discouraging productive economic activity.

Why is it so difficult to reform the tax system? Most scholars, lawmakers and practitioners routinely claim that it is politically infeasible to simplify and reform radically the tax system. Talk of simplification is a sign of unrealism. Congress would, it is alleged, never abolish the exemptions and deductions for mortgage interest payments, charitable contributions, excess medical care costs, or remove the many benefits and credits enjoyed by low-income households and a bevy of special interest groups. The American demand for justice means that the rich should pay higher taxes. As a result of these beliefs, changes in the tax code are invariably incremental and represent slight modifications to the corporate or personal income tax.

We sense growing interest in the public and in Congress for drastic reform in the tax system. As a contribution to the debate and discussion on this important subject, we propose a simple income tax based on low marginal rates to replace the entire current system of separate tax rate schedules on corporate and individual income. The new tax would be a low, flat rate applied to all taxpayers, excluding the very poor, and to all types of income. It would be applied to a much larger tax base than the present system, thus generating similar amounts of revenüe as the current high-rate system with its exemptions and deductions. The simple flat rate would end "bracket creep," which is caused by inflation pushing people into higher and higher tax brackets. It would largely minimize the penalty current law imposes on two-earner households ("the marriage penalty"). It would be stable, predictable, and cease further proliferation of a variety of tax credits used to attain social goals. Most important, it would restore the incentives to work, save and invest, thereby promoting growth and higher standards of living.

Our proposal does not include reform of the social security payroll tax and the retirement benefits it finances, though reform is long overdue. The social security tax cannot be discussed separately from benefits, and we would be taken too far from our basic subject of tax reform to go into the massive changes in social security needed to put the system on a sound footing.

Basic Principles of the Simple Income Tax

The simple income tax rests on four basic principles:

1. All income should be taxed only once, as close as possible to its source.
2. All types of income should be taxed at the same low rate.
3. The poorest households should pay no income tax.
4. Tax returns for both households and businesses should be simple enough to fit on a postcard or one page.

We propose the replacement of the existing corporate and personal income taxes with a business tax and a compensation tax. The business tax includes the earnings of corporations, unincorporated businesses, farms, professionals, and rental income. The business tax does not permit a deduction for interest payments, dividends, or other payments to the owners of the business. As a result, all income that individuals receive from business activity has already been taxed, and should not be taxed again. The same holds for capital gains. The business tax is like a withholding tax; it means that the tax authorities do not have to track down all the interest, dividends, capital gains, and other business income received by the public. Compensation is the only element of household income not taxed under the business tax. We therefore propose a new compensation tax to replace the present personal income tax. The new compensation tax would have a set of personal allowances to insure that the poorest families pay no compensation tax.

Under our existing laws, tax rates can be as high as 50 percent for compensation and 80 percent for business income, because income is taxed first under the corporate tax and again under the personal tax. To collect the same amount of revenue that the present system generates, assuming the same flows of income as occur today, the simple tax system would require a standard rate of only 19 percent.

The Business Tax

The new business tax would rationalize the present hodge-podge of federal tax provisions for business income. It would reduce the high marginal rates currently paid on some types of income from capital. By eliminating interest deductions, it would also end the subsidies embodied in current tax shelters. A uniform rate of 19 percent would replace the current range of tax rates that stretch from actual subsidy of highly leveraged tax shelters with large interest deductions to rates as high as 80 percent imposed on income earned by corporate stockholders.

The new business tax applies equally to all forms of business--corporate, partnership, professional, farm, and rentals and royalties. The base for the tax is gross revenue less purchases of goods and services and compensation paid to employees. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions for depreciation, interest, or payments to owners are permitted. However, the self-employed may pay themselves salary in any amount they choose, provided they report it on the compensation tax form.

The business tax return would fit easily on a single page, even for a multibillion dollar corporation. Here is what it would look like:

HALL-RABUSHKA SIMPLIFIED FLAT RATE TAX FORM

Form 2	Business Tax	1982
[illegible]	[illegible]	
[illegible]	County	
City, State and ZIP Code	[illegible]	
1 Gross revenue from sales	1	
2 Allowable costs		
(a) Purchases of goods, services, and materials	2(a)	
(b) Wages, salaries, and pensions paid to employees	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	

Gross revenue from sales does not include earnings the business may receive from its ownership of other businesses (provided these businesses file their own tax returns) or from its ownership of securities. These earnings have already been taxed in other businesses. Gross revenue does include sales of used plant and equipment. Businesses are not required to maintain inventory or depreciation accounts for tax purposes.

In place of the hodge-podge of investment incentives in the current tax system, we propose the use of straightforward first-year writeoff of all business investment, both in new and used plant and equipment. First-year capital recovery is a great simplification over the complicated depreciation deductions and investment credits in present tax law. It also eliminates the present problem that depreciation based on historical cost is not rapid enough to offset the effects of inflation. The first-year system avoids all distortions of inflation.

In 1981, the net revenue of U.S. business was $1179 billion. Under the new business tax, capital recovery allowances would have been $349 billion, leaving net taxable business income at $830 billion. A tax rate of 19 percent would have yielded $158 billion, nearly triple the revenue from the actual corporate income tax in 1981 of $57 billion. The extra revenue, despite the much lower tax rate, comes from (1) the much wider tax base, including unincorporated business, and (2) taxing business income at its source.

Under the simple tax system, all business income would be taxed only once, at its source. Household receipts of interest, dividends, and capital gains would be after-tax income. Though wealthy households might receive large amounts of these types of income, it is important to understand that the taxes on this income have already been paid. The recipient household itself should not pay any more tax on business income. Taxing business income at its source has an important practical benefit. Under the present personal income tax, large amounts of interest and dividend income escape taxation through outright evasion and tax avoidance. Apparently people find it easy to overlook these types of income when filling out personal income tax returns. Under our business tax, the only way dividends, interest, and other earnings of capital could escape taxation would be for the business to fail to file a tax return, which is easier to detect and punish.

Capital gains on rental property, plant, and equipment are taxed under the business tax. The purchase price is deducted at the time of purchase, and the sale price is taxed at the time of the sale. These provisions are most important for real estate, where they will eliminate the current abuses in which low capital gains tax rates create an incentive for artificial turnover of property. Every owner of rental real estate would be required to fill out the simple business tax return.

Capital gains in the overall value of a successful firm are also taxed under the new business tax and should not be taxed again at the household level. To see this point, consider the case of the common stock of a corporation. The value of its stock in the market is the capitalization of its future earnings. Because the owners of the stock receive the earnings after the corporation has paid the business tax, that tax depresses the stock's market value. When the market learns that future earnings are likely to be higher than previously thought, the stock rises in value and its owners receive capital gains. When the high earnings materialize in the future, they will be correspondingly taxed. To tax the immediate capital gains of the stock would be double taxation. Thus with comprehensive taxation of business income at the source, capital gains should be excluded from taxation at the household level.

In order to impose the appropriate tax on banks and certain other types of business, it is necessary to separate the value of the service the bank provides to its customers from the interest the bank pays to the customer. Today, most banks net one against the other, so the customer gets free services in exchange for lending the bank funds at zero or below-market interest rates. Because the business tax is imposed on the value of the product sold by a business (the services provided by a bank, for example), but does not allow a deduction for interest paid out, it would not be permissable for a bank to report the net receipts from its customers as its sales. Instead, it must add in the difference between the interest its pays its depositors and the full market interest rate they could earn elsewhere. As a general matter, businesses would not be permitted to borrow from their customers and pretend that the value of sales was only the net charge after deducting interest--this violates the basic principle that interest payments are never deductible. Businesses like banks could continue to carry on their relations with their customers in any way they chose, but for tax purposes, the full value of their services would be reported as their sales.

One other potential source of abuse of the business tax would need to be monitored--the conversion of business assets to personal use. There is nothing new about this problem--under today's income tax, one can buy a car for business purposes at the end of the year, take the investment credit, and then convert the car to personal use at the beginning of the next year. Under the proposed business tax, conversion to personal use would be counted as a sale, and the market value of the asset would be included in the revenue of the firm. Auditors would check that the assets on the books of the firm were actually used by the firm and not for the personal use of the owners.

First-year writeoff of investment would create large tax losses in the startup years for almost all businesses and occasional large tax losses even for established businesses when they made significant investments. The business tax provides unilimited carry-forward of tax losses so that they reduce taxes in future, profitable years. Further, the balances carried forward earn interest at the market rate.

The Compensation Tax

Most income in the United States is compensation for work. We propose that compensation be taxed at the level of the individual or married couple. Compensation is defined as cash wages, salaries and pensions received by workers from employers. Pension contributions and other fringe benefits paid by employers are not counted as part of compensation.

To limit the tax burden of poor families, we propose a set of personal allowances. Taxes would be 19 percent of compensation in excess of personal allowances. The proposed allowances for 1982 are

Married Couple	$6200
Single	3800
Single head of household	5600
Each dependent	750

Except for the personal allowances, no deductions of any kind would be permitted, including interest deductions.

The tax return for the compensation tax would fit on a postcard. It would look like this:

In 1981, wages, salaries, and private pensions were about $1503 billion. We estimate that personal allowances in 1981 would have been $481 billion, leaving taxable compensation of $1022 billion. At a rate of 19 percent, tax revenues would have been $194 billion. By comparison, the personal income tax in 1981 yielded about $289 billion. The required revenue from the compensation tax is less than from the personal income tax it replaces because the business tax covers part of the tax base of the current personal tax. The reasons that a low rate of 19 percent yields revenue reasonably close to that obtained from the current tax system are: (1) the business tax includes currently untaxed fringes in its base, (2) the current income tax fails to tax fully dividends, interest, and other forms of business income because of widespread evasion and avoidance, and (3) the current tax allows a number of deductions not included in our proposal, the most important of which is the deduction of state and local taxes.

HALL-RABUSHKA SIMPLIFIED FLAT-RATE TAX FORM

Form 1 — Individual Compensation Tax — 1982

Your occupation ▶

Spouse's occupation ▶

1 Compensation as reported by employer	1	
2 Other wage income, including pensions paid directly by employer	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	

International Aspects of the Simple Tax

We favor the straightforward principle that the U.S. tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from sales of products sold within the U.S. plus the value of products as they are exported is to be reported on the top line of the business tax form. Only the costs of labor, materials, and other inputs purchased in the U.S. or imported to the U.S. are allowable on the second line as deductions for the business tax. Physical presence in the U.S. is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the U.S. Its costs would include the actual amount it paid for its imports, valued as they entered the U.S.--this would generally be the actual amount paid for them in the country of their origin. Its revenue would be the actual receipts it obtained from sales in the U.S. Second, consider an exporter selling products to foreigners produced in the U.S. Its costs are all of the inputs and compensation paid in the U.S., and its revenue is the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the U.S.

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Third, consider a firm that sent parts to Mexico for assembly, and brought back the final product for sale in the U.S. The value of the parts as they left the U.S. would count as part of the revenue of the firm, and the value of the assembled product as it entered the U.S. would be an expense. The firm would not be allowed to deduct the costs of its Mexican assembly plant.

Under the principle of taxing only domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the simple tax and followed the principle, all income throughout the world would be taxed once and only once. Because the principle is already in use in the many nations with value added taxes, it makes sense for the U.S. to adopt it as well.

By the same principle, the compensation tax applies to the earnings of everyone working within the U.S., whether or not they are Americans, but does not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The U.S., with the low marginal rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the simple tax does not tax the overseas earnings of American workers and businesses, there is no reason to fear a mass exodus of economic activity. On the contrary, the favorable tax climate in the U.S. would draw in new business from everywhere in the world.

Balancing the Budget with a Simple Tax

If federal spending can be held to the level proposed by the President in his budget for the 1983 fiscal year, or if any increases can be financed by user fees or earmarked taxes, then the 19 percent tax rate would balance the budget by 1985.

Even if spending is at the high level projected in the Congressional Budget Office's baseline budget, a tax rate of 19 percent would bring the federal deficit down to $75 billion by 1987.

Under the President's spending proposals, the tax rates necessary to balance the budget starting in FY 83 would be 21 percent in that year, 20 percent in 1984, and 19 percent in 1985.

Under the higher CBO baseline spending projections, the tax rates necessary to balance the budget would be 23 percent in 1983 and 1984, 22 percent in 1985, 21 percent in 1986, and 20 percent in 1987.

Immediate adoption of the simple tax would bring moderate deficits during the current recession, but would commit the nation to a balanced budget within three years, provided spending is kept at reasonable levels.

The base for the simple tax is gross national product less indirect business taxes and investment. In arriving at the conclusions just stated, we used projections of GNP from the President's budget and from the CBO. We approximated the base as 79 percent of GNP, based on detailed calculations for 1980.

The simple tax allows each taxpaying individual or family to deduct a personal allowance. These allowances are indexed according to the cost of living from the proposals for 1981. The total allowance for a husband, wife, and two children in 1983 would be $8355.

Our estimates of total allowances were derived from our estimate for 1981 by assuming one percent annual growth in the number of taxpayers and rates of increase of the cost of living from the President's budget and from the CBO baseline projections.

The simple tax replaces the personal and corporate taxes, but not the rest of the federal tax system (of which the social security payroll tax is by far the most important part). Our computations take a projection of total federal spending less a projection of revenue from the other taxes. If the simple tax yields exactly this amount of revenue, it would just balance the budget.

The computations take account of the influence of past deficits on current spending through the interest on the national debt. We used the projections of the Treasury bill interest rate underlying the President's budget and the CBO projections in order to track the effect of a reduced national debt on interest expense.

We do not attempt to take account of the influence of tax reform on total economic activity and the corresponding augmentation of federal revenue, though we think these effects could be substantial.

Details of the future budgetary implications of the simple tax appear in Appendix 2.

The Future of the Economy under the Simple Income Tax

At the outset, the simple income tax, with common flat rates of 19 percent on business income and compensation, would raise revenue equal to about 12 percent of GNP, the same as the current combination of corporate and personal income taxes. The personal allowances under our proposed tax system are raised from year to year in line with inflation, which would tend to hold its revenue constant as a fraction of GNP (the new law provides for this kind of indexation starting in 1985).

The switch from the current corporate and personal income taxes to the simple income tax would have some mild transitional effects on the U.S. economy. Briefly, the elimination of depreciation deductions for business would be costly to the owners of existing plant and equipment, but this would be largely offset by the reduction in the taxation of the earnings of capital assets. We do not think any special compensation is necessary for the loss.

Adoption of the simple tax would lower interest rates. Rates would fall immediately because investors would require a lower rate of interest when they were no longer paying tax on the interest. In the medium run, the investment boom set off by the more favorable tax treatment of capital formation might bring interest rates partway back to their earlier level. In the long run, interest rates would decline as capital accumulation proceeded. Prices of bonds would rise as soon as the tax was announced. None of these effects would be large, and none seems to call for any corrective action by the government. Compared to the gigantic capital losses inflicted on bondholders by inflation and rising taxes over the past decade, and the corresponding capital gains accruing to homeowners over the same period, neither of which has been offset by any government policy, the effects of the simple tax in the opposite direction are mild.

Though our system will stabilize revenue as a fraction of GNP, it will probably produce more revenue than the government needs to maintain existing programs. Low marginal tax rates will draw economic activities from the underground economy into the formal market, where they are recorded as part of GNP. Businesses and individuals will spend less time worrying about the tax consequences of their actions and will concentrate instead on earning higher incomes. On these grounds, we believe that the revenue needs of the federal government could be met with tax rates as low as 16 or 17 percent, rather than the 19 percent needed to reproduce current revenue at current levels of GNP.

Over the postwar period, cuts in marginal tax rates have coincided with episodes of vigorous economic growth and reduced inflation in the United States. Moreover, those nations with lower marginal tax rates have achieved the highest economic growth over the past decade. The growth stimulated by tax reform is not only favorable for the increased income it would bring to the American public, but it would also moderate and eventually eliminate the federal budget deficit.

The benefits of tax reform are not purely economic. The complexities of the federal tax system foster contempt for government and make petty criminals out of a large fraction of the population. A simplified tax with low marginal rates would help restore confidence in government and would support the basic honesty of the American people.

Appendix 1. Income flows and tax yields

Following are the relevant numbers from the U.S. National Income and Product Accounts for 1981. All data are in billions of current dollars.

Gross domestic product[1]	2868
Federal indirect business tax[2]	57
Imputed items[3]	129
Wages, salaries, and pensions[4]	1503
Investment[5]	349
Taxable business income[6]	830
Revenue from the business tax at 19%	158
Taxable compensation[7]	1022
Revenue from compensation tax at 19%	194
Total tax revenue	352
Actual personal income tax[8]	289
Actual corporate income tax[9]	57
Total actual tax revenue	348

Notes:

[1] Economic Report of the President, January 1982, Table B-8

[2] ERP, Table B-76

[3] Survey of Current Business, "National Income and Product Accounts, 1976-1979," Special Supplement, July 1981, Table 8.8, p. 77

[4] ERP, Table B-21 plus our estimate of private pensions

[5] Business investment is estimated as total investment in equipment, nonresidential structures, and farm investment, plus 20 percent of investment in residential structures, ERP, Table B-15. The remaining 80 percent of residential structures are owner-occupied and not deductible under the business tax.

[6] Gross domestic product less federal indirect business taxes, wages, salaries and pensions, imputed items, and investment

[7] Wages, salaries, and pensions less personal allowances

[8] Estimated as 75 percent of the revenue for fiscal year 1981 and 25 percent of the revenue for fiscal year 1982, ERP, Table B-19

[9] Same as personal income tax.

Appendix 2. Revenue and deficit projections

Table 1 presents our computations based on the economic assumptions and spending proposals in the President's February budget.

Table 1

	81	82	83	84	85
GNP	2922	3159	3522	3881	4257
Tax base	2314	2502	2789	3074	3372
Allowances	481	535	580	620	655
Tax. inc.	1833	1967	2210	2454	2717
Tx.inc.,FY	1790	1933	2149	2393	2651
Rev. P&C tax	347	345	370	407	450
Rate, sm rv	19.4	17.8	17.2	17.0	17.0
Rate, 0 def			21.2	20.0	19.0
Rev. at 19%			408	455	504
Def. at 19%	58	99	51	29	8

The first four lines compute the level of taxable income on a calendar year basis. The fifth line gives taxable income on a fiscal year basis. When divided into an estimate of required revenue, taxable income gives the necessary tax rate under the simple tax.

The next line, labeled "Rev. P&C tax", gives the administration's estimates of the revenue from the personal and corporate income taxes, including the effects of ERTA and the modifications proposed by the President in February. The line below, labeled "Rate, sm rv," gives the rate under the simple tax necessary to yield the same revenue as the personal and corporate income taxes. Note that the rate declines from around 19 percent in 1981 to 17 percent in later years, as the major personal tax reductions of 1982 and 1983 go into effect.

The next line, labeled "Rate, 0 def," gives the simple tax rate necessary to eliminate the deficit starting in FY 1983. Though this rate starts above 21 percent, it falls to 19 percent by 1985. Again, these computations take account of the favorable effect on interest costs of lower deficits in earlier years.

The last line shows the projected size of the federal deficit if the simple tax were adopted starting in FY 83 at a constant rate of 19 percent. The deficit is manageable in all years and essentially disappears in 1985.

Table 2 presents similar computations for the CBO's baseline budget projections.

Table 2

	81	82	83	84	85	86	87
GNP	2922	3140	3515	3882	4259	4659	5083
Tax base	2314	2487	2784	3075	3373	3690	4026
Allowances	481	535	581	627	676	726	777
Tax. inc.	1833	1952	2203	2448	2697	2964	3249
Tx.inc.,FY	1790	1922	2140	2387	2635	2897	3178
Rev. P&C tax	347	350	354	378	407	431	469
Rate, sm rv	19.4	18.2	16.5	15.8	15.4	14.9	14.8
Rate, 0 def			23.4	22.5	21.7	20.9	20.2
Def. at 19%			101	102	97	87	75

The format of this table is the same as that of Table 1, except that it covers two additional years. The Administration and the CBO are projecting GNP at about the same level through 1985, though the Adminstration foresees higher levels of real growth and lower rates of inflation. Allowances grow more rapidly under the CBO projection as a consequence.

The simple tax rates necessary to raise the same revenue as the personal and corporate income taxes fall to even lower levels--below 15 percent--under the CBO's assumptions, because the Administration's revenue enhancements are not included in the baseline. On the other hand, the tax rate necessary to balance the budget starting in FY 83, shown in the next-to-last line in the table, is about a point higher because the CBO projects significantly higher federal spending than does the Administration.

The last line of Table 2 shows that with higher spending and weaker real growth, the simple tax at a fixed rate of 19 percent does not eliminate the federal deficit even by 1987. However, it does bring it well below $100 billion, as against the CBO's projection of nearly $250 billion.

Sources

Budget of the United States Government, Fiscal Year 1983, February 1982

Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1983-1987, A Report to the Senate and House Committees on the Budget--Part II, February 1982

Questions and Answers About the Simple Tax

We have spent a good deal of time presenting the simple flat tax and answering questions about it on radio talk shows, before professional and lay audiences, and testifying before Congress. In this section, we have assembled a number of the questions that have recurred in those discussions together with our answers. Many aspects of the simple flat tax are perhaps best explained in the question-and-answer form.

Deductions

Q: What about charitable deductions?

A: No charitable deductions would be allowed under the simple income tax. We do not believe that current tax incentives are a major part of the motivation to make contributions to community, religious, and other organizations who qualify for deductions at present. A large volume of contributions are made by people who cannot deduct the contributions because they do not itemize deductions. Deductibility of contributions is widely abused by wealthy taxpayers to avoid taxes. On net, you will save more by blocking the tax-avoiding tricks of the wealthy than you will lose from the elimination of tax deductions from your own contributions. There is little merit in public subsidy for organizations whose success in raising funds depends on tax deductibility rather than the intrinsic merit of their activities.

Q: What would happen to the restaurant industry?

A: Though business meals are an important element of the restaurant industry, there is no reason to expect that the simple tax would reduce restaurant patronage. Neither the existing tax system nor the simple tax gives business an incentive to spend money at restaurants rather than anywhere else. All reasonable business expenses, including restaurant meals, are deductible under either tax system. A limited amount of restaurant spending may arise from abuse of the current system by providing untaxed income to employees. This problem would be alleviated under a tax system with lower marginal rates. On the other hand, as the new tax system brings businesses out of the underground economy and into the market, taxed economy, spending at restaurants will be slightly increased. Neither effect should be large. The restaurant industry also stands to gain from the incentive effects of lower taxation of many of its employees.

Q: Shouldn't the tax system provide some relief to families with high medical costs?

A: Virtually the entire U.S. population is now covered by medical insurance, Medicare, or medical benefits through welfare. The medical deduction under the current personal income tax is a source of many abuses, including the deduction of swimming pools and other home improvements as medical expenses. Few families would suffer, and the overwhelming majority would gain, by closing off this source of abuse.

Q: Why is there no deduction for moving costs in the simple tax?

A: Moving costs are only one of hundreds of costs incurred by taxpayers in order to earn an income. It is inconsistent to permit deduction of moving costs when costs of commuting, purchase of special clothing, and other employment costs cannot be deducted. Many moves are undertaken for reasons unrelated to earning a higher income and so should not escape taxation. The deduction for moving expenses is one of a number of tax provisions abused by a small minority of taxpayers at the expense of the great majority. It should be eliminated.

Q: I am a salaried employee. How would I treat unreimbursed business expenses? There is no room for this deduction on the simple individual compensation tax form.

A: Deduction of so-called business expenses of salaried employees is a major loophole in the current tax system.

It is widely abused to subsidize summer travel for teachers, trips to conventions, and other activities for which special incentives are inappropriate. Genuine business expenses ought to be borne by employers, in which case they are deductible under the business tax.

Q: The current income tax grants deductions for certain adoption expenses. Do you want children to remain orphans to save a few dollars in government revenue?

A: Deduction of adoption expenses is a good example of a well-intentioned complication of the tax system with little practical impact. Lower-income families can't take the deduction in many cases, and even if they could, it would have little importance because their marginal tax rates are not very high. All the benefits of the deduction go to prosperous families who do not need help from the government. By adding slightly to the financial attraction of adoption, the government only further increases the demand for adoptable babies, which already far exceeds the supply.

Housing

Q: What would happen to the housing market as a result of ending the deduction for mortage interest?

A: The simple tax would end the deduction for interest of all kinds, not just mortgage interest. It would not discriminate against housing. However, improvements in the taxation of business investment would tend to draw wealth out of housing and into plant and equipment, which might reduce housing values temporarily. The effect would not be more than a few percent, and would last only for the duration of the investment boom set off by the new tax system. In the longer run, the outlook for housing values would be improved as overall economic activity increased in response to the tax.

Q: How would the flat tax affect the savings and loans, who are in so much trouble today?

A: Like all owners of long-term debt, savings and loans would receive a benefit from the lower interest rates brought by the flat tax. The market value of their mortgages would rise as interest rates fell, improving their currently depressed net worth. Because the interest the savings and loans would pay on their borrowing would fall, their operating deficits would decline.

Q: Why shouldn't we tax the capital gain from the sale of a house?

A: These capital gains are rarely taxed under the current system, because of the rollover provision, forgiveness of capital gains for the elderly, and the stepping up of the basis for capital gains at the time of inheritance. We believe that the taxation of housing is properly ceded to

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local governments under the federal system. Local property taxes capture part of the value of the services of a house. A capital gain occurs when the market valuation of the services rises. These gains arise from after-tax income, just as capital gains from the ownership of business arise from after-tax income. Hence taxation of capital gains would amount to double taxation.

Q: The only way I can afford my house today is the large tax deduction I get for the interest on my mortgage. Won't I have to sell my house if I can no longer take the deduction?

A: Don't overlook the benefits you will receive from a much lower tax rate. Suppose you and your husband earn $60,000 per year and pay $18,000 in mortgage interest. Your tax in 1981 would be $11,553, after taking account of the large deduction for interest. Under the simple tax, you would not be able to take the deduction--your tax would be 19 percent of $55,000, or $10,450. You come out more than a thousand dollars ahead, even though you can no longer take the deduction. If you could afford your house before, you can certainly afford it now. However, if you have been extremely aggressive in taking advantage of interest deductions, so you are paying little tax in spite of a large income, you will come out behind with the simple tax.

Q: I plan to install solar heating in my house and know the current tax law offers a credit for this energy conservation investment. Will I still receive this tax credit under the simple tax? If not, won't this discourage conservation and make us wasteful of energy?

A: Like all the complications of the existing tax system, the residential energy credit would disappear with the advent of the simple flat tax. The energy credit makes little economic sense--it puts the taxpayers money into elaborate installations which are at or below the margin of economic efficiency. With all forms of energy except natural gas already decontrolled, and gas decontrol on the way in the later 1980s, homeowners face the right incentives for solar energy investments without any special tax gimmicks.

Q: Since your plan removes the tax incentives now offered for preservation of historic structures, won't this accelerate the destruction of many buildings that belong to our national heritage and should be saved for future generations to enjoy?

A: For every genuinely important historical building saved by the tax incentives, dozens or perhaps even hundreds of buildings are subsidized that are not important or would be kept by their owners anyway. Accelerated depreciation for historical structures is a terribly inefficient way to accomplish the goal of preservation--most of its effect is to create yet another tax shelter. Direct appropriation of local government funds for saving individual buildings is far superior as a social policy for preservation.

Q: Doesn't the simple tax encourage speculation in land by granting first-year writeoff for land purchases?

A: The sellers of land have to count their proceeds as taxable income; this offsets the deduction granted to the purchaser. Prices of undeveloped nonresidential land may rise a little, but with a 19 percent tax rate, this effect should be very small. Land transactions are included in the simple tax because it is very difficult to separate the value of land from the value of buildings on it.

Intergovernmental relations

Q: How would local governments be affected by the change in the taxation of bonds?

A: Local governments derive a small advantage from the tax-free status of their bonds and the taxation of all competing bonds in the current system. Under the simple tax, local government bonds would remain untaxed, but all other bonds would also provide tax-free interest, because the earnings of business would be taxed at the source. The immediate impact of the simple tax would lower the borrowing costs of other borrowers to the levels paid by local governments. In the ensuing investment boom, as interest rates rose, local borrowing costs would gradually rise. The slightly adverse effect on local governments would be confined to a few years, and would not be large. In the longer run, local governments would face no higher interest rates and would benefit in many other ways from the improved performance of the U.S. economy.

Q: What about such other taxes as state, county, excise, and sales taxes? What would happen to them under the simple income tax?

A: Although we would prefer that other government units besides the federal government switch to taxes based on the same principle as the simple income tax, we have limited our proposal to federal action. The only important implication of our proposal for other taxes is the elimination of the deduction for other taxes under the federal personal income tax. Because this deduction is important only for higher-income families, who benefit enormously from lower marginal tax rates, we do not believe that the elimination of deduction will have any harmful effects.

Q: How would the simple income tax affect state taxes where the tax returns are linked to the federal tax system?

A: Because the new federal taxes would raise approximately the same revenue as the old taxes, a state that retained the linkage would continue to receive about the same revenue as well.

Q: How does the simple tax treat government? Are state and local activities taxed? Does the federal government tax itself?

A: State and local governments pay no taxes themselves, but their employees pay the compensation tax on their wages, salaries, and pensions. Similarly, the federal government does not tax itself, but its employees pay the compensation tax.

Retirement

Q: How are existing IRA and Keough retirement accounts treated under the simple tax?

A: IRA and Keough accounts have provided benefits to a limited fraction of taxpayers of the same type that the simple tax would provide to all taxpayers. Under the simple tax, they would be treated exactly as under the current system, except that the tax rate would usually be much lower. When the accounts begin to pay retirement benefits, those benefits would be taxed as compensation. It would no longer be necessary to impose a minimum age for the payment of benefits. Holders of IRA and Keough accounts could elect to liquidate their accounts at any time, and pay the compensation tax at that time. For the future, IRA and Keough accounts would not be necessary, because the taxation of interest income at the business rather than the personal level would make any form of savings have the same advantage as IRAs and Keoughs have today.

Q: Interest on the savings in my life insurance policy is excluded from current taxation under today's law. What will happen to the life insurance industry and the value of my insurance when taxation of all interest is eliminated?

A: As far as you are concerned, the tax benefits you are enjoying will continue--there will be no taxes on the interest you are earning. Furthermore, when your insurance pays off, you will not have to pay income tax on the interest component, as you do under current law. As far as the industry is concerned, taxation of its interest earnings and deduction of its interest payments will end. Only its actual insurance premiums will count as income, not the saving that goes with some types of insurance, and only its payoff for death and other insured events will count as business expenses.

Business and The Rich

Q: Isn't the simple tax a windfall to the rich?

A: Taxation of families with high incomes and few deductions would be dramatically reduced under the simple tax. On the other hand, taxes paid by those who take advantage of the almost unlimited scope for reducing or postponing taxes through tax shelters and other gimmicks will rise a great deal. The simple tax would be a windfall to the hard workers and a loss to those who have concentrated on avoiding tax.

Q: Is the simple tax progressive?

A: The simple tax is progressive in the sense that families with higher incomes pay a larger fraction of their incomes in taxes. Families with incomes below the personal allowance level pay no tax at all. The proportion of income paid in tax rises to close to 19 percent for the highest income. Proportions of income paid as tax are

Income	Tax
10,000	4.4 %
15,000	9.2
20,000	11.7
30,000	14.1
40,000	15.2
50,000	16.1

Q: Does business pay its fair share of taxes under the simple tax?

A: Only people pay taxes. The simple tax is designed so that income from business sources is taxed at the same rate as income from employment. Under the current system, some business income is taxed at excessive rates because of the double taxation of corporate dividends. Other business income is lightly taxed or even subsidized through tax shelters.

Q: Isn't the tax unfair because rich people can live off interest and capital gains income and thereby pay no taxes?
A: Not at all. In effect, the simple tax puts the equivalent of a withholding tax on interest and capital gains. The business tax applies to business income before it is paid out as interest, or if it is retained in the business and generates capital gains for stockholders. The interest, dividends, and capital gains received by the rich have already been taxed under the business tax. The rich cannot escape the tax.

Q: Won't part of the tax on capital be shifted onto consumers in the form of higher prices rather than being paid by the owners of the capital? Isn't this unfair relative to the compensation tax, which will not be shifted?
A: Yes. There is a fundamental difference between capital, which is a produced input, and labor, which is a primary, unproduced input to the economy. Because it permits first-year writeoff of investment, the simple tax puts no tax on the marginal addition to capital--the tax benefit of the writeoff in the first year just counterbalances the taxes that will be paid from its productivity in the future. For this reason, the tax is not actually shifted forward. On the other hand, all of the growth in the revenue from the simple tax comes from growth in the size and real incomes of workers. It is not an issue of equity but rather of economic

reality that all taxes bear fundamentally on labor income. The simple tax embodies the right incentives for people to save labor income to form capital.

Q: Isn't it unfair not to tax capital gains received by individuals?

A: Capital gains are taxed under the simple tax. Capital gains from the sale of a business property--an office or an apartment building, or a house held for investment purposes--would be taxed under the business tax, which treats the proceeds from the sale of plant, equipment, and buildings as taxable income for the business. Capital gains on stocks, bonds, and other financial instruments arise from the capitalization of after-tax income; it would be double taxation to tax the capital gain as well. Capital gains on owner-occupied houses arise from the capitalization of rental values which are heavily taxed by state and local governments; again, it would be double taxation for the federal government to tax the capital gain as well.

Q: Why does the simple tax collect the business tax from the firm and the compensation tax from the worker? Wouldn't it be more consistent to collect both from the firm or both from the individual?

A: The nation's experience in trying to collect income taxes on interest and dividends from individuals has been dismal. One of the huge advantages of the flat-rate simple tax is that it permits airtight collection of taxes on business income at the source, where enforcement is easiest. On the other hand, requiring individuals to fill out the compensation form is necessary to provide the benefits of the personal allowance to each taxpayer. The tax withholding system already in operation would be adapted to permit the collection of most of the compensation tax from the employer, so that taxpayers would not be faced with a large single tax payment at the end of the year.

The Business Tax

Q: What would happen to the unused depreciation deductions from capital investments made under the old tax system?

A: These deductions would simply be lost. In the first place, much lower tax rates make the deductions much less important--reduced taxation of the earnings of capital completely offsets the decline in the value of the deductions because of lower tax rates. In the second place, the existing combination of an investment credit taken at the time of purchase and accelerated depreciation for tax purposes means that most plant and equipment has already received most of the tax benefits; eliminating the remaining depreciation would not impose an important burden on business.

Q: I'm a travelling salesman. I earn commissions and pay my own travel expenses. I do not receive a salary. How would I fill out the simple tax?

A: All self-employed individuals will file the business tax form, where they can deduct business expenses. In order to take advantage of the personal allowance, you will want to pay yourself a salary of at least, say, $6200 if you are married. Report this amount along with your wife's earnings on your compensation tax form. In this way, you will be able to deduct your legitimate business expenses and receive the personal allowance.

Q: Please explain how the current system taxes income twice. Isn't income income no matter what its source?

A: Income is an individual's command over resources. Only people have income. The income of a corporation is just the income of its owners, the stockholders. The current tax system sometimes taxes the same income twice, once when the corporation receives it and again when it is paid as dividends to the stockholders. The combined tax rate on the stockholder's income is almost confiscatory, even though the two separate taxes are at rates of around 50 percent.

Q: How are tax losses for individuals and businesses treated?

A: Remember that the self-employed fill out the business tax form just as a large corporation does. Business losses can be carried forward without limit to offset future profits. There is no such thing as a tax loss under the compensation tax. You can't reduce your compensation tax by generating business losses.

Q: Would a company going bankrupt get a tax refund in proportion to its loss?

A: No. The simple tax would never make payments to taxpayers. However, a bankrupt company could be acquired by another firm, which would assume the tax loss.

Q: Some companies pay so much interest today that requiring them to pay the business tax (which does not permit the deduction of interest) would make them operate at a loss. Is this appropriate?

A: This is an aspect of the transition to the simple tax. Corporations and homeowners with large amounts of debt will suffer, just as those with large holdings of bonds or mortgages will gain. For two reasons, the problem will not be too serious. First, the dramatic reduction in the tax rate to 19 percent will more than offset the increase in taxes from the loss of interest deductions in most cases. Second, most corporate debt can be called and reissued at lower rates as soon as the simple tax goes into effect.

Q: If a firm plowed back all of its income into plant and equipment, and hence paid no business tax, couldn't the firm increase its value forever without paying taxes? Wouldn't the stockholders receive the capitalized value of the firm as untaxed capital gains?

A: Sooner or later, the firm will run out of sufficiently profitable opportunities and will start paying out its income to its owners instead of plowing it all back. If the market didn't believe this, the stock would have no value, because the stockholders would not believe that they were ever going to get anything. The market will always know that the tax will be imposed on any returns earned by the stockholders, so the market value of the firm will always be the capitalized value after taxes.

Q: Won't businesses constantly buy and sell equipment in order to take advantage of the immediate writeoff?
A: There is nothing to be gained from extra purchases and sales. The proceeds of a sale of equipment must be reported as income, and offset the tax benefits of a subsequent purchase.

Q: How are individuals taxed on their rental activities? Is rental income part of individual compensation or business income? Would individuals have to file both business and individual tax forms if they had both kinds of income?
A: Renting is definitely a business activity and would call for a business tax form. Rental receipts are taxed as business income, but purchase of a rental unit qualifies for first-year writeoff. Because there are no complicated depreciation computations, very little effort would be required to fill out the business tax form for a rental unit.

Q: If a company provides its employees with subsidized lunches, physical exercise facilities, company cars, and the like, how are these treated under the simple tax?
A: Fringe benefits cannot be deducted as expenses under the business tax. Of the firm's expenditures for the purpose of

attracting and keeping workers, only those paid directly to the worker and reported for the purposes of the individual compensation tax are deductible for the company.

Q: As an investor, I currently find that percentage depletion is better than cost depletion for my oil wells. What will happen to depletion under the simple flat tax?

A: Depletion will disappear as a special complication of the tax law. Instead, first-year writeoff will apply to all purchases of oil property and all development costs.

Q: I am involved in a highly leveraged investment company. Won't my company and others like it be forced out of business by the simple tax because we won't be able to deduct interest expenses any more?

A: It is true that you will no longer be able to deduct interest expenses. But it is likely that your borrowing is linked to market interest rates. If so, the decline in interest rates upon the adoption of the simple tax will offset the loss of the deduction. Also, don't forget that the income from your company will be taxed at only 19 percent. Try filling out the business tax return to see what will happen to your total tax payment.

Q: Does the simple tax cover the fringe benefits of government and non-profit organizations?

A: Yes. They are required to file the business return in a particular way that exempts all of their income except what is paid to their employees as fringes. In this way, the simple tax avoids a distortion in favor of government and non-profit activities which would arise if they alone could pay untaxed fringes.

Q: How will the simple tax affect the value of the U.S. dollar in the foreign exchange market?

A: The tax treatment of imports and exports of goods and services will be essentially the same under the simple tax as under the existing income tax, so there will be no change in the value of the dollar on that account. The lower interest rates that will accompany tax reform may bring a temporary decline in the value of the dollar, which will stimulate U.S. exports and discourage imports.

The Compensation Tax

Q: With the current income tax, my fringe benefits aren't taxed. Your simple tax doesn't tax fringes either, but it does not permit my employer to deduct them. What will happen to my fringe benefits under the simple tax?

A: Your fringe benefits are one of the features that attracted you to your job, and your employer will not want to cut them without compensating you in some other way. The simple tax eliminates the distortion toward fringe benefits created by the present income tax, so you can expect that your employer will offer you reduced fringes in exchange for higher pay, which you can use to buy the benefits yourself or for any other purpose.

Q: My teenage daughter has taken a part-time job and will earn about $1000 this year. Can she use the personal allowance of $3800 to avoid paying tax? Will I lose my dependent's allowance of $750 for her?

A: All taxpayers are entitled to the personal allowance, including your daughter. You will retain the dependent's allowance as long as you provide more than half her total support over the year.

Q: As a member of the armed forces, I get to exclude certain benefits and allowances from my pay for tax purposes. What will happen under the simple tax?

A: The benefits you receive in kind--for example, military housing--are not taxed under the individual compensation tax. Just like a private employer, the Defense Department will have to pay the Treasury a business tax on the value of those benefits. Your cash benefits will be taxed under the individual compensation tax. The government will have to make a modest increase in these benefits in order to offset the 19 percent tax you will have to start paying on them.

Q: I am an American citizen and now enjoy a $75,000 exclusion for income earned abroad. How will this income be treated under the simple flat tax?

A: All income earned from work performed abroad, or from enterprises located abroad, is excluded from the simple tax. Such income will be taxed by the country where you earn it.

Q: The simple flat tax eliminates the credit for child and dependent care expenses. Won't this force people to stay home to take care of their children and elderly dependents, thereby increasing their dependence on welfare, reduce their participation in the labor force, and cost more money to the government that it would save from its elimination?

A: Like many of the complications in the tax system, the child care credit fails to focus its benefits in an area of particular social need. In effect, it lowers the taxes of a significant fraction of all taxpayers--families with two earners and one or more children. It is available at all income levels. Higher tax rates are required to finance this lowering of the amount of taxes. Features like the child care credit are antithetical to the flat-tax philosophy, which favors a broad tax with the lowest tax rate. We think that the special problems of helping poor families with child care and other responsibilities should be attacked specifically within the welfare system, not with the scatter gun of the tax system. The simple flat tax provides plenty of revenue for a generous welfare program.

Q: Isn't it unfair to start taxing workman's compensation?

A: Workman's compensation makes payments to replace wages when a worker is disabled on the job. The wages themselves would have been taxed, so it stands to reason that the replacement should be taxed. Failing to tax workman's compensation would create an inappropriate incentive for workers to remain off the job after a period of disability.

Q: Why does the simple tax eliminate the extra exemptions for the blind and the elderly? What makes you want to lay higher taxes on these two especially unfortunate groups in our society?
A: Many of the elderly and a few of the blind are quite well off. It raises everybody's tax rate inappropriately to provide extra exemptions to every elderly and blind individual. It makes sense to concentrate policies with respect to the incomes of the elderly in the social security system--the value of the current extra exemption is trivial compared to the social security benefits received by the typical older person. For the blind, efforts should be concentrated in welfare agencies, not in the tax system.

Non-profit Organizations

Q: How does the simple tax treat non-profit organizations like cooperatives that pay dividends?
A: They are exempt from the business tax, but their employees must pay the individual compensation tax. As under present law, their dividends are untaxed. Note that non-profit organizations cannot benefit from the investment incentive of first-year writeoff either.

Q: What about non-business entities such as trusts, estates, or charitable organizations including churches and schools?

A: Any actual business owned by one of these entities must file the business tax form. Their employees must pay the individual compensation tax. Otherwise, they are not taxed. Note that a conventional personal trust, which holds stocks and bonds, deals entirely in after-tax income and there is no reason for the tax system to pay attention to it.

Inheritance

Q: What about the inheritance tax?

A: We do not believe that an inheritance tax is necessary under a system with watertight comprehensive taxation of income.

Q: Wouldn't it be a good idea to broaden the tax base by including gifts, life insurance proceeds, inheritances, and so forth?

A: No. The base for the simple tax is carefully chosen to provide the most efficient economic incentives. Further broadening to the listed items would be double taxation. Gifts represent the transfer of income that has already been taxed and there is no reason to tax it again. Life insurance proceeds are a mixture of interest earnings, which have already been taxed by the business tax, and return of premiums, which again were paid from income already taxed. Inheritances are just a special form of gifts.

Economic and social benefits

Q: How will the simple tax change the spending and savings patterns of individuals and businesses?

A: The improved, uniform investment and savings incentive provided by universal first-year writeoff will channel capital into its most productive uses. Equalization of tax rates across taxpayers will prevent the widespread abuse of tax shelters which divert savings from their efficient destinations. Dramatic reductions in marginal tax rates will stimulate investment and work effort, and draw activities out of the underground economy and into the more efficient market economy.

Q: How much time and money will we save by having to fill out only the two postcard returns in place of form 1040 and all its schedules?

A: The Treasury estimates that businesses and the public spend over 600 million hours filling out returns; almost all of this would be eliminated by the simple tax. At a conservative value of $6 per hour, that 600 million hours is worth $3.6 billion.

Q: It sounds like the simple flat tax is just a clever ploy to raise taxes on the already overburdened American taxpayer. Aren't we actually better off with the present system, with all its defects?

A: It is true that many people's taxes will rise a little right after the tax reform. But quickly everyone will benefit from the increased economy activity that will accompany a dramatic improvement in the incentives facing the most critical participants in our economy. Within seven years, we foresee a nine percent increase in real incomes on account of the simple tax, almost double its immediate tax increase for any income group.

Q: How will the simple tax help the American economy to grow?

A: The most obvious and best-documented effect comes from workers' response to improved incentives. With lower tax rates, the take-home pay from extra work--longer hours, more weeks per year, or a second job--will rise. For the most productive and highly-paid workers, taxed today at rates up to 50 percent, the improvement in work incentives will be especially dramatic when their tax rate falls to 19 percent. More subtle, but equally important sources of growth will come from the vast improvement in the incentives for entrepreneurial activity. Today's tax system puts tax rates as high as 60 or even 70 percent on the rewards to successful innovation, thanks to the cascading of the corporate and personal income taxes. With the taxes rationalized by the new business tax, at the low rate of 19 percent, bright people will be attracted to innovation and away from the tax-sheltered activities favored by the current tax system. Finally, the simple tax provides stronger incentives for capital formation, an important source of growth in the longer run.

Senator LONG. Thank you very much, gentlemen, for some very useful statements. We go under the early bird rule here, so since I was the first one here, I will ask the first question.

Mr. Pechman, we had Mr. Harris, who is a good pollster, here yesterday. He provided us with some useful information about what the Harris Poll shows on taxes. Let me ask you this question: If you just asked the question to the average American out there—just a rank and file of middle-income people—if you said something like this: There are many ways a flat tax could be levied. Would you favor a flat tax if it meant that your taxes would be substantially increased?

Mr. PECHMAN. Well, the answer would be no.

Senator LONG. That would be my reaction because my impression about tax simplification is that most people are all for tax simplification unless they find they are going to pay more. When they find they are going to pay more, that's the end of it.

Now let me ask you this. Do you have available to you or has it been made available to you one of those Treasury studies that we were getting for several years that showed on several different bases, such as expanded income, how much taxes people in various groups are paying?

Mr. PECHMAN. Yes, I've seen those studies. And, in fact, the tables that I appended to my statement provide the same type of data. They give you what an expanded income tax ban would yield in terms of revenue with various tax rates.

Senator LONG. Right. We had Mr. Weidenbaum before our committee a couple of years ago. And then he came a year later as the chairman of economic advisors. And he made the statement at that time that the very affluent, those over $200,000, were paying 42 percent of the expanded income in income taxes. Now if that was the case, then I would think in this next year when you get this top rate down from 50 to 70 and you get the capital gains rate from 28 down to 20, it looks to me like those people should be paying about 30 percent of their expanded income in income taxes.

Mr. PECHMAN. Your arithmetic is almost right. If you look at my table 8——

Senator LONG. Table 8. Let me find it.

Mr. PECHMAN. This is an estimate of the distribution of the effective rates of tax paid in each income class in 1984, after the Reagan tax cuts go into effect. As you can see, the top effective rate is for incomes between $500,000 and $1 million. It's 26 percent of an expanded AGI. In the class above that, it's 23 percent.

Senator LONG. Well, according to this—and this would surprise people. Now if this is correct, I think we ought to put an ad on television or something and tell the people about this. According to this—and I take it that you get these figures from the Treasury. This is from the Treasury studies?

Mr. PECHMAN. This is from a file provided to us by the Treasury which we ran through a computer. Yes.

Senator LONG. Well, I think we ought to try to get this and see if this is correct because according to this, the people who make a million dollars and over on the average are paying less to us in income taxes than the people who are making $500,000 to $1 million.

Mr. PECHMAN. That is correct. That is largely as a result of the fact that people with over a million dollars have a very, very high percentage of their income in capital gains, which are subject to a maximum rate of 20 percent. That overwhelms the ordinary tax rates. But you are entirely right. It's slightly regressive at the top.

Senator LONG. Now I know some of those people. And I am proud to know them. Those people have good manners. They eat on tables that have tablecloths on them and all that. They are very nice people. I like to know people like that. Some of them can even contribute to campaigns. [Laughter.]

Mr. PECHMAN. Or to the Brookings Institution. [Laughter.]

Senator LONG. But according to this—and I am not sure you are right. I think we ought to study that and see—those making over a million dollars are paying 23.1 percent of their expanded income in income taxes.

Mr. PECHMAN. That is correct, sir.

Senator LONG. It seems to me as though they aren't hurting. I don't know what the hell they would be kicking about if that is all they are paying. Maybe they are spoiled.

Mr. PECHMAN. Well, I agree with you. What this table shows is that, when you take into account the exclusions and deductions under present law, we have a very mildly progressive tax. It is not a punitive tax at all.

Senator LONG. Well, my thought is that in order to arrive at that conclusion, to arrive at that point—where they are only paying 23 percent of their expanded income in taxes—they probably have to do some things that are not necessarily in the national interest. And maybe we ought to change the laws in that respect. So I don't see where those people have any great claim on a tax cut, especially those that are paying even less than that because this is an average.

I see we have a response over here from Mr. Penner.

Mr. PENNER. I would like to comment on that, Mr. Chairman. I don't want them to shed tears over those having over a million dollars a year in income, but I think it should be pointed out that those people only get their tax bills down that far by accepting some rather large costs. That is to say if you want to engage in tax shelters and so on, you very often have to buy investments with low rates of return relative to rather enormous risks. So that while some of those people may escape the tax system in the sense that they don't pay any money to the Treasury, and that's bad, they don't escape the effects of the tax system. It costs them a lot of money to avoid paying taxes to the Treasury.

Senator LONG. I don't think you ought to say that they don't pay any taxes because if you know anybody making a million dollars and not paying us anything, I wish you would just give me his name. And I will ask that they pull tax returns because we have been working hard to see to it that that number is reduced to a minimum. That they invested in tax-exempt bonds, State and local bonds. But in the record they pay something because they get less interest that way than they would if they hadn't invested in those.

Mr. PENNER. That's my point exactly. And a flat tax would change all that.

Senator LONG. I guess I am just stating a philosophical difference here. I have been on both sides. I know what it is to make a little income and I know what it is to make a lot of income. I've been on both sides of that fence. And I, for the life of me, don't know why somebody who has the good fortune to make a hell of a lot of income—a million dollars worth—shouldn't be willing to pay us more than a 10 percent tax. Do you?

Mr. PENNER. I have no problem with that kind of tax rate. I just wish it would apply to all of the people who were making a million. While you are quite correct that the changes in the tax laws greatly reduce the people who getting away with paying no tax at all, the real problem with our system is, if you look at those people over a million dollars, you will see an enormous variety of tax rates paid by them, as you will in any other income class.

Senator LONG. And I can support the simplification. I can support something that makes it more attractive for a person to make a wise investment in the national interest, and an unwise investment. Some of these phony tax shelters I don't agree with, but there are also a lot of provisions in the law that makes them make investments that are very good for us. Some are very much criticized. But as bad as we need energy, I think you are serving the Nation when you drill an oilwell or a gas well. And I feel sorry for the poor soul that lost every nickel he put into one of those things. I've had that experience.

But, likewise, when you build a new plant or equipment, that gives you some tax advantages, too, doesn't it?

Mr. PENNER. Most certainly.

Senator LONG. Well, I have trespassed long enough, but I do think that I ought to invite Mr. Hall to comment on what has been said here because I have had a shot at all of you.

Mr. HALL. Let me just make one brief remark on that point. The numbers that we have been discussing don't bear on the issue of incentives at all. Suppose that I had a good idea and I took the project to one of your million dollar individuals and made a simple investment proposal. That individual would be taxed, personally, at the 50 percent rate. Even though he is paying, say, 10 percent tax, any increments to his income would be taxed at 50 percent.

And, furthermore, a good idea embodied in a corporation would be taxed as well at the 46 percent corporate rate. So that the disincentives to investments that appear in our tax system today are not revealed by this type of calculation. And they are very, very severe.

Focusing just on the distributional consequences of taxes, I think, is a very serious mistake. If we can revitalize the economy by improving the incentives, it makes everybody better off. Even if that makes the million dollar taxpayer get a larger than proportional share, it seems to me it's a step ahead. And we ought to pursue such improvements in the system even though they tend disproportionately to help people who are already well off because they help everybody.

Senator LONG. Now let me just invite you three witnesses—as far as that is concerned, I would be willing to invite all the witnesses that are going to appear today—after you have heard what has transpired here, and you are like a lot of all good witnesses who have done a lot of study on the subject, you will find some things that were not said that you think ought to be said. And I would like to invite all of you to send a rejoinder to add whatever you would like to add to the record because I think all three of you have really studied the matter, and you have a useful contribution to make. I think the committee would benefit from it.

Senator LONG. Senator Bradley was the next one.

Senator BRADLEY. Thank you, Mr. Chairman. Let me say to Mr. Hall that I am glad that you have very clearly separated the flat tax advocates who support the Hall-Rabushka plan, from the fair tax advocates of the Bradley-Gephardt. I think one thing these hearings will do is precisely that—separate the two.

I would like to try to get a little better understanding of what your plan really is. There are a number of things that have been asserted. You've asserted them. I've read them in other places. And I would just like to get a sense of just what your plan is for the committee's benefit. When you say you tax income only once, what does that mean?

Mr. HALL. That refers to the problem that exists in the current tax system of the taxation of corporate income where income is taxed first in the corporation. And then when it is paid out as dividends or capital gains, it's taxed again at the individual level. The effective rate of taxation for an investment say in a new firm—someone has a good idea and creates a firm based on that idea and then has to pay taxes on that—the tax rate on that income, as I say, can be, with a compounding of the two tax systems, as high as 65 percent.

Many, many economists have pushed the idea of integrating the two tax systems—corporate and personal—so that taxation occurs only once. Now we have figured out how to do that in a way that solves some other problems in the tax system as well. Essentially what we have is the taxation of all business income, corporate and noncorporate, at the source. That is, at the business. Then when it is paid from the business to the owner of the business, it's after-tax income. That, incidentally, solves another major problem in the tax system which is a lot of business income is simply not reported. It is illegally evaded because of the fact that it is supposed to be taxed at the individual level. A large business can have millions of owners. And each one is supposed to report the dividends, for example. According to the IRS, something like 20 percent of dividends are simply not reported. That's why Congress finally enacted a withholding tax provision this year. But it's very minor.

In essence, our proposal is an airtight withholding system. It says there is going to be only one tax on this income, but that tax is going to be paid in a way, as I said, that is completely airtight.

Senator BRADLEY. So you are saying that the corporation would pay a 19 percent tax essentially.

Mr. HALL. That's right.

Senator BRADLEY. But all the profits of the corporate sector, except the profits that are not reinvested, would be subject to that tax? Is that the idea?

Mr. HALL. Well, "profit" is not quite the right word because we tax interest and dividends. Normally, firms are allowed to deduct interest before they compute profit. We tax both interest and what is now called profit. But then, of course, we also allow first write-off investment incentives.

Senator BRADLEY. Well, what I am getting at is that we had a couple of witnesses earlier in these hearings say that what they were for was a tax where if you spent the money, you paid a tax on that. But if you didn't spend it, if you saved it or reinvested it or whatever, you wouldn't pay a tax on that. Now we call that a consumption tax.

Mr. HALL. Right.

Senator BRADLEY. What is the difference between that tax and the one that you have advocated?

Mr. HALL. None at all.

Senator BRADLEY. None. So you are advocating a consumption tax?

Mr. HALL. That's right, but we are careful not to label it as a consumption tax because there has been so much misunderstanding of the problems of a consumption tax.

Senator BRADLEY. But that's what it is. I know you don't label it that, but that's what it is.

Mr. HALL. That's correct. It has exactly the same incentives as a consumption tax. Certainly.

Senator BRADLEY. What's the difference between that tax and a 19 percent sales tax?

Mr. HALL. Only the progressivity. The problem with doing it as a sales tax is——

Senator BRADLEY. What if we said we had a 19-percent sales tax, but then we would give some exemptions for families with kids?

Mr. HALL. Well, as a sales tax, that's not practical. How would you excuse people from, say, the first $8,000 of their purchases?

Senator BRADLEY. Well, how do you know who is eligible for the rebate?

Mr. HALL. This is a very significant problem because there are many, many people physically present in the United States at any one time who would not be eligible for a rebate. And it's very difficult to find people lining up who are——

Senator BRADLEY. Well, let's look at it like we are designing the ideal tax system. Right? Or you are designing the ideal tax system.

Mr. HALL. Which credit?

Senator BRADLEY. We could increase the earned income tax credit.

Mr. HALL. There's a very significant administrative problem with that type of proposal. Were it not for the administrative problem, I would be very much in favor of the system you are talking about.

Senator BRADLEY. OK. Well, I accept that. We had the IRS here yesterday telling us not to make any changes either because it is too tough to administer any changes. I don't think that is going to sell.

Mr. HALL. The administrative problem I am referring to is if the IRS gets in the business of writing large checks to individuals, then people will figure out millions of ways to fraudulently apply for those checks. That's a very significant problem. And it defeats, it seems to me, the proposal to tax everything and then give it back in the form of a rebate.

We figured out how to avoid that administrative problem by designing a tax system which does not involve having the IRS write checks to people.

Senator BRADLEY. Have you calculated what the tax would be on a family earning $30,000 under your system? Have you done that?

Mr. HALL. Yes.

Senator BRADLEY. What would that be?

Mr. HALL. I didn't bring that number with me.

Senator BRADLEY. Basically what I am going to get at, if you don't know—as you probably would know—is I want to compare what that family would pay under your tax versus what it would pay under existing law.

Mr. HALL. Let me give you the results of what I have done in that area. But let me first point out why it is a complicated question.

We are proposing that individuals pay a tax only on the wage and salary part of their income personally. The rest of the tax they pay is already paid before they receive dividends, interest, and other types of business income. The calculations that I have done attempt to impute to individuals the income that they have already paid the tax on as well as the tax that they pay on wages and salaries. Otherwise, the comparison is really meaningless because we are changing the logic of the tax system so you must compare all the taxes that people pay today with all the taxes——

Senator BRADLEY. You mean all the income tax?

Mr. HALL. All the income tax.

Senator BRADLEY. Federal income tax.

Mr. HALL. Federal income tax, personal and corporate under the current system has to be compared to the individual compensation tax plus the business tax that they would pay under the reform.

Senator BRADLEY. Well, since you don't know how much more a family earning $30,000 would pay under your plan——

Mr. HALL. I do. I have done these calculations.

Senator BRADLEY. How much more would they pay?

Mr. HALL. The answer is that their taxes would increase by an amount equal to about 5 percent of their current income; $30,000 is the worst case. That's the case where the——

Senator BRADLEY. Say that again. Their taxes would increase by how much?

Mr. HALL. Their taxes would increase by about 5 percent.

Senator BRADLEY. But what percent increase in Federal income taxes is that?

Mr. HALL. I didn't bring those numbers with me.

Senator BRADLEY. Does any other panelist have it?

Mr. PECHMAN. Very simply, if a person receives $30,000 and gets a $10,000 exemption for a family of four, his tax base would be $20,000. If he paid at a 19-percent rate, his tax would be $3,800. Under present law, the average person at that level pays 10 percent of his income, which is $3,000. So his taxes would be increased by $800 or little less than 30 percent.

Senator BRADLEY. A 30 percent tax increase.

Mr. PECHMAN. Yes.

Mr. HALL. I want to make two points on that. First of all, it seems to me that the relevant way to compute a tax increase is relative to income; not relative to tax. Suppose you change from a tax system that charged somebody zero to one that charged them $1 a year. That would be an infinite percent increase, and yet we wouldn't be concerned about that increase. That's the first point.

The second point is that the U.S. economy today is operating at about 10 percent below its potential. There is really a serious problem in the economy today. I'm convinced that an important part of that shortfall in performance has to do with the tax system. And I don't advocate a system that would have a long-range effect on people's income of reducing their aftertax income by 5 percent. I think that would be a disaster. It's only because I believe that revitalization of the economy requires a change in the way we treat successful taxpayers to improve incentives.

Senator BRADLEY. I think all of us would agree with that. The question is whether we are going to evolve into a system that has some consistency with present law or whether we are going to strike out in a totally new direction.

Let me just point out for the record, because I see out of the corner of my eye the amber light, that in this list of various income categories that Dr. Pechman submitted with various amounts of tax, that under current law we are talking about the person with a million dollars or more, and granted that that person probably gets the bulk of that income from a capital gains transaction, under current law, that person still pays 23 percent of his or her income in taxes. Under the Bradley-Gephardt that person would pay 25 percent of his or her income in taxes. Under a 17-percent flat rate, that person would pay 16 percent of his income in taxes. So what you have is an enormous tax reduction for individuals with more than a million dollars worth of income.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Hall, I was curious about a comment you made earlier that if there were no mortgage interest deductions that, in fact, housing would increase due, presumably, to lower interest rates because—whatever reason. And I'm not quite sure. And that's my question. Could you please explain to me why you think that if there were no mortgage interest deduction that the rates would, therefore, fall, and housing would increase? And could you document that, too, in some way?

Mr. HALL. The starting point in the explanation is to observe that the tax reform would put all interest on a different basis from where it is today. This is not a specific treatment of mortgage interest. I would strongly oppose the elimination of the deduction of mortgage interest by itself. It's the reform and the entire treatment of interest throughout the economy that brings about the reduction in interest rates.

Senator BAUCUS. Let me just ask the question a little differently if I could. Let's assume two different situations. Under one, we have a flat tax. Say 19 percent or whatever it might be with no deductions. In the second case we have the same flat tax with the home mortgage interest deduction like we have today. My question is under which of those two alternatives would there be more housing?

Mr. HALL. Under the second proposal you would be introducing a special break for housing so that that would stimulate housing relative to the flat taxes, as I am proposing it, in a quite inappropriate way.

Senator BAUCUS. How?

Mr. HALL. It would be a substantial stimulus relative to the current situation assuming that all other interest was being treated in the way that we proposed. Then to give a special break for mortgages would be to pour Federal tax money into housing, which I think would be quite inappropriate.

Senator BAUCUS. I'm just trying to clarify this.

Mr. HALL. I think your first question was a more appropriate one. That is, how would the housing industry look if we had the flat tax today, compared to the current tax system.

Now my answer is that because of the change in the treatment of all interest throughout the economy, interest rates would fall. We have computed that they would fall by about 3 percentage points. So in mortgage rates today, a 16-percent rate would become a mortgage rate of 13 percent. And the same thing would be true of Government bonds, corporate bonds and so forth.

The reason for that is very simply because we propose that the taxation of interest be on a different basis. It's not that interest is being untaxed. It's that it's being taxed on a different basis. It's being taxed at the source. So, for example, a corporation that borrowed would no longer have deductibility of the interest under the tax system. They would be willing to pay less interest. On the other hand, the holder of the bond would no longer have to pay income tax on the interest income. And, therefore, he would be satisfied with a lower interest rate. So it is a simple, logical matter. And I don't think it is one that is argued by any economist I know of that that change in the basis of taxation would dramatically lower interest rates.

Now on the other hand, of course, the homeowner would no longer enjoy deductibility of interest. In our computations, those two influences almost exactly offset. So from the perspective of somebody thinking about buying a house, the economics of homeowning is unchanged. They would see on the one hand a less favorable tax treatment. But on the other hand, they would see lower interest rates. And to a reasonable approximation these exactly offset.

Therefore, the attraction of a house, which is what determines the price of a house, would remain the same. And the profitability of building new houses, which is determined by the prices of existing houses, would also remain the same.

So our answer is that there is no threat to the housing industry.

Senator BAUCUS. Let's take the proposal introduced by Senator Bradley. Let's take it as it is. An alternative proposal would be as is without the home mortgage interest deduction. The question is, again, under which of the two alternatives would there be more housing?

Mr. HALL. Again, you are asking quite a different question because you are asking a question that deals only with mortgage deductions.

Senator BAUCUS. That's right. Answer my question. What's your answer to my question?

Mr. HALL. The answer to that question is very straightforward. Namely, that the housing industry would be in better shape in a system such as Senator Bradley is proposing where the deductibility of interest is retained as opposed to one where it is eliminated just for mortgages.

Senator BAUCUS. If I might, Mr. Chairman, just one more quick question.

The CHAIRMAN. Sure.

Senator BAUCUS. Mr. Pechman, on your table 8, did you assume a 6-month or a 1-year holding period for capital gains?

Mr. PECHMAN. Well, the present law calculation assumes a 1-year holding period.

Senator BAUCUS. Right. So how would the 6-month holding period change that table?

Mr. PECHMAN. It would reduce the average effective rates in the top brackets somewhat. Not a great deal.

Senator BAUCUS. Thank you very much.

The CHAIRMAN. Thank you very much. I want to thank the members of the panel for being here. I am sorry that I missed the testimony.

Mr. Pechman, how long has the idea of flat rate been around? Did it just spring up this year?

Mr. PECHMAN. Well, the first article I wrote on the comprehensive income tax was published in 1955.

The CHAIRMAN. 1955?

Mr. PECHMAN. Yes, sir. In that article, I concluded that you could reduce tax rates by something like a third. I later raised it to 40 percent assuming the tax base were broadened by eliminating unnecessary exclusions and deductions. And that's exactly what my calculations show today: that we could reduce the top bracket rate from 50 to 30 or 28 percent and still get the same revenue.

The CHAIRMAN. Mr. Hall, how long have you been working on your plan?

Mr. HALL. Well, I would say since 1965 when I first began to think about it. The catalyst to my interest in this was the article I wrote in the Wall Street Journal that appeared last December which received a much larger enthusiastic reception than I ever anticipated, and drew me into this movement in a very serious way. But it's a very longstanding interest of mine.

The CHAIRMAN. You don't have a plan, do you, Rudy? [Laughter.]

Mr. PENNER. No, I don't.

The CHAIRMAN. Fine. Well, the only point I wanted to make is that I hope anybody who might be reading about our hearings or listening or whatever, they will not conclude that we will probably do anything this year. Maybe even next year, or the next year. [Laughter.]

Because I think as Mr. Pechman indicated, and was agreed in a discussion Senator Bradley and I had at the press club, we haven't originated this great idea. It has been around for 30 years. And I guess it is about 27. And maybe over the years you have known a time when there has been this much interest in at least broadening the base. Maybe that interest has surfaced before we arrived on the scene. But it has surfaced again. I think there is a great deal of interest in base broadening and lowering rates. And I think that's the real impetus that may push us along the right path.

But it's not easy. We found that out this year. But in any event, we are going to continue. And we will be asking you again, as Senator Long indicated, as we proceed if you have any additional ideas. We would hope to have some field hearings some time next year, as well as additional committee hearings. I'm not certain what the House intends to do. But we know there are a lot of problems when you start eliminating unnecessary deductions and exemptions and credits. And I need somebody to give me a nice pat list of which ones are unnecessary. And Senator Bradley has picked out some that certainly have strong appeal.

When I read Mr. Hall's statement, the mortgage interest deduction is not necessary—medical or charitable. You suggest offsetting benefits in support of that. And I don't know if Mr. Penner touched on specifics. Did you get into specifics, Mr. Penner?

Mr. PENNER. Well, I guess the one deduction, and the only deduction, that I see a great merit in keeping is the charitable deduction. Most efforts to subsidize this or that by the tax system could be handled on the spending side of the budget. But, frankly, I don't see any satisfactory way of handling that particular one.

The CHAIRMAN. Did you list, Mr. Pechman, the necessary or unnecessary? I haven't had a chance to go through these charts.

Mr. PECHMAN. Yes. Plan one in my statement is the most comprehensive plan. I limit the deductions there to what I regard as the most essential and necessary. If you were a purist like I am, and had a moderately progressive income tax on a broad base, I think the only deductions you would allow would be deductions for unusual medical expenses and casualty losses because people with those kinds of expenses and losses really have less ability to pay out of a given income than other people with the same income.

I would also allow deductions for work related expenses. For example, expenses that are associated with earning income.

The CHAIRMAN. Work related.

Mr. PECHMAN. But the basic personal deductions I would allow would be deductions for medical expenses and casualty losses in excess of 10 percent of income. I would allow an interest deduction only up to the amount of property income that a person reports on his or her tax return on the ground that it shouldn't matter whether you borrow money or invest out of your own funds. You ought to net out your property accounts.

However, if your interest payments exceed your property income, that amount of interest has not been counterbalanced by income, and I would not allow that deduction, but would permit people to carry it forward into future years against property income.

So I have a pretty broad base. My message is that you don't have to be a purist. Senator Bradley and Congressman Gephardt have shown that you can make your own judgments about which deductions are essential, and still come out with a top bracket rate of 28 percent. I think the American people would find that very attractive—a tax rate schedule that doesn't exceed 28 percent. That's the case under my plan, and under Senator Bradley's plan. That would be very attractive to a lot of people. It would capture most of the economic advantages that Bob Hall talked about without sacrificing progressivity, which I think is terribly important in our society.

The CHAIRMAN. Thank you very much.

Senator LONG. Let me ask you this, Mr. Pechman. Under the plan that you think is the best, the one that you would recommend most, what would be your beginning tax rate?

Mr. PECHMAN. Nine percent on the first $5,000 of taxable income, above the zero bracket amount.

Senator LONG. And then your top rate would be what?

Mr. PECHMAN. Twenty-eight percent.

Senator LONG. Twenty-eight percent. Now let me just share a point with you. How would you feel about that if we simply dropped the rate across the board? Instead of a 9-percent rate, for example, start them out with a 5-percent rate, and instead of a 28-percent rate, start them out with a 24-percent rate. And then pick up the difference with something that would clearly be a consumption tax. I don't care whether you wanted to call it added tax. You could have it a tax on all energy. There are all kinds of ways you could get the money. But how would you feel about it if we simply dropped the rate? Just said, all right, let's just drop 4 points off on the top and 4 points off on the bottom and 4 in between.

Mr. PECHMAN. I think I would not like it as much as the plan that I proposed—plan one. I think it's less progressive than plan one because your consumption tax would tax people with incomes below the poverty line on their consumption. Under this plan, there is no tax on such people.

I would argue that a plan that goes up to 28 percent is quite reasonable. I mean the rates are not so large that we ought to use a consumption tax to reduce the rates even further. I don't think it's necessary.

Senator LONG. Well, I'm just thinking in these terms. It had a lot of appeal to me. And I think that you find some appeal to the idea. Starting every individual out with a tax credit of a given figure. Suppose you said, all right now, we will start everybody out with a tax credit of $1,000. And you just go ahead and compute whatever your tax would be, and you reduce it by $1,000. So after you get through your computation, you've got the credit of $1,000. In fact, as far as I am concerned, it has a lot of appeal to it because if that $1,000 exceeds what you would owe, we would just send you a check because, obviously, at that point you need some help. A negative income tax to that extent. So you start out with a minus $1,000. If you don't owe us the $1,000, we will pay you. But on the other hand, above that, you pay us.

But our intent of getting the money in—it seems to me that if you put your tax where it all comes together, just like generating power by striking the water up where it flows through a canyon. You've got a good point at which to tax. You can raise a lot of money. You can raise whatever you need to raise. And then I think that you can see the equity you are looking for by just simply starting with a tax credit so that the low income people get the best of it on that end.

Mr. PECHMAN. Well, the tax credit, doubtlessly, takes the curse off a good deal of the regressivity of a consumption tax. There's no question about it. I would say that, given the amount of revenue we are raising, we don't need to go into the complications of rebating consumption taxes. You would have to set up special machinery as Bob Hall pointed out to make those rebates. I'm not as concerned as he seems to be about the administrative problems, but I don't think we ought to saddle the Internal Revenue Service with such a burden if it's not necessary.

I agree with you that I can marry my plan with a negative income tax. If you are interested in working with me on that, I would be glad to devise a plan that will satisfy both your objective and my objective in the welfare area.

Senator LONG. Thank you very much.

Senator BRADLEY. I'd just like to thank the panel. Their testimony is extremely important. And I found it personally very helpful. Thank you.

Senator LONG. Thank you very much, gentlemen.

Now let me call the next panel of witnesses. Mr. Robert McIntyre, director of Federal tax policy, Citizens for Tax Justice; Mr. Fred Wertheimer, president, Common Cause.

[Pause.]

Senator LONG. We start out in the order in which you were called. Mr. McIntrye will go first.

STATEMENT OF ROBERT McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, D.C.

Mr. McINTYRE. Thank you, Mr. Chairman. I appreciate the opportunity to appear before the committee today on behalf of Citizens for Tax Justice. As you probably know, CTJ is a coalition of public interest organizations, unions, and citizens groups around the country. We represent tens of millions of American taxpayers.

This spring when Senator Flat and Representative Rate, as Senator Dole calls them, got together, the buzz word was simplicity. But, as I think these hearings have made very clear, the operative principle was trickle-down economics. These hearings have let the cat out of the bag. And I think this will probably mean the political death of talk about flat-rate taxes.

We now all understand that abandoning progressive tax rates in favor of a single rate is almost necessarily going to mean very much higher taxes on middle-income people, and very much lower taxes on the very wealthy. In addition, Senator Bradley, with his proposal, has made very clear that we can have a dramatically simplified, economically superior kind of tax code without making things even worse for working people. Neither of these ideas is particularly new, but their public airing is extremely useful. And I think these hearings, just as an exposé of what the flat-tax people are really after, already have served a tremendously useful purpose.

The remaining question I think we have to ask is whether we can get anything more out of this week besides this kind of exposé. A number of witnesses have said it would be a wonderful thing to come out of these hearings with a consensus on the future direction in which tax reform should be headed. Others have suggested that might not be possible.

But when we look at congressional action over the last many years in taxes, I think at least trying to get some idea of where we are going would probably be worth the attempt, because I think, on balance, most people would agree that the Tax Code has been getting more complex, more baffling, more economically destructive, and probably less fair over the last decade. Yet, obviously, Congress didn't intend, when it started out, that those kinds of things would happen. And I think some of the blame has to be put on the way the process works—on just an ad hoc basis. Where, if we see a problem we immediately search for a tax-based solution: Unemployment is too high? Let's have a job credit. We think we need more business investment? Let's have faster depreciation or an investment credit. We think we need more personal savings? How about an all-savers certificate? And then the public gets angry about tax unfairness, so we impose a minimum tax. And the process goes on and on, the Tax Code becomes more and more complex, and there are more and more problems for ordinary people.

The results of all this, I think, fairly clearly have not been very good for the middle class. If you look at what happened to Government revenues from 1969 to 1980, they didn't go up as a share of the GNP. But taxes on individuals went up, even as wages and salaries are going down as a share of the GNP. Now where was the shift? Well, part of it was the dramatic lowering in the corporate tax burden, as we all know. Part of it was also that we, by adding so many new loopholes to do this and that, ended up lowering the share of the tax burden paid by the wealthy. The official name for these new loopholes is "tax expenditures." We have seen them growing very rapidly. And, of course, in 1981 we saw them essentially going out of control. The figures that the Joint Tax Committee and the Treasury have put out suggest that under the 1981 bill by 1987, we would have had $1.88 in tax corporate tax subsidies for every dollar we collected in corporate taxes. In a sense, we would have passed the break-even point.

Now, of course, the idea of all these things was to help the economy. I think that's what everybody had in mind, and certainly it is a goal that we all share. But as one commentator has put it, it may be that we are suffering from a disease caused by the attempted cure. Because I think if we look at the record, in spite of all the tax breaks we've added for investment, for example, we haven't increased the share of the GNP going into investment. In spite of all the tax breaks added for personal savings, we haven't increased personal savings. But we have caused, besides higher tax rates, besides complexity, besides more unfairness, more economic distortions. And I think people are starting to realize that the time has come to try to move back to a system that is based on marketplace economics.

And I think most of us would agree with that. I think there are very few Members of Congress who would say "I hate the market." Just as there are very few Members of Congress who would say they have a very great fondness for unfairness or that they favor complexity.

So those three principles everyone has talked about this week are ones that I think have to form the basis for where we start. We want a Tax Code that's fair, simple, and economically efficient. We have to define the terms, of course. With regard to efficiency, I think we have to say we have to start relying more on the good old free market, and less on us trying to figure out here in Washington what makes sense out there in the country. We don't know what the right investments are here, I don't think. I think if we started relying more on the market we would have a system that would make more sense. At the same time by doing it, we would lower the tax rates, we would simplify the system, and we would make it fairer. They all go together. I am hoping we get a consensus that's the direction we should head in.

Thank you.

[The prepared statement of Robert S. McIntyre follows:]

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STATEMENT OF ROBERT S. McINTYRE,
Director, Federal Tax Policy,
CITIZENS FOR TAX JUSTICE

on

FLAT-RATE AND OTHER TAX REVISION PROPOSALS

Before the Senate Committee on Finance
September, 30, 1982

I appreciate the opportunity to appear before this Committee to offer the views of Citizens for Tax Justice on the direction in which we believe tax policy should be headed in the future.

Citizens for Tax Justice is a coalition of public interest organizations, labor unions, and citizens groups around the country. Through our members, we represent tens of millions of middle- and lower-income Americans, who have vital stake in a fair, understandable, and economically efficient tax system.

When Senator Flat and Representative Rate got together this Spring to talk taxes, "simplicity" was the buzzword. But, as has been made abundantly clear by previous witnesses at these hearings, "trickle-down" was the operative principle.

The cat has now been let out of the bag, and with it is likely to go most political interest in the flat-rate tax. It is now agreed that abandoning progressive tax rates in favor of a single rate on all taxable income would almost necessarily mean sharply higher taxes on middle-income Americans and sharply lower taxes on the very wealthy. In addition, Senator Bradley's "Fair Tax" proposal has made it clear that a dramatically simplified, economically sensible tax code can be designed without making the tax burden on working people even more onerous.

Neither of these ideas is new, but their public airing is extremely useful. In fact, simply as an exposé of the true agenda of the flat-rate tax advocates, these hearings have already served sufficient purpose. The question is whether we can accomplish even more this week if we try.

Several witnesses have suggested how beneficial it would be to emerge from these hearings with a sense of direction as to where future tax policy ought to be headed. Senator Dole, on the other hand, has expressed a good-natured skepticism about the possibility of establishing a consensus on such an agenda. "We have a loophole session at two this afternoon," the loophole-closing champion of 1982 announced on Tuesday morning. And indeed the Committee did spend the afternoon and evening preparing a package of new tax breaks, special exceptions, and so forth to be added to the tax laws.

Since we are opposed to the legislative actions taken by the Committee on Tuesday, it is not clear that we would be happy with the results even if the Committee does try to establish some general ground rules for future tax policy changes. Perhaps we should be joining with those participants at these hearings who have been fearful enough of the future to suggest that the

Committee simply declare a moratorium on tax legislation for the next year or so. When we look at the lurching legislative record in the tax area over the past decade, however, we are inclined to believe that a consensus on basic principles could be helpful.

On balance, most people would agree that the tax code has become more complex, more baffling, more economically destructive, and less fair over the past decade. Yet Congress did not, of course, set out to make such a mess of the tax laws. Some of the blame, we believe, stems from the almost completely ad hoc basis upon which tax policy has been made.

Unemployment is too high? Let's try a jobs tax credit. We'd like more business investment? Let's install faster write-offs and an investment tax credit. The personal savings rate seems too low? How about an "All-Savers Certificate." The public is grumbling about tax unfairness? Let's impose a minimum tax. And on and on the process has gone.

This ad hoc approach to tax and economic policy has made the tax code an easy prey for special interests, especially those who can back up their arguments with campaign assistance. Ways and Means Committee member Andrew Jacobs (D-Ind.) has described the process this way:

> "If you evade your taxes, you go to the penitentiary. If you want to avoid taxes, you go to the U.S. Congress -- and see what they can do for you."

The results of this approach have not been happy for middle-income taxpayers. Although federal revenues as a share of the GNP stayed constant from 1969 to 1980, the tax burden shifted rather dramatically. The growth in real wages and salaries lagged 22 percent behind the growth in real GNP, but individual income

TRENDS IN THE ECONOMY AND FEDERAL
GOVERNMENT RECEIPTS, 1969 TO 1980

% Increase In:	Current $	Constant $
Gross National Product:	+178%	+36%
Government Receipts:	+177%	+36%
Without Social Security:	+144%	+20%
Individual Income Taxes:	+181%	+38%
Social Security Taxes:	+296%	+94%
Corporate Income Taxes:	+ 77%	-13%
Corporate Profits:		
Pre-Tax:	+183%	+39%
After-Tax:	+246%	+70%
Compensation of Employees:	+179%	+37%
Wages and Salaries:	+161%	+28%
Population:		+12%
Over 65:		+30%

NOTE: Constant dollar figures are derived using the change in the GNP deflator 1969-80 (104%). Figures for government receipts are for fiscal years; all other figures are for calendar years.

SOURCES: Most data are from the 1982 Economic Report of the President (Feb. 1982). Some 1969 data are from the Staff of the Joint Committee on Taxation, Tax Policy and Capital Formation (April 1976).

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taxes went up faster than GNP, and social security taxes went up 2½ times as fast. On the other hand, corporate pre-tax profits grew faster than the GNP, but corporate income taxes actually fell in constant dollars. By 1980, the corporate income tax's share of federal revenues was down 36 percent from 1969, while individual income taxes and social security taxes had grown to 78 percent of all federal revenues. The 1981 tax act capped the process, and was expected to cut the corporate share of the tax burden to only 7 percent by 1987, while raising the individual income tax and social security tax share to over 85 percent. We have also seen a large shift in the tax burden among individuals. The effective individual tax rate on the highest income class is now about 25 percent according to the Joint Committee on Taxation staff -- down from over 35 percent in 1978. The effective rate on the average middle income family, counting the full social security tax, is just about the same 25 percent.

The culprit in this tax shift onto working people, of course, has mainly been the continuing expansion of loopholes -- or incentives, tax expenditures, tax aids, or preferences, as some prefer to call them. Under the 1981 act, the federal government was scheduled to provide 76 cents in tax subsidies for every dollar it collected in income taxes in fiscal year 1983 -- rising to 86 cents on the dollar by 1987. On the corporate side, the figures are even more striking: $1.14 in tax breaks for every dollar collected in FY1983, rising to $1.88 per dollar by 1987.

Of course, this redistribution of the tax burden was supposed to pay off in an improved economy. Sad experience should have taught us, however, that the added tax incentives have not only failed to further their goals, they actually appear to have made things worse. One commentator has suggested that "the economy may well be suffering from what doctors call an iatrogenic illness:

THE SHIFTING TAX BURDEN

	Share of Federal Revenues From:		
	Individual Income Taxes & Social Security Taxes	Corporate Income Tax	Other
1948	55.7%	23.2%	21.1%
1965	60.9	21.8	17.3
1969	67.8	19.5	12.7
1973	72.1	15.7	12.2
1980	77.8	12.4	9.8
1987p	85.2	7.1	7.7

SOURCES: Figures for 1948 though 1973 are from the staff of the Joint Committee on Taxation, Tax Policy and Capital Formation, April 1977, at 40. Figures for 1980 and 1987 are based on data in the Budget of the U.S. Government, Fiscal 1983, at 3.32.

Projection for 1987 assumes continuation of 1981 corporate tax law.

THE DISINTEGRATING TAX BASE:
FEDERAL INCOME TAX COLLECTIONS COMPARED
TO FEDERAL TAX EXPENDITURES
FY1977-FY1987

Fiscal Year	Percent of Taxes Forgone Through Tax Expenditures			Ratio of Tax Expenditures To Taxes Collected		
	Corporate	Individual	Total	Corporate	Individual	Total
1977	34%	35%	35%	.50	.53	.53
1978	36%	36%	36%	.55	.56	.56
1979	38%	35%	36%	.60	.55	.56
1980	40%	38%	39%	.67	.62	.63
1981	44%	39%	40%	.80	.63	.66
1982	54%	40%	42%	1.18	.66	.73
1983	58%	41%	43%	1.14	.69	.76
1984	54%	41%	44%	1.19	.70	.78
1985	57%	41%	44%	1.31	.69	.80
1986	62%	42%	46%	1.60	.71	.84
1987	65%	42%	46%	1.88	.71	.86

SOURCES: Data on actual and projected tax collections are from the 1982 Economic Report of the President (Feb. 1982) and the Budget of the U.S. Government, Fiscal Year 1983 (Jan. 1982). Data on actual and projected tax expenditures are from Budget of the U.S. Government, Special Analyses, Fiscal Year 1979 and Fiscal Year 1980, and Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987 (March 8, 1982) and Estimates of Federal Tax Expenditures for Fiscal Years 1981-1986 (March 16, 1981). All projections assume continuation of 1981 tax policies.

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a disease caused by an attempted cure."1/ There is much evidence to support such a diagnosis. For example:

-- During the 1970s, some $36 billion in annual investment tax breaks were added to the tax laws. Did investment go up? No. The share of the GNP going toward investment was exactly the same in 1981 as it was in 1969 -- 16.3 percent. Or looking at longer periods, investment as a share of the GNP averaged 16 percent from 1948 through 1965, 16 percent from 1966 through 1973, and 16 percent from 1974 through 1981.

-- Congress has also added or expanded tax preferences for personal savings over the years. The result: personal savings as a share of disposable personal income has shown no trend, averaging 6.4 percent from 1948 through 1965, 7.5 percent from 1966 through 1973, and 6.8 percent from 1974 through 1981.

-- The downside effect of these tax preferences, besides added complexity, higher tax rates, and increased unfairness, was economic distortion. By tilting the economic playing field away from the most productive investments and toward the most tax sheltered ones, bad investments were made good, and good ones, bad. One study has estimated that tax distortions lowered the marginal productivity of new corporate capital investment in 1979 to almost 50 percent below its optimal level.2/ And this study looked only at the effects of two of the major tax preferences.

1/ Kinsley, "Reagan's Industrial Tonic," Harper's, June 1982.

2/ Jorgenson and Sullivan, "Inflation and Capital Recovery in the United States," Harvard Institute of Economic Research.

The 1981 tax act carried the approach of throwing tax subsidies at economic problems to perhaps its ultimate extreme. New credits and deductions for various and sundry activities were provided. Sharply negative tax rates were installed for investments in equipment -- ranging as low as minus 194 percent by 1987 according to figures from the Council of Economic Advisers.

The 1982 Tax Equity and Fiscal Responsibility Act was born of the need to stem the revenue shortfall created in 1981, but its designers also recognized that the '81 tax act had made the tax code's economic distortions even worse. And there can be little doubt that the '82 bill will improve economic efficiency and fairness. But we still have far to go before we will have a tax system we can comfortably live with. The question is: How can we sustain the process begun in 1982?

We believe that, without a guiding set of principles, continued progress will be difficult. Without some intellectual basis to resist special interest pleading and without some consensus around the need to rationalize our tax laws, we could easily return to the same kind of tax policy chaos that we have witnessed for at least the last decade.

A colloquy between Senator Long and Senator Hart at these hearings on Tuesday helps illustrate this point. Senator Hart had suggested that the Committee investigate a "progressive expenditure tax" -- in essence a graduated-rate version of the Hoover Institute flat-rate consumption tax plan put forward by Senator DeConcini. The tax base under this approach would be income minus savings and investment (and plus dissaving). Senator

Long delicately baited and sprung a trap for the senior Senator from Colorado:3/

SENATOR LONG: So, Senator Hart, as I understand your program, we would allow people a tax deduction for the money they saved or invested?

SENATOR HART: Yes.

SENATOR LONG: Now, would you allow this deduction for all kinds of savings and investments? Would you give people these big write-offs for unproductive things like real estate speculation that just bid up the price of land, or Krugerands, or other things that don't add to our productive capacity?

SENATOR HART: Well, Senator Long, I think that's a legitimate point, and, of course, one of the areas we'd have to analyze is which kinds of investment would qualify for the savings/investment deduction under the approach I'm suggesting, and we'd probably want to limit it to what we conclude is productive investment.

SENATOR LONG: But, Senator, that's the current system.

Senator Long is, of course, exactly on the mark. The current tax laws reflect a series of congressional decisions as to which economic activities ought to be favored. This complex web of tax subsidies forms no coherent economic pattern, and to a stranger

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3/ The quotations here are not word-for word, but reflect my recollection of the colloquy.

unfamiliar with the legislative process would seem to reflect only a deep distrust of the marketplace as an efficient allocator of resources. Yet there is little doubt that most members of Congress would disavow such an anti-market economic philosophy, just as they would quickly deny a commitment to complexity or a fondness for unfairness.

Almost every witness before the Committee this week has described fairness, simplicity, and efficiency as the basic principles upon which the Committee's future tax policy efforts ought to be based. We agree, but the fact that these concepts are so often cited yet so frequently ignored in the legislative decisionmaking process suggests two things: The first, which we think is obvious, is that public financing of congressional campaigns would have a salutory effect on tax legislation. The second is that, if fairness, simplicity, and efficiency are to form the basis for a consensus on the future direction of tax policy, then clearly more flesh needs to be put on them. Let me therefore offer the Committee our views on what these tax policy principles should mean:

Fairness. Everyone seems to agree that one element of fairness must be the approximately equal treatment of equally situated taxpayers. We would sharpen this definition to mean taxpayers with equal abilities to pay -- that is, in general, equal incomes. Here, we differ sharply from the consumption tax advocates, who would establish instead a "standard-of-living" test, by exempting savings from the tax base. This, we believe, is a false route to reform, not only because we find income to be a more appropriate measure of taxpaying capacity, but because the consumption tax approach flies in the face of the popular understanding of fairness. The income tax, you will remember, was originally established as a levy on the "surplus wealth" of the rich. To exempt that wealth is neither fair nor politically acceptable.

The second prong of the fairness test involves progressivity. As representatives of middle and lower income income working people, we believe that their share of the tax burden is already too large. Rather than destroying progressivity, as the flat-raters argue, we believe it should be improved.

Simplicity. This concept is much easier to find definitional consensus on. In a nutshell, it means that most taxpayers should have an easy time filling out their tax returns. Every government program administered through the tax system tends to be destructive of simplicity, and such tax subsidies should be avoided whenever possible.

Efficiency. We accept the view of most American economists that economic efficiency is maximized when marketplace forces dominate economic decisionmaking. Of course, this rule has no application where market forces are not at work. Pollution control is obviously a proper subject of regulation, as are health, worker safety, and many other areas. Moreover, the government can play an extremely useful role in macro-economic stabilization policy. But the tax code should avoid affecting economic choices in the private sector. Elimination of tax preferences coupled with lower rates would have this effect.

The combination of these principles leads us to only one conclusion: The ideal tax system is a progressive income tax with few deductions and credits and lower rates.

Of course, comprehensive tax reform will not -- and cannot -- be achieved overnight. But the closer the system comes to acceptability, the easier it will become to move closer still. Just as high statutory tax rates put a premium on obtaining special tax breaks, so lower rates make the loss of a special write-off less traumatic.

In conclusion, the following should, we believe, always be kept in mind in making future tax policy decisions: Tax changes which reduce economic distortions will certainly be helpful to the economy, but they will not solve all our economic problems, any more than tax policy mistakes have caused all those problems. Tax simplification is an important cause, and the people have a right to a tax code they can generally understand and deal with. But the overriding, most important factor in all tax policy decisions is who wins and who loses on the pocketbook question of who bears the tax burden.

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The anti-loophole coalition is fighting back.

FLAT-RATE TALK

BY ROBERT S. MCINTYRE

CRITICS WHO have called President Reagan ideologically inflexible on economic matters got their comeuppance the other day when David Stockman, director of the Office of Management and Budget, announced that he "would not be surprised" to see repeal of most tax loopholes—apparently including the gaping new ones included in last year's tax act—proposed as part of Reagan's next budget. Of course, there's a catch: the Administration would preserve its commitment to "trickle-down" principles by requesting elimination of progressive tax rates as well. Stockman's remarks suggest that the Administration may be caught up in what a front-page story in *The Wall Street Journal* called an "intellectual groundswell . . . for the notion of a greatly simplified tax system with a single rate and few deductions—if any."

The Washington Post calls a flat-rate, no-deductions income tax the "obvious" answer to the internal revenue mess. Democrats like Senator Dennis DeConcini of Arizona and Representative Leon Panetta of California have introduced specific flat-rate legislation. So have Republicans like Senators Mark Hatfield of Oregon and Jesse Helms of North Carolina. And Presidential adviser Edwin Meese says anything but a flat tax is "immoral." Does all this mean that a flat-rate income tax with few deductions and credits is the wave of the future? Probably not, but the growing fascination with it deserves some serious attention.

Flat-raters are divided into two camps, and each camp makes two basic points. On the first point, they agree, along with almost everyone else: the current system of high tax rates, imposed on a taxable income base that has been heavily eroded by special tax breaks, has given us outrageous complexity, gross inequities, and terrible economic distortions. And it's getting worse. By 1987 the federal government will forgo 86 cents in "tax expenditures" for every dollar it collects in income taxes—up from 53 cents per dollar in 1977. The corporate tax data are even more extreme, with $1.88 in loopholes for every dollar that will be collected in 1987, up from 50 cents on the dollar in 1977.

Robert S. McIntyre is director of federal tax policy for Citizens for Tax Justice, a coalition of public interest, labor, and citizens groups which represents middle- and lower-income taxpayers.

The second point made by traditional flat-rate advocates, like the National Taxpayers Union, former Republican Treasury Secretary William Simon, and others on the political right, is that taxes on the well-off are too high and taxes on moderate-income people are too low—a problem, they say, a flat-rate would solve. The traditional flat-raters forthrightly admit that what they are promoting is more "trickle-down" tax policies. "I don't care what you call it," said Jim Davidson of the National Taxpayers Union in a recent interview. "Trickle-down economics makes reasonable sense."

A rather different second argument is made by some of the newcomers to flat-ratism, such as *The Washington Post*. They claim that the current loophole-ridden system is no longer progressive, and that a flat-rate tax would in fact be at least as tough on the rich, if not more so, than the existing code—and would do away with all the flotsam and jetsam.

Both sides have a point. Until the 1981 tax act, it would have been hard to argue that a flat-rate could possibly be as progressive as the existing tax code. In spite of the loopholes, the pre-1981 law did retain a modest progressivity. Corporations and the top 5 percent of individual taxpayers paid average effective rates of 25 to 30 percent, compared to 15 to 20 percent for the middle class and about 10 percent for taxpayers at the bottom. Thanks to last year's bill, however, there would now be little difference in progressivity between the current individual tax structure and a flat rate of 20 to 25 percent—assuming that there would be generous personal exemptions and standard deductions and that Social Security taxes would be part of the package. From the perspective of corporations, a flat 25 percent rate on real income would be a great improvement in progressivity.

On the other hand, in practice if not in theory, a flat rate would almost certainly mean far less progressivity than even the current approach. First, most of the traditional flat-raters would keep the separate Social Security payroll tax—which would ensure that people earning under $30,000 would pay taxes at a *higher* rate than their richer neighbors. Second, the old-line flat-raters understand that the pressures for tax loopholes would not vanish with a change in the tax rates.

Does any serious person believe, for example, that business taxpayers would cheerfully agree to the loss of their investment "incentives"? Or that charities will be content to lose the benefits of tax-deductible contributions? On the contrary, they would probably ask for more: a *double* deduction, say, or a large tax credit for charitable gifts—proposals seriously put forward by a national commission on philanthropy just a few years ago. What about Social Security recipients? Will they be willing to pay taxes—even a mere 20 percent or so—on half their stipends? Will homeowners gratefully give up their mortgage interest deductions if a single tax rate prevails? Are the oil companies and the banks standing ready with their checkbooks? This is not to say that elimination of many or most or all loopholes would not be a good thing. But, and this is basic point number one, a flat-rate does not necessarily reduce the pressures for tax breaks. The fight against loopholes is separate from the fight over rates.

Which leads us directly to basic point number two: just as one can imagine a flat-rate tax with no deductions and credits, so one can imagine a progressive tax system with none. The latter has long been the goal of traditional liberal tax reformers, whose ideal is a simple tax code with much lower but still progressive tax rates, ranging from, say, 10 percent to 35 percent.

WHY SHOULD an executive earning $500,000 a year contribute a higher share of his income toward supporting the government than a working mother earning $10,000? We can start with the basic themes usually summarized in the "ability-to-pay" principle. Assuming we want to spend a certain amount of money on collective projects such as defense, roads, and aid to the elderly, it's fairer to ask the well-off to contribute more than to burden those with lower incomes. And the redistributive effect adds more to total social welfare. Most economists would agree that a dollar's "marginal utility" is higher in the hands of a poor person than in the hands of a rich person. The extra food that the lower-income worker can buy for his or her children is worth more than the rich person's extra drink at the country club.

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

Finally, real free-market liberals, in the tradition of Supreme Court Justice Louis Brandeis, would argue that progressive rates can help mitigate the concentration of wealth and power which, unless kept in check, undercuts the basic rationale for the capitalist system.

In terms of the tax base—that is, what income is taxed—liberal reformers make the same kinds of points now being made by the flat-raters. A "comprehensive income tax," with few of the government subsidies now included in the tax code, would be simpler, fairer in treating equally situated taxpayers alike, and much sounder economically. Liberal reformers argue persuasively that most tax loopholes, when seen as the government subsidies they are, are foolish, mistargeted, or even perverse, and that almost all the tax preferences either would function better as direct spending programs or would never be enacted at all if they could no longer be hidden in the tax system.

SOMEHOW, IN SPITE of these cogent arguments, loopholes remain—and they're rapidly expanding. Corporate tax breaks are the fastest-growing item in the Reagan budget, outdistancing even defense, and will double between 1981 and 1985. In constant dollars, the only broad functions showing increases between 1981 and 1985 under the Administration's 1983 budget are corporate tax subsidies (up 57 percent), defense (up 45 percent), interest (up 15 percent), health (up 13 percent), individual tax subsidies (up 11 percent), and income security (up 3 percent). (The increases in health and income security, by the way, are misleading. The former is due to growth in the age group eligible for Medicare and to projected inflation in the health sector. The latter is also due to an increasing number of elderly, and masks substantial real cuts in other programs that help poor people.)

The 1981 additions to the tax expenditure list include some of the most foolish ever adopted. The new corporate depreciation breaks will be death to productivity growth unless amended. They lead to effective tax rates on profits from new investments ranging from a 37 percent tax on income from industrial buildings to a subsidy—or "negative tax rate"—of 194 percent on profits from short-lived machinery. The result may be consistent with the President's vision of America as one giant tax shelter, but it will also mean a dramatic shift in investment toward tax-favored areas, even when investment in longer-lived assets makes far more economic sense.

Besides the depreciation changes—which will virtually wipe out the corporate tax—the 1981 act was festooned with Christmas tree baubles ranging from breaks for oil companies and utilities, to the misnamed "All Savers Certificates," to preferential treatment for trucking companies, multinational firms, and people who adopt children. As Stockman has ruefully admitted, the process "just got out of control."

Last year's tax bill was so outrageous, however, that the pendulum appears to be swinging back the other way. The Harris poll shows that 78 percent of the voters want last year's decision to abolish the corporate tax reversed. Fifty-eight percent now want the President to try something other than his current Robin Hood-in-reverse economic policies. At the same time, many in Congress who had talked themselves into believing the economic promises of the special interests are now furious at the lobbyists, as the economy fails to respond to the snake oil. Some Democrats are particularly angry that even though they went out of their way to prostitute themselves on last year's tax bill, their opponents are still garnering the lion's share of the business PAC money.

PART OF THE renewed interest in a no-deductions flat-rate tax comes from the anger over last year's excesses. As another dose of "trickle down," the flat rate is exactly the wrong prescription. But the general attack on tax breaks is a healthy development. Liberals and conservatives alike need to consider what a simplified, less loophole-ridden tax code would mean to them.

In the 1950s before loophole mania took hold, Democrats and Republicans in Congress were generally united in their opposition to tax breaks, other than long-standing ones with entrenched constituencies, like the oil depletion allowance, and very narrow special-interest measures which had little impact on the overall system. For the Republicans, the main reason was ideological: they believed in the free market, and were opposed to government-created economic distortions. For the Democrats, the major rationale was political: tax breaks generally benefited Republican constituencies, not the poor and working people who voted Democratic.

The anti-loophole coalition began to break up during the Kennedy Administration. Despite Republican opposition on economic grounds and labor antagonism for distributional reasons, the best and the brightest successfully promoted the single biggest (until last year) loophole in the tax code—the investment tax credit, a tax subsidy which was supposed to encourage business purchases of equipment. After briefly reuniting during the first year of the Nixon Administration to enact numerous reforms (including repeal of the investment credit), the anti-loophole coalition completely fell apart in the 1970s.

Beginning with the 1971 Revenue Act, both parties reversed their philosophies toward the tax system. Republicans began playing constituency politics—which meant more loopholes for corporations and the wealthy—and Democrats began indulging their urge to get the government tinkering with the economy. There were plenty of opportunities for both, as inflation-driven "bracket creep" necessitated frequent amendments to the tax laws. As a result, scores of new tax breaks, including reinstitution of the investment tax credit, were enacted in the 1970s, interrupted only briefly by a few reforms in 1975 and 1976. By the end of the decade, effective corporate tax rates had been slashed by at least one-third, capital gains preferences had been increased enormously, and "incentives" for everything from energy conservation to exports had been added to the tax code.

Small wonder that middle-income taxpayers were getting frustrated with the tax system. Although government revenues as a share of the gross national product increased not at all from 1969 to 1980, the tax burden on middle-class wage earners went up substantially, due to the sharp decline in taxes on the well-off, particularly corporations, in combination with "bracket creep" and much higher Social Security taxes. The corporate share of the federal tax burden fell by one-third from 1969 to 1980. In constant dollars, corporate tax payments were 13 percent less in 1980 than in 1969—while constant-dollar after-tax profits were up 70 percent. The 1981 tax act capped the process, as Democrats and Republicans stumbled over each other to provide new tax breaks for every interest group and pet economic project that beckoned.

Yet few members of Congress are happy with their handiwork. Liberal Democrats are discovering that they can't fund social programs without revenues, and that middle-class support for the government has plummeted as the tax burden has shifted increasingly onto wage earners. Conservative Republicans look at the wreckage of the free market which tax preferences have given us—and many are aghast.

SOME STIRRINGS on both sides of the Congressional aisle are already evident. As a counter to the large crop of flat-rate plans which have sprung up, Democratic Senator Bill Bradley of New Jersey and Representative Dick Gephardt of Missouri have introduced a comprehensive reform package with graduated rates and few loopholes, to which they have attached the oxymoronic label, "progressive flat-rate tax." Republican Senators Robert Dole of Kansas and Pete Domenici of New Mexico, chairmen of the Finance and Budget Committees respectively, have tried to make loophole-closing the centerpiece of their budget strategies, both because they think it's right and because they have nowhere else to go after last year.

If Democrats will start representing middle-income wage earners as taxpayers again, the old 1950s coalition may be ready to regroup. If liberals will forswear economic tinkering through the tax code—no "Tax-based Incomes Policies" (TIPs), no energy tax credits, no "targeted" investment tax incentives—and if conservatives will forgo hidden subsidies for corporate and high-income constituents, there may be a way out of our income tax mess.

The idea of throwing out the whole tax code and starting over with a simple system may be impractical. And for many politicans it may even turn out to be an excuse to do nothing. "I'll believe these guys are serious about eliminating all loopholes when I see them vote to close one," says a long-time Hill tax expert. But if the flat-raters succeed in promoting a public debate about the benefits of a loophole-less tax code, they will—in spite of their "trickle-down" bias—have performed a useful service for the economy and for tax fairness.

STATEMENT OF FRED WERTHEIMER, PRESIDENT, COMMON CAUSE, WASHINGTON, D.C.

Mr. WERTHEIMER. Thank you, Mr. Chairman. I would like to start off by thanking you for the leadership you just provided on the 1982 tax bill that passed. We feel that legislation was important. And the passage of it was a remarkable accomplishment, given the opposition that existed. I want to thank you for that.

We would also like to congratulate Senator Bradley for his fair tax proposal, which I know Senator Baucus is a cosponsor of.

We have talked a little bit here, I guess, about the newness of ideas. I guess I remember, although I wasn't there, in 1907 when President Theodore Roosevelt first proposed the idea of public financing of elections so that when Senator Long in the mid-1960's came up with a dollar checkoff, it wasn't a new idea per se.

Senator LONG. I didn't say it was.

Mr. WERTHEIMER. But it represented a historic political breakthrough at least from our perspective, and I guess from anyone's perspective, no matter what you feel about it. And I think that's what we see in the work that Senator Bradley and Representative Gephardt have done. It is a political breakthrough. And it does set the stage for maybe making some dramatic change in the tax system in this country.

These hearings are taking place because—in large part—because there is massive citizen dissatisfaction with the way the system works. The same words keep coming up. But if you came down to it from a citizen's standpoint, I think it would come down to the issues of complexity and fairness. A major cause of both of those problems was just alluded to. It's the issue of tax expenditures and their growth; particularly, in recent years. But that becomes a problem not just for the tax system and its fairness, it goes to the whole question of this institution's ability to deal with the budget. It's a leak in the whole budget process in the sense that it's an easier way, that it is the back door to the budget process. It's an easier way to grant Federal aid. And it is a major contributor to the problems that the country has had in terms of lacking budgetary discipline. That's why we have supported sunset in the past for tax expenditures. We've supported, and still support, a better integration into the process. And why the proposals that are here address not just the issue of the fairness of the tax system or the appropriateness of the tax system, but whether we will ever get a handle on the budget, the national budget of this country.

All these tax proposals, obviously, are fundamental approaches to the tax system. We believe that the key issue that this committee must consider in any of these matters is the fairness question. It is the fairness question that has created a national interest and focus on this issue. And if this committee and the Congress were to do anything that wound up without really dealing with that problem, we would not be moving. We would not be moving forward, we wouldn't be moving at all.

For this reason, we find all the straight flat-rate tax proposals as fundamentally flawed. And it's our view, and I think it's the point that Senator Long was making earlier, that as the American public finds out that the bottom line of the flat tax approach is to shift financial burdens from the higher income to the middle class, I think you will find that most Americans will find that approach fundamentally flawed.

On the other hand, the Bradley-Gephardt proposal, I think, shows that we can broaden the base, reduce rates, and still build progressivity into the system, which we believe is essential.

So in summary I would simply say that to the extent this committee is bringing to the public's attention the fundamental flaw of the flat tax, which it is, that's a very healthy sign. And I hope this committee goes ahead and struggles with the very difficult battle that any tax fight is in the context of the Bradley-Gephardt proposal. It could make an enormous change in this country for the good. And there's a national constituency waiting for that kind of action.

Thank you.

[The prepared statement of Fred Wertheimer follows:]

TESTIMONY OF FRED WERTHEIMER, PRESIDENT OF COMMON CAUSE, BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

Mr. Chairman and members of the Committee:

I appreciate the opportunity to appear before you today on behalf of Common Cause to speak about the need for reform of the federal income tax and, in particular, to stress the need for focusing on the issue of fairness as you consider proposed reforms of the tax system.

At the outset I would like to congratulate Chairman Dole for the exceptional leadership he provided the nation on the Tax Equity and Fiscal Responsibility Act enacted last month. The passage of this important legislation was a remarkable accomplishment achieved over powerful opposition. With it the Congress--spurred by the initiative of this Committee--took a positive step towards reducing the unfairness of the present tax system. We hope this represents a sign of future things to come.

I also want to congratulate Senator Bradley for the legislative proposal he has developed along with Representative Gephardt and that is now pending before the Committee. I believe that the Senator's proposal represents a historic breakthrough. It provides the nation with the framework for fundamentally restructuring our tax system to create a fairer, simpler, and more efficient basis for distributing the financial burdens that our society must impose on its citizens.

While my testimony today focuses on the individual income tax, I do not mean to minimize the importance of corporate taxation or to ignore the need for meshing the corporate and individual tax systems. Corporate taxation has important consequences both for economic efficiency and for the equity with which tax liabilities are distributed. It is worth noting that some of the most glaring tax loopholes relate to the tax treatment of business income and expenses. We are pleased that Senator Bradley and Representative Gephardt are currently developing a corporate tax proposal as a companion to their income tax system for individuals.

Need for Tax Reform

A recent Business Week/Harris poll underscores the public's disenchantment with our present income tax system.*/ By majorities of roughly two to one, the respondents indicated that they favored replacing the present tax system either with a flat-rate tax that eliminated nearly all deductions or with a simplified progressive tax that retained some of the most widely used deductions and exclusions. While the poll's other findings suggest that the public may not fully understand these alternative tax systems, the deep unhappiness with the present system is unmistakable.

Raising revenue is the principal purpose of any tax system. Beyond that, however, the public has a right to expect that needed revenue will be raised in ways that are fair, that ensure compliance by all taxpayers, and that do not interfere with the

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*/ The poll was conducted in mid-August. A summary of the results appeared in the September 6, 1982 issue of Business Week.

efficient functioning of the economy. These latter criteria provide a useful basis for categorizing the problems of the present tax system, as follows:

1. Problems of fairness. Most people believe that some taxpayers are not paying their fair share. In the Business Week/Harris poll, for example, 86 percent of the respondents agreed with the statement that ". . . most higher income people get out of paying much of their taxes by hiring clever tax accountants and lawyers. . . ."*/

2. Problems of compliance. Estimates of the "underground economy" of unreported income range from $100 billion up to several hundred billion, with lost tax revenues coming to roughly one-fifth to one-third of that amount. Although hard data are scarce, many tax experts seem to feel that tax evasion has increased in recent years, threatening the voluntary compliance on which our tax system is largely based. The increase in evasion appears related in part to the public's

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*/ This finding is hardly surprising. In recent months, the American public has learned, among other things, that Attorney General William French Smith had invested in tax shelters that promised four dollars in tax write-offs for each dollar invested; that former U.S. attorney Roxanne Conlin, a candidate for governor of Iowa, and her husband, whose joint net worth is estimated at over $2 million, paid no Iowa state income taxes and less than $3,000 in federal income taxes in 1981 because of tax losses on their real estate holdings; and that Mayor Pete Wilson of San Diego, a candidate for the U.S. Senate, paid no federal income taxes in 1980 on a salary of $75,000 because of losses on a business investment.

perception that the tax system is unfair, with more people thinking that if everyone else is cheating, they should do the same.

3. Problems of economic efficiency. Certain economists and businessmen maintain that the present tax system, especially its high marginal rates, has hindered economic growth and productivity. Among other things, they claim the present system discourages saving and channels too much investment into non-productive uses.

These problems have many sources, but each stems in part from the complexity of the present tax system. That complexity permits unfair tax avoidance, undermines individuals' compliance with the tax laws, and distorts economic decisionmaking. The movement for tax simplification has thus been able to attract support from all parts of the political spectrum.

Comprehensive reform proposals

Various proposals for comprehensive tax reform and simplification have been advanced in recent months. While dissimilar in some respects, most have one feature in common: broadening the tax base. That is, they are designed to enlarge the base of taxable income by eliminating many of the deductions, exclusions, exemptions and credits in the present system. This allows the proposed systems to raise similar amounts of revenue as the present system, but with lower marginal tax rates for most or all taxpayers.

The proposed tax systems differ from each other in two significant respects. First, they differ in the number and kind of tax preferences that would be eliminated to broaden the tax base. Some would eliminate all such preferences, while others would retain a selected number. Second, the proposed systems differ in the rate structure they apply to taxable income. For example, some systems would apply a single ("flat") rate to all taxable income, while others propose a set of rates that varies according to the level of taxable income.

There are three major points that we believe should be considered in evaluating these reform proposals:

- First, base-broadening, the common feature of these proposals, should help to simplify the tax system, increase fairness by reducing the opportunities for tax avoidance, improve taxpayer compliance, and lessen economic distortions. In general, it is a constructive reform that will increase fairness in the tax system.
- Second, the reduction in marginal tax rates offered by these proposals would lessen the value of tax shelters, thereby reducing inequities that exist under the present system. Lower rates should also reduce disincentives to economic growth and productivity. However, claims that lower tax rates will stimulate economic growth have been greatly exaggerated; they should be viewed skeptically.
- Third, the rate structures of the proposed tax systems will substantially affect the distribution of tax liabilities among individuals in different income classes. Progressivity, that is, the concept that

higher income taxpayers should pay a higher percentage of their income in taxes, is an essential ingredient of tax fairness. Fairness issues, including progressivity, should be given primary consideration in evaluating proposed tax reforms.

Broadening the tax base

Broadening the base of taxable income involves eliminating most or all of the deductions, exemptions, exclusions and credits that have been inserted in the present system to promote non-tax purposes.*/ We believe that base-broadening is desirable principally for two reasons. First, base-broadening will make the tax system substantially more fair by eliminating many of the opportunities for tax avoidance that exist at present. This will lead to greater equity among taxpayers whose financial circumstances are essentially similar (so-called "horizontal equity"). Second, base-broadening will make the tax system simpler for the average citizen to understand. Although the present system is relatively simple for those taxpayers--some 70 percent of the total--who do not itemize their deductions, most people view the tax laws as full of hidden loopholes for those few taxpayers who can afford high-priced accountants and tax attorneys. Simplification should help to restore public

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*/ We recognize, however, that some deductions, exemptions, exclusions and credits (e.g., the exemption for dependents and the exclusion for moving expenses) help to determine a taxpayer's net income and "ability to pay." They serve to create a more equitable tax system, not to promote non-tax purposes.

confidence in the tax system's fairness, and therefore stem the growing problem of non-compliance.

In broadening the tax base, the government will give up much of its ability to use tax preferences (sometimes termed "tax exepnditures") to further policy purposes unrelated to the tax system. Among the non-tax purposes that currently benefit from preferential tax treatment are encouraging ownership of stock (helped by the exclusion of up to $100 in dividend income), providing funds for political campaigns (helped by the 50 percent credit for political contributions totalling $100 or less), supporting historic preservation (helped by the credit for rehabilitation of buildings), assisting state and local governments (helped by the deductions for interest paid on state and local bonds and for certain state and local taxes), supporting charitable organizations (helped by the deduction for charitable contributions), and promoting energy conservation (helped by residential energy credits).

Some comprehensive reform proposals would retain selected tax preferences, but most preferences must be eliminated if the tax base is to be substantially enlarged. While many tax preferences provide support for worthy purposes, their elimination is not too high a price for a fairer and simpler tax system. Continued support can be provided in more direct forms, if warranted, such as through grants or loans. Direct support has the advantage of being subjected to more rigorous oversight than support provided indirectly through the tax system.

Reduction of marginal tax rates

The reform proposals that provide for base-broadening typically provide for a substantial reduction in marginal tax rates as well. Rate reduction accompanies base-broadening in part for the obvious reason that these proposals' main purpose is to improve the tax system, not to raise more revenue for the government. Unless tax rates are cut, a larger tax base will result in more taxes being collected.

A second reason for reducing tax rates is that it may be a prerequisite for eliminating certain tax preferences. In particular, most of the reform proposals would eliminate the current exclusion for 60 percent of long-term capital gains. As a result of that exclusion, the maximum effective rate on capital gains currently stands at 20 percent. Clearly, opposition to taxing capital gains as ordinary income will be stronger to the extent that the top marginal rate in the proposed system exceeds 20 percent.

A third reason for reducing tax rates, often given by certain businessmen and "supply-side" economists, is that reduced rates would spur economic growth. This argument has been oversold. While it is true that extremely high (or extremely low) tax rates can distort an individual's decisions to work, save and invest, it is generally true that such decisions are more affected by other factors unrelated to the tax system. For example, decisions about how much to work appear to be influenced more by established working hours and lifestyles, union rules, and the availability of jobs than by tax rates. Similarly, the existence of federal programs that displace personal savings, such as Social Security, pension guarantees and student financial aid, seems to have a far greater impact on the national savings rate than does the federal income tax. And in the last ten years, external economic developments, including a surge in foreign oil prices and a worldwide recession, have affected the health of the economy and the level of investment more than have tax rates.

History supports this conclusion. For example, this nation experienced a relatively high rate of economic growth during the 1950's and early 1960's, even though the top rates on personal income were above 90 percent during most of that period. Conversely, since the 1981 Economic Recovery Tax Act lowered the top marginal rate to 50 percent, we have experienced a decline in capital outlays of 4.4 percent. While high tax rates are often cast as villains, the case has not been made that they are a primary cause of our nation's economic ills.

Progressivity of the rate structure

The proposed comprehensive tax systems differ most significantly in terms of their rate structures, which determine how tax liabilities will be distributed among individuals at different income levels. This may be seen by estimating the "effective" tax rate imposed on the taxpayers in each income class, that is, the average percentage of total income*/ paid as taxes by individuals in that class. Under the present system, for example, the tax rates on taxable income (the "nominal" tax rates) range from zero to 50 percent, but the effective tax rates on total income range from zero for those taxpayers with total incomes below $3,000 to around 25 percent for those in the $200,000 to $500,000 income bracket.**/ The system is thus progressive, although less so than the nominal rates would suggest.

The most important fact to recognize about the flat-rate tax proposals, which typically have a single rate between 14 and 20 percent, is that they would redistribute the tax burden away from high-income taxpayers and onto the middle class. This is readily apparent when we remember that the average taxpayer in the $200,000 to $500,000 bracket would pay around 25 percent of his total income in taxes under the present system, but only 20 percent or less under a flat-rate system. Lost revenues would be made up by middle-income taxpayers who would pay higher taxes.

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*/ Since the definition of "taxable income" varies among tax systems, "total income" is often used to provide a fixed standard of comparison. Under the definitions established in the present tax system, total income equals the sum of taxable income, personal exemptions for the taxpayer and his or her dependents, the standard deduction, other deductions in excess of the standard deductions, excludable sick pay, excludable dividends, excludable moving expenses, and tax preference items as defined in the Tax Reform Act of 1969, including excluded net long-term capital gains.

**/ Source: Unpublished estimates based on projections from the Brookings Institution's 1977 Tax File.

The unfairness of shifting more of the tax burden onto middle-income taxpayers is even more evident when we recognize that the federal income tax is already less progressive than it was only a few years ago. In particular, the 1981 tax act caused a substantial reduction in the effective tax rates paid by high-income taxpayers. This is shown by the attached table, which compares the effective tax rates on total income for high-income taxpayers in 1976 with the projected effective rates in 1984 under the 1981 tax act.*/ The table indicates, for example, that the effective rate for individuals with incomes between $100,000 and $150,000 has dropped from 30 percent to 20 percent, and the rate for individuals in the $200,000 to $500,000 bracket fell from 33 percent to 25 percent. These are dramatic reductions indeed for the most well-off members of our society.

The unfairness of a flat-rate tax is inherent in its rate structure. The only way to eliminate the unfairness is to combine the broader tax base that is characteristic of most flat-rate proposals with a graduated rate structure. That is the approach Senator Bradley and Representative Gephardt have adopted in their "Fair Tax" proposal. They have found that even a greatly simplified rate structure--one with only four or five brackets instead of the dozen or so in the present system--is sufficient to keep the same degree of effective progressivity that exists under the present tax law. As a further innovation,

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*/ The effects of the 1982 tax act have not yet been projected, but they are not expected to be much different from the results shown here for the 1981 act.

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they have developed a two-tiered system that taxes both gross income and taxable income. This further adds to their system's fairness by ensuring that a dollar of deductible expenses has the same value for all taxpayers, regardless of income level.

As Senator Bradley and Representative Gephardt have convincingly demonstrated, the advantages that can be obtained by broadening the tax base and reducing marginal tax rates need not be linked to the inherent unfairness of a flat-rate structure. They can be combined with a graduated rate structure, thus maintaining the concept of progressivity that we believe is essential to a fair system for taxing Americans.

The Bradley-Gephardt proposal is designed to carry forward the progressivity that exists in practice under the present tax system. Many Americans rightly perceive, however, that the massive 1981 tax cut gave disproportionate benefits to upper-income taxpayers. As such it cannot and should not serve as our standard for fairness in the tax system.

We believe the distribution of tax liabilities that existed prior to the 1981 tax cut provides a better basis for judging whether a particular reform proposal will distribute the tax burden fairly among taxpayers in different income classes. We urge Senator Bradley and Representative Gephardt to reexamine this key element of their proposal.

Conclusion

Adoption of a flat-rate tax would benefit high income taxpayers at the expense of the middle class. We urge this Committee to reject such proposals as grossly unfair.

In contrast, the approach developed by Senator Bradley and Representative Gephardt provides the opportunity for base-broadening and reduced tax rates without unfairly shifting an additional tax burden onto the middle class. Their simplified progressive tax can provide the basis for solving one of this nation's most pressing and fundamental problems--the growing lack of confidence in the nation's tax system.

The Bradley-Gephardt approach will undoubtedly need further refinement. We urge this Committee to give it the serious and careful consideration it deserves. We further urge the Committee to meet head-on the tremendous challenge and opportunity it faces to provide the country with a fairer tax system.

No one likes paying taxes, but we dislike it less if we are confident that others are paying their fair share to support the government. On behalf of Common Cause, I ask that you keep the issue of fairness uppermost in your minds as you continue your deliberations. No issue is more central to continued public support for, and compliance with, the federal tax system.

ATTACHMENT

Effective Rates of Federal Income Tax for High Income Taxpayers, 1976 and 1984, Estimated by Joseph Pechman of the Brookings Institution

Total Income Class*/ (dollars)	Effective Tax Rate (percent)	
	1976**/	1984***/
75,000-100,000	27.9	19.2
100,000-150,000	30.5	20.8
150,000-200,000	32.2	22.8
200,000-500,000	32.7	25.2
500,000-1,000,000	31.2	23.7
1,000,000 and over	27.9	17.7

*/ Total income is the sum of adjusted gross income, excludable sick pay, excludable dividends, excludable moving expenses, and tax preference items as defined in the Tax Reform Act of 1969, including excluded net long-term capital gains.

**/ Source: Brookings 1972 tax file projected to 1976. Effective tax rate equals nominal tax rate (for married couples filing separate returns applied to total incomes) reduced by personal exemptions, deductions, tax preference items, capital gains, maximum tax, income splitting, the earned income credit, and retirement and foreign tax credits.

***/ Source: Brookings 1977 tax file projected to 1984. Figures are rounded, and do not reflect adjustments in the tax laws from the 1982 Tax Equity and Fiscal Responsibility Act. Effective rates calculated as 1976 rates (see note 2) plus reduction due to tax deferrals for IRAs and Keogh plans.

The CHAIRMAN. Senator Long.

Senator LONG. Do I take it that both of you two gentlemen favor the idea of a flatter tax? You would favor eliminating a lot of deductions and going for a top rate of 28 percent; bottom rate of what?

Mr. WERTHEIMER. Well, without getting on the specifics of whatever the rate is, yes, we certainly favor an approach that would dramatically reduce the number of preferences.

Senator LONG. But both of you do, if I understand it, favor the principle of progressivity? That is, that those who are making a great deal of money ought to pay a higher percentage of their income in taxes than those who are making a modest amount of money.

Mr. MCINTYRE. That's right. In fact, I think that we could easily improve the progressivity of the Tax Code without any economic problems. We certainly had a much more progressive system when we had a high growth rate in the 1950's and 1960's.

Mr. WERTHEIMER. I would like to add that we not only favor it, but if you left it out, you would have far greater national dissatisfaction on your hands than you have now.

Senator LONG. Now Mr. Harris testified yesterday, I believe, or the day before that the public is inclined to favor a flat tax. My impression about these polls is that it all depends on how you ask a question. How do you think the average person in the middle-income bracket would respond if you asked that question? If a flat tax means that you pay a 30 percent increase in your income tax, and the wealthy get a substantial tax cut, how do you think they would answer it?

Mr. WERTHEIMER. Don't do me any favors. [Laughter.]

That's the problem right now. And that's part of what these hearings are accomplishing. They are educating people on what is involved in these proposals. What appeals to the public on the flat tax, as they understand those two words, is the view that it is going to be simple and it is going to be fair. And it may well be simple, but the fairness isn't there. And as soon as anyone finds out about it, they will move away from that.

Senator LONG. But you do favor, I take it, it and you think there is a great deal of appeal and you would support a proposal that would drastically reduce deductions provided that the rates did maintain the principle of progressivity?

Mr. WERTHEIMER. Yes. And if I could add, as I mentioned in my prepared testimony, it's our view that the distribution of tax liabilities prior to the 1981 tax cut is a better framework for looking at the progressivity than the system as it exists today. Because the Bradley-Gephardt proposal is designed to carry forward the progressivity that exists in practice under the present tax system, we recommend both Senator Bradley and Congressman Gephardt take another look at that question in terms of what should be the starting point of progressivity in a new system.

Senator LONG. Well, I am pleased to see that the sentiment on this committee so far seems to be moving toward the type thing that you favor. More and more, I think, those who consider it and have a chance to study it and focus on it and hear it are going to see that we should not just drop the idea of progressivity because those who make a great deal of money should, and they are in a position, make a larger relative contribution than those who make a very modest amount of money. I believe and hope that that will be a part of it, if we do anything.

The CHAIRMAN. Before yielding to Senator Bradley, I wonder if I might just ask a question. And then if you could conclude the hearing. Don't pass any bill out. [Laughter]

Senator BRADLEY. I don't have a quorum.

The CHAIRMAN. Oh, that's right. But I just want to express my appreciation to both Mr. McIntyre and Mr. Wertheimer for appearing here. And I do believe that we have got a big educational job ahead of us. I'm not certain how soon it might be accomplished, but there is certainly a great deal of merit in trying to streamline the system.

But I think it was Mr. Harris yesterday who said it was 81 to 7 on not eliminating the mortgage interest deduction. Now that's fairly substantial odds. And I'm not certain whether we could persuade that group. I think most people perceive the flat-rate tax as keeping all the deductions they have now, but with a flat rate. And if that's the way it has to be, then we are never going to be able to accomplish it unless we do it maybe on an incremental basis, as we have started this year. Each year, take another look at the Tax Code and figure out where we can modify some tax expenditures. And that becomes more and more difficult. A little less difficult under the reconciliation process under the budget constraints. But certainly we intend to continue not only the hearings but other efforts to inform the American taxpayers. I am certain that both of you have done that through your newsletters and other communications. So I assume we will have you back again next year.

Mr. WERTHEIMER. If I could just say one thing. Everyone in this room knows the degree of difficulty increases when you start to try to take away preferences as opposed to adding them. And this kind of struggle is an enormous struggle. And I would have been far more skeptical about the capacity for being able to do this until I saw the miracle you just pulled off on the recent tax bill. That has given me hope that this committee can, in fact, head in the other direction and take on what starts off as a battle that is unwinnable, and yet the pieces are there to win it.

The CHAIRMAN. Well, if we agree to vote on all these things we are going to eliminate in one package, it would be easier than trying it one at a time. I think that's where you would have some fall off rather rapidly. But I think Senator Bradley's bill certainly will be helpful. There are other measures that are purely flat. But I think our primary responsibility now, as I see it, for the committee is to make sure the American people, at least those who have a real interest, may learn a little more about the flat-rate tax and what some of the different ideas are. And then we will see what happens as far as public opinion is in another 6 months or a year.

Senator BRADLEY. Thank you, Mr. Chairman. Let me thank both of you for your testimony. I think that it is very helpful. And as I read it, both of you have strongly endorsed the concept of lowering tax rates and eliminating tax expenditures simultaneously. Is that correct?

Mr. McINTYRE. That's right, Senator. We might want to do it simultaneously rather than lowering rates one year and plugging loopholes the next, as we did last time. It probably would be better for the economy.

Senator BRADLEY. You mean if we close loopholes and cut rates in the same year as opposed to a lag of one year?

Mr. McINTYRE. Yes.

Senator BRADLEY. One of the things that some people have said in response to your testimony is that it is odd to see you coming in and arguing for letting the marketplace work. There are some who say Government doesn't have any role. There are others who say Government does have a role. Are you saying that you would like to get Government out of the loophole business because of an attitude toward Government, or is it more a question of economic efficiency?

Mr. McINTYRE. Well, its completely an issue of efficiency, Senator. There are so many important things that the Government can do better than the private sector. Running the schools, building the roads, manning the national defense—the list is almost endless. But there are certain things that the private sector can do far better than the Government. These include building factories, hiring workers, and making the decisions about where investments ought to go. And when the Government gets into those fields, we get in trouble.

Mr. WERTHEIMER. Well, I would just add another factor. In the world of preferences, there's a power game. And the powerful do very well with preferences, and the average person who is not in this arena except through the representation that you folks provide doesn't do that well in this kind of system. And that's part of why we have seen this growth occur.

As someone mentioned earlier, you take every one of these items on its own and on its own merits, it works or it doesn't work. You add them altogether and you have got a monster on your hands. And that's where we are now. And if you could make the kind of widespread change that is being talked about, you have a shot at restoring some of the balance that has gone out of the system.

Senator BRADLEY. So you are saying that even though we started out with low rates, as we financed wars and depressions, the rates went up. Then people came to Congress and obtained selective relief. And the fundamental question is, then, whether the general good is best served by granting selective relief or by dropping the rates for all Americans and eliminating the loopholes? Is that right?

Mr. WERTHEIMER. Yes. It has been very hard for Congress to resist that kind of specified interest. It's very, very difficult just from a strategical—the way the system functions, it has been very hard to resist. And it remains hard. And it will always be hard to resist.

Senator BRADLEY. As you are out dealing with people like we do, what do you find is the most compelling argument when someone comes up to you and says, well, yeah, but there's my little provision in the law and I don't want to lose it.

Mr. WERTHEIMER. That's not where people start.

Senator BRADLEY. What do you find is the most appropriate response?

Mr. WERTHEIMER. I think people start with the question of is there something wrong with the system. It's not fair. Many people say, "I believe I am paying my fair share, and there are a lot of folks, whether or not they are Senator Long's million-dollar cases, who are not." I think it starts with a basic fairness question.

Mr. McINTYRE. Well, the first question people always ask when you talk tax reform around the country is whether they are going to pay more or less, as Senator Long said. Then they get to the details. But that's the first question. And then people are, of course, interested in simplicity. Everybody is.

Senator BRADLEY. The next response in my town meetings, after am I going to pay more or less, is that the idea, as Senator Quayle said, I think, when he was describing a conversation he had with some worker in Indiana—the response is that the idea makes too much sense.

Now what do you say to the fear out there that somehow or another if we go in this direction it might work for a couple of years that then the kind of problems we had in the past would reassert themselves and we would end up with a lower rate tax, but gradually the law would again be cluttered by more and more exemptions?

Mr. McINTYRE. Well, there is one significant advantage in this process if we do undertake it. And that is as time goes by and rates come down, let's suppose, the pressures for loopholes go down. Your program keeps mortgage interest deductions, for example. Some people would say that's a terrible defect. But your tax rate from those people is 14 percent. So the mortgage interest writeoff is just not going to be that significant for them. And at some point, you might even eliminate it. They won't care.

That's the point, I think. If we do lower the tax rates, while the pressures for special interest breaks are still going to be there—you are going to feel them; we are going to see them—they will be less.

Senator BRADLEY. Thank you very much.

Senator LONG. Mr. Baucus.

Senator BAUCUS. I am trying to determine how far you would go in letting the marketplace make some of these decisions. Would you keep some of the deductions that we have or eliminate them all? How far would you go?

Mr. McINTYRE. Well, if you are talking about the personal income tax, Senator, I think the kind of political decisions that Senator Bradley has made in his proposal are eminently sensible. Since this process is, obviously, going to be incremental, it would be silly to go after deductions that are broad based as a starting point.

Now somewhere down the road we may say, gee, we could further simplify the system. And we will ask people: How do you feel about the mortgage interest deduction at a 14-percent tax rate? And maybe at that point people would rather have a simple system. But that's not a deduction that is destroying the fairness of the American tax system. It's not like some of these tax breaks that go predominantly to the wealthy or to corporations. And certainly the last place to start would be on a broad-based kind of deduction like that.

Senator BAUCUS. As I understand it, you keep deductions that are broad based because more Americans utilize them. But you would look more closely at those that are less broad based.

Mr. MCINTYRE. That's certainly where I would start. In the ideal tax reform world we wouldn't have any of these deductions. But that isn't what we are talking about. We are talking about the real world where politics matter, and where we have to deal with real people. And the bottom line question is: Are we protecting the middle class from too heavy a tax burden. And to start by proposing to eliminate the mortgage interest deduction isn't going to help in that process—as Jimmy Carter found out in 1976.

Senator BAUCUS. Let me ask a second question. What about business taxes? Should we attempt some reform there or should we stay only with the individual income?

Mr. MCINTYRE. Well, I think the business tax side is clearly the most important side. Senator Bradley's plan deals only with unincorporated businesses, as of now.

Senator BAUCUS. I'm talking about the corporate tax.

Mr. MCINTYRE. I'm hopeful Senator Bradley is ready to come up with a proposal on the corporate side because that is where our biggest tax shift has been in the last 10 years.

Senator BAUCUS. What do you think we should do for corporate tax? That is, how should the corporate tax, in your view, be melted in with whatever we may do on the individual tax?

Mr. MCINTYRE. Well, I think that the result we end up with, Senator, under the current Bradley-Gephardt program, where we only allow loopholes if you are incorporated, is an unsatisfactory one. What we ought to be doing is saying let's get the corporate tax base up to something that resembles corporate income. Let's get the rate down. And then let's deal with the problem of dividends.

Mr. WERTHEIMER. Let me say that we also strongly believe that it's essential to take a comprehensive look on the corporate side.

Senator BAUCUS. And what would you do, Fred?

Mr. WERTHEIMER. I don't have an answer to that question.

Senator BAUCUS. What's your response to the point that because business taxes, corporated or unincorporated, tend to be aggressive—that is, they are passed onto the consumers in higher prices—that we should probably eliminate the corporate income tax?

Mr. MCINTYRE. Senator, as you know, there are legions of lobbyists working for large corporations. They are constantly petitioning you to lower their taxes. Do you think they are doing that out of some kind of public spiritedness?

Senator BAUCUS. I'm asking you the questions.

Mr. MCINTYRE. They know that they and their shareholders are bearing those taxes, or most of them. They are not the real consumer groups, Senator. What we are talking about with the corporate tax is the only effective tax we have ever had on the high-income owners of corporations. And if you think by eliminating that you are going to benefit consumers, you probably think that the windfall profit tax cuts in the 1981 tax bill lowered oil prices.

Senator BAUCUS. What I am trying to determine, though, is what you think we should do with the corporate income tax. What direction do we go? Fred is not quite ready to give his proposals. I am curious as to whether you have any.

Mr. McINTYRE. As I meant to say a minute ago, the exact thing you want to do is try to return to a measure of economic income, which means we put depreciation back on an economic basis, we get rid of the various tax credits for this and that; we then lower the corporate rate to some reasonable level—let's say 25 percent; and then we deal with the problem of dividends. In that order.

Senator BAUCUS. What would you do with dividends?

Mr. McINTYRE. Well, you will have to find a way, if you can reform both sides of the Tax Code, to integrate the corporate and personal taxes. In other words, if we really start taxing capital income on the individual side, which we aren't now, then you would probably need to find some way to avoid taxing dividends twice.

Senator BAUCUS. So you would broaden the base of individual incomes. You would also broaden the base of corporate income. And then moving toward the direction of not taxing dividends twice.

Mr. McINTYRE. Right. That's the last step.

Senator BAUCUS. Thank you.

Senator LONG. Let me just touch on one other subject while we have you here. Now you mentioned, Mr. Wertheimer, the $1 checkoff for the election of the President. And I appreciate what you said about that. Now you would favor retaining that, I would think, even if we do go to a flat tax?

Mr. WERTHEIMER. I'm in favor of any system with public financing of elections. I would point out on the $1 tax checkoff that whatever decisions are made on that does not affect the amount of tax that individual taxpayer pays so it's not a differentiation in terms of providing an advantage or disadvantage for the taxpayer.

Senator LONG. Well, it is a burden on the Treasury though.

Mr. WERTHEIMER. Well, it is, as are any number of expenditure programs. I do favor retaining your $1 checkoff, Senator.

Senator LONG. Well, my thought is that like you, whatever the decision is about the manner, I think we ought to retain the $1 checkoff because it seeks to bring about a situation where whoever is elected President is not overwhelmingly beholden to some particular group for money. You believe like I do—I see you nodding, just so the record will show it—that the President ought to do what is best for 230 million people. And his decisions should not be colored by the effect of the campaign contributions. It ought to be based on what is good for the country and not what is good for those who pay for the campaign. And we agree on that.

But that's something that you and I are thoroughly familiar with. So much so that we think that ought to be retained. And I just think that those who are involved in something like the United Givers or the Red Cross or the church would be the first to insist that if we have a so-called flat tax or a flatter tax, whichever way you want to do it, that that ought to be retained. And I think that the deduction for a religious contribution—by the time we get through I would just be willing to bet you my life on this—that if we take it away, it won't be gone but for a year. They will come back in here and get it back. And I'd like to ask you what you think about the charitable contribution when it is, in fact, a charitable contribution—not something to ones own private foundation, but a charitable contribution to a church or for a public charity that has general acceptance.

Mr. WERTHEIMER. Well, you are, obviously, raising the bottom line public struggle that this kind of effort faces. One, where will you come down in terms of making your judgments about what, if anything, stays, and what goes. And, second, and in some ways it is the most worrisome thing, even if you were successful, how do you stop this whole process from immediately beginning to repeat itself?

Senator LONG. Exactly.

Mr. WERTHEIMER. And that is extremely worrisome. But I think that there are judgments that have to be made. Senator Bradley has made a set of judgments in his initial proposal. Assuming this goes forward, we will go through a series of battles. We did not specifically state in our statement, and aren't prepared at this point to say that those six or five items are the key items, and that's where the political judgment should come down.

As was pointed out, there are other ways to deal with a number of programs. If you look at the direct expenditure side, and if you treat them as Government expenditures rather than going through the taxes.

Senator LONG. Well, the day before we held the hearings on the flat tax the committee met and an amendment was offered to provide a tax advantage for lawyers and for writers who donate their works of art or their manuscripts to charity. There will be a lot of cases where these people will make more money by donating one of those paintings than they could make by selling it. In effect, Uncle Sam is the unwilling purchaser of those donations.

Now the significance of that was that here I was vehemently protesting, and I was voted down—only one person on the committee to stand up against this new tax expenditure, which I think has very, very dubious merit to it—at a time when everybody is getting his mind all set thinking about the hearings that we are going to hold the next day on the flat tax. In fact, right now that thing is out there to be passed with only one Senator, to my knowledge, opposing it because it has been well lobbied by those who have an interest in the matter. And I just find myself asking what do you think our prospects are if we managed to eliminate a great deal of tax expenditures, or drastically cut back on them and then be able to keep it that way?

Mr. WERTHEIMER. Well, that's a tough problem. That doesn't lead me to conclude that we shouldn't get there. Even if we started all over again, we would at least have a different framework, and we would have a different situation. I guess I would be interested in looking at the budget process, and the process itself, in the ways in which tax expenditures are added to the system. And perhaps we could devise a way of making it far more difficult to add tax expenditures to a new system. It's pretty hard to deal with them now one at a time. You don't have to come up with the money to pay for them. I mean you don't have to take it from somewhere else, you can just add it.

And one of the things that might well be worth looking at is whether the process for dealing with tax expenditures should be different in the future under a different system.

Senator LONG. Well, thank you very much, gentlemen. You have made a very good contribution. And if you want to make an additional rejoinder, submit it to us, and we will include it in the record.

Thank you very much.

[Whereupon, at 11:47 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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THE FLAT-RATE TAX: AN OVERVIEW AND COMPARISON OF PROPOSALS AND REFLECTIONS ON TRANSITIONAL ISSUES

The magnitude and frequency of changes in our income tax system have led a number of policymakers to ask the question, "Isn't there a better way?" Much of the impetus for this reappraisal initially arose during the consideration and subsequent passage of the Economic Recovery Tax Act (ERTA) in 1981. Under ERTA, the top tax rates were lowered substantially and attempts were made to eliminate perceived abuses in tax sheltered investments. Yet many concluded that the complex provisions devised to preclude tax avoidance--by "tax shelter devices" as well as from the problem of lost revenue resulting from unreported income generated in the underground economy--still needed further refinement. In fact, the recent 1982 tax proposals that led to a Senate-generated tax bill created additional fervor to meet the challenge of abusive tax shelters and the underground economy revenue drain. This highlighted the possibility that the solution could better be accomplished through other approaches. Thus, support for a radical change in our income tax system is focusing attention on the need for a greatly simplified approach, particularly for individual taxpayers. While the ideas are not new, some Congressmen and economists have proposed either a flat-rate tax system or one that has far less complexity, with a simpler tax rate schedule and fewer brackets.

The rush of various "flat-rate tax" proposals is reminiscent of the excitement a few years ago when similar euphoria was exhibited about VAT (value-added tax). In fact, one leading legislator, Representative Barber Conable, has alluded to the flat-rate tax momentum as having "fad" overtones.

While legislative action on these proposals is not likely this year, Senator Robert Dole has announced that the Finance Committee will commence hearings in September. Increased interest from both liberals and conservatives suggests that the public should be better informed about the alternatives under consideration. The remainder of this letter discusses some of the issues involved in a simpler system, some of the problem areas that are likely to emerge, a brief discussion of the types of proposals that have so far been made and their impact on different taxpayer groups. The text is followed by exhibits comparing the tax under various proposals and the components of the tax base.

What is wrong with the present tax system?

Under present law, individual taxpayers must deal with confusing definitions of gross income (and exclusions), complex limitations on certain deductions (e.g., charitable contributions, casualty losses, medical expenses, interest deductions) and a myriad of tax credits. There are special calculations for capital gains (and disagreements over qualification for this tax-favored status), special treatment of so-called tax preference items and multiple methods (such as income averaging) to calculate the tax. In spite of Congressional attempts to simplify return preparation for individual taxpayers, over one-half of all individual taxpayers still seek outside assistance in preparing their returns.

Moreover, concern about "bracket creep" (inflation pushing taxpayers into higher tax brackets) has been a bane of the U.S. middle class. Provisions of the '81 Act (ERTA) were intended to mitigate these problems through rate reduction and indexation. Nevertheless, many conclude that these changes did not go far enough.

Business taxpayers also face many complexities, although most maintain adequate accounting records and are accustomed to the requirements for preparing tax returns. Even here, however, there is still a wide range of choices that must be made among cost recovery proposals and inventory accounting systems. Complications also arise from the corporate reorganization, partnership and foreign income provisions.

While some of the recent proposals focus on both business and individual taxpayers, most show the greatest concern for the plight of the individual taxpayer. The discussion that follows concentrates on that area.

What are the concepts underlying a flat-rate tax system?

The threshold question in the development of any flat-rate tax system is, of course, the definition of income against which the tax rate will be applied. The definition of income would form the tax base, so it naturally follows that the broader the tax base, the lower the tax rate can be. Using our present tax system as a model, a flat-rate tax could be imposed on taxable income or on adjusted gross income. A broader tax base could be called comprehensive income, deemed by econnomists to be more analogous to economic income. This type of base might include such presently exempt income as additions to retirement accounts, social security benefits, railroad retirement payments, accretions in insurance policies, unemployment benefits, the full amount of realized capital gains and municipal bond interest.

Taxable income, as presently defined, probably provides a poor base against which to apply a flat-rate tax. Retaining the concept of taxable income would retain most of the complexities of the present system and would require the imposition of a rather high tax rate to derive revenues comparable to present levels. Under a system based on taxable income, low and middle income taxpayers would probably experience a significant increase in their tax burden. Unless there were a substantial increase in the "zero bracket" amount, many flat-tax economic studies project a profound switch in total tax burden to these groups. Only upper income taxpayers would realize significant relief. However, an advantage of retaining taxable income as a tax base is that there would be little impairment of tax-favored activities such as charitable contributions and home ownership deductions for mortgage interest and real estate taxes.

Adjusted gross income (AGI), as presently used in the tax system, would provide a much broader tax base by eliminating itemized deductions. In a true economic sense, however, even AGI does not always reflect an individual's total economic income. Under present law, social security, federal transfer benefits and 60% of capital gains are exempt from taxation, as are some dividends and interest (especially on state and local government obligations). In addition, to the extent an individual contributes either to an IRA or, through his employer, to some other qualified pension or profit sharing plan, such amounts and the related income are not taxable to the individual until he actually begins to receive retirement benefits. Also, many special rules apply to determine AGI. Therefore, some favor taxing all economic income currently.

Under a more comprehensive income tax system, there would be few or no deductions available, and income that is presently exempt or excluded --such as social security, the earnings on retirement accounts and tax-exempt interest--could become taxable. This would be the simplest system for taxpayers and would also allow the lowest tax rates. Nonetheless, this system would also probably increase the tax burden for low and middle income taxpayers, and investment distortions would occur because amounts devoted to previously deductible or excludable items would become taxable.

General problems from a comprehensive tax base

The major criticism against using comprehensive income as a tax base is the distortion that would follow the loss of special tax incentives. Home builders and homeowners could be hurt by the loss of the ownership deductions, and the charitable sector would likely receive fewer gifts because of the loss of the contribution deduction. Oil and gas exploration would be curtailed by the loss of depletion and the current deduction for intangible drilling costs.

The loss of other tax incentives potentially gives rise to a reallocation of resources wherever there is presently favored treatment. This is especially acute regarding gains from capital investments that are now subject to tax at 40% of the rate applied to other income. Likewise, state and local governmental funding by borrowing could be severely impacted because they would lose their ability to borrow at lower tax-exempt interest rates.

Finally, a comprehensive income system could put tremendous pressure on major financial systems if the definition of income included several forms of savings, especially retirement savings. If social security were to be taxed, there would be great pressure to increase the benefits from a system already in serious financial trouble. Employers would experience similar problems if their contributions to profit sharing or pension plans were taxable to employees or the growth in retirement or insurance reserves were similarly currently taxable.

Business flat-rate tax. Much of the discussion about flat-rate tax has centered on individual taxpayers. However, such a tax system could be applied to businesses as well. If a flat-rate tax applied to businesses, it should probably apply to a modified taxable income base. A gross receipts tax would mean an enormous tax increase for capital intensive industries, extractive industries that use percentage depletion and development cost deductions, financial institutions, marketing and distribution organizations, and sectors where there is a high reliance on inventory. There would also be a severe increase for those thousands of low margin businesses (such as retailers and wholesalers) who may generate gross profits but little (or no) economic net income.

What tax rate is necessary?

The Congressional Research Service has developed a series of models projecting the rates needed to maintain present levels of revenues, depending on the tax base. For example, a rate of about 12% for individuals is needed if the AGI tax base is used. This would result in a tax increase of over 1000% for taxpayers earning less than $5,000, but about a 50% tax decrease for taxpayers earning over $200,000. For taxpayers in the $20-$30,000 income group, the tax increase would be roughly 13%, while taxpayers in the $30-$50,000 brackets would experience about a 5% decrease.

By contrast, using the 1984 tax tables and projected 1984 income and using a taxable income tax base, a rate of 18.5% is required to raise the same revenues the Treasury received in 1980. Under this system taxpayers earning less than $50,000 would experience a tax increase, with the greatest burden falling on income levels below $20,000.

What proposals have been suggested?

Legislation has been introduced embodying the flat-rate tax system for individuals only or for individuals and corporations. Three basic approaches prevail. The first repeals all present tax laws relating to deductions, exclusions and credits that apply to individuals and imposes a flat-rate tax on all income. A second group of proposals would replace the entire system for both individuals and corporations with a flat-rate tax on all income. The third approach is actually a graduated tax for individuals on a significantly expanded base. Under all of these proposals, some amounts of personal exemptions and/or zero bracket amounts are retained. None of these proposals distinguishes between ordinary and capital income, so capital gains would be taxable in full.

Broad, comprehensive definition of income

Individual flat-rate system. Undoubtedly the simplest flat-rate tax proposal is made by Senator Helms (S. 2200) and provides a 10% tax rate applicable to all individuals. Its simplicity, and its weaknesses, flow from its requirement that virtually all exclusions, deductions and credits be eliminated. Only a $2,000 deduction for each current personal exemption would remain. There would be no low income exemption. This extreme simplicity is likely to be the bill's greatest impediment. Although other proposals made under the aegis of a "flat-rate tax" sharply reduce, if not eliminate, many so-called tax preferences (primarily deductions or specially treated items), none goes so far as this in broadening the tax base.

The Helms proposal includes in income many items whose nontaxability has been considered sacrosanct for years, such as insurance proceeds, gifts and inheritances. Naturally the Helms approach would also tax retirement nest eggs, social security and other federal and state transfer payments (including unemployment compensation), tax-exempt interest income and 100% of capital gains. Interestingly, even though bequests and gifts are subject to income tax in the Helms proposal, no reference is made to revamping or eliminating gift and estate taxation. Thus, double taxation could occur unless the two tax systems are coordinated.

Individual and corporate flat-rate system. H.R. 6070, introduced by Representative Panetta, illustrates the flat tax as it might apply to individuals and corporations. All income would be taxed at 19%. Under that legislation, a $1,000 exemption credit would be allowed for the taxpayer, $1,000 for a spouse, $200 for each dependent and $200 for each individual who is blind or at least age 65. Thus, very low income individuals would, for the most part, remain exempt from taxation.

Under the Panetta plan, municipal bond interest and all income transfer payments (e.g., social security) are included in income and are taxable. Similarly, all employer-purchased group-term life insurance benefits would become taxable to employees. All present law deductions would be repealed, except those for expenses for the production of income, real economic losses and alimony payments. These repealed deductions would specifically include capital gains on all assets, including the sale of a personal residence. Corporations would also be subject to tax at the 19% rate, and many special deductions would be repealed. These include the deductions for depletion of intangible drilling costs, accelerated cost recovery (and depreciation), special deductions for dividends received and deductions for contributions to qualified employee benefit plans and entertainment expenses. Deductions for other trade or business expenses would be retained.

The "simple" progressive (flat) rate tax

The proposal receiving the most publicity is actually not a flat-rate tax but a progressive-rate tax, with reduced rates applied to a significantly broadened tax base. Senator Bradley and Representative Gephardt have developed a proposal (S. 2817) for individual taxpayers having some support among both conservatives and liberals. Their plan has been called the "Comprehensive Income Tax" and would impose a basic tax of 14% on all taxable income. A progressive surtax would then be imposed on total income above $40,000 for joint returns and $25,000 for unmarried individuals. The highest surtax rate, 14%, would apply to taxpayers filing single returns with adjusted gross income over $37,500 and to taxpayers filing joint returns with adjusted gross income over $65,000. Thus, for the taxpayers in the highest adjusted gross income class, the maximum effective tax rate would be 28%. Adjusted gross income would be expanded, however, by including certain items not currently taxed and repealing certain other deductions.

Under this "comprehensive" tax plan, several provisions of present law would be retained. The zero bracket amount would be increased to $4,600 on joint returns, and the exemption level would be increased to $1,500 on a single return, $3,000 on a joint return and $1,750 for heads of households. The deduction for employee business expenses would be retained, as would the exemption for interest on general obligation municipal bonds. Several itemized deductions would be retained, including home mortgage interest, charitable contributions, state and local income taxes, and real property taxes. Social security and veterans' benefits would remain tax-exempt.

Some current provisions would be modified, including the child care credit, the exclusion for employer-provided health insurance, the deduction for medical expenses (limited to expenses in excess of 10% of AGI) and the $125,000 exclusion of gain on the sale of a residence. A 14% tax would be applied to the investment income of pension plans, IRAs and Keogh plans. Many other special exemptions, deductions and credits presently available to individuals, such as for percentage depletion, intangible drilling costs and the investment credit, would be repealed. The entire amount of capital gains (without any excludible portion) would be subject to tax.

A pragmatic proposal--an integrated business and individual flat rate

A fourth approach eliminates the present tax system for both individuals and corporations. S. 2147, introduced by Senator DeConcini, sets out a series of guidelines for business taxation covering all entities, including partnerships, proprietorships and individual investment activities. Under DeConcini's proposal, a tax would be imposed on gross revenues, with deductions allowable for "capital expenses of the business" and for amounts the business pays during the taxable year for "goods and services." No consolidations would be allowed, and each subsidiary would pay tax on its own income. The DeConcini proposal does not tax capital gains. No rate is mandated, since the proposal only sets out guidelines. Apparently individuals would essentially be taxed only on compensation income but not on interest, dividends, capital gains or business income.

Evaluation of four approaches

In the purest sense, probably none of these four approaches truly qualifies as a "flat-rate tax." The closest would be the Panetta approach. The Helms version has the broadest definition of income. The Bradley approach is not a flat-rate tax at all, but merely a simplification of our present progressive tax rate structure. The DeConcini bill is based on a report that has received a great deal of notoriety, prepared by Alvin Rabushka and Robert E. Hall, senior fellows at Stanford's Hoover Institution. Very simply, this version presents guidelines for taxing all business activities, regardless of whether incorporated, at a flat-rate tax of 19%. The individual segment of the tax system would then be a flat-rate tax based solely on compensation.

What bothers proponents of maintaining the current progressive system? Some of the problems inherent in adopting any of these proposals are:

- Regressivity.
- Fringe benefits and deferred and retirement benefits may be taxed currently at fair market value.

- Transitional problems in going from the current system to a completely new one, whereby current investment tax basis (i.e., buildings, plant and equipment) may no longer provide tax benefits, resulting in an economic loss therefrom.
- The impact on special industries or their investors, such as real estate, home ownership and construction, and oil and gas exploration.
- Probable reduction in charitable contributions.
- Fair market value of collectibles (i.e., antiques, art and jewelry) may be drastically affected.
- Municipal bond funding and ownership may be adversely affected.
- The impact on state income tax linkage to a federal tax system.
- The concern that once the definition of income is broadened to include items of income not currently taxable, Congress will be greatly tempted to increase the basic tax rate.
- Distortion to investment incentives and return on investment.

In other words, once the door is open to a much broader definition of income, there is nothing to assure that a low rate or even a few brackets will continue forever. Seemingly, nothing can deter Congress from the temptation to impose higher tax rates on more substantial incomes in order to obtain revenues for government expenditures.

Special transitional problems

To the extent that any change in the system would disallow deductions on investments made before enactment of a new tax system, it is evident that serious economic displacement could take place unless there is a substantial transitional period. As one commentator stated, many citizens would probably be put in a negative net worth position, particularly if there were long-term commitments based on the current system of taxation in computing investment risk, rate of return and profitability. Loss of deductions for these amounts not only results in current loss of tax benefits but also undoubtedly creates reduction in portfolio asset values. Many economists and tax policy experts have shrugged at this problem, asserting that it is simply one of the costs of making a significant change and that the loss is offset by substantially lowered income taxes. Whether this is true or not can only be decided on a case-by-case determination.

Others more concerned about the substantial mischief or taxpayer revolt that might result from such a significant diminution of wealth have suggested that a lengthy phase-in period is imperative, such as 20 or 30 years for those who have homes as well as other investments subject to long-term mortgages. Transactions entered into after enactment of a new system should be subject to the new system at the time of the transaction. Undoubtedly the grandfathering would be helpful to the extent of investment maintenance, but one can still wonder about the diminution in wealth from the "resale market," whereby purchasers will be willing to pay less because the net after-tax cost of investment will be higher. A transitional rule creates additional complexities: two different systems of taxation may be running contemporaneously.

Similar statements can be made if businesses or business activities are considered separate from individual income subject to taxation, primarily compensation. In addition, under the Helms approach, there would have to be a substantial transition period and coordination between the current gift and estate tax transfer system and taxation of such transfers as income to the recipient.

Another area that would require complex transitional adjustment provisions is qualified retirement benefits, including employer plans and Keogh or IRA plans. Two questions immediately come to mind: On the effective date, should sums be frozen under the old (i.e., the current) system, including earnings thereon; or should there be a cutoff of the balance only as of the effective date? If so, should taxation take place only at the date of distribution or over a phase-in period? Is there any need to continue special tax provisions, such as 10-year averaging? Or will the presumed lower rates under flat-rate tax obviate the need for some of the complexities of maintaining a plan under two vastly different tax systems? Inherent in all of this, of course, is the problem of the details to be maintained, by whom and for how long.

Because of the vast differences in the four systems set forth above, it is not possible to explain simply or point to all the transitional problems. Suffice it to say that many proponents of the flat-rate tax seemingly have been caught by the attractiveness of its superficial simplicity. Enthusiasts ignore the fact that, although simplicity will probably result once the system is fully operational, any change as significant as a flat-rate tax is likely to require an orderly transition period. Providing "equitable transition" will create a taxpayer's dilemma--increased complexity under a dual system for a lengthy period of time.

Conclusion

In spite of the concerns and problems set forth above, the movement toward serious consideration of a flat-rate tax must be recognized. In recent days, there has been editorial support in The New York Times and Washington Post, as well as guest editorials in The Wall Street Journal criticizing the complex individual income tax system currently in operation. Moreover, President Reagan, Senator Dole and the Office of Management and Budget (OMB) have recently noted the appeal of a flat-rate tax system. Whether doubters of such a system will provide a balance to the movement remains to be seen.

Under any circumstances, however, because of the likelihood of strong reaction by groups who will be affected substantially by removal of tax incentives provided to them for many decades, such as charitable and educational institutions, the oil and gas industry, and the real estate industry, among others, any substantial change in the philosophy of individual taxation will evolve slowly. As this brief discussion indicates, many variables can be injected into a flat-rate tax system, even though the goals of the system are retention of a very broad tax base and a low tax rate, and massive simplification of the system for most taxpayers. Whichever approach gains favor, efforts to accomplish fairness during a transition are likely, even though complexity would inevitably result. Moreover, the strong bi-partisan opposition of two respected tax experts in Congress--Senator Russell Long and Representative Barber Conable--cannot be ignored.

Thus, even in today's chaotic legislative environment and with the tremendous pressure on the federal budget, we do not anticipate that flat-tax legislation will be stampeded through Congress.

Exhibit 1

Comparison of Taxes Under Flat-Rate Proposals

	Present Law	Helms	Panetta	Bradley
Example I				
Income before capital gain and Keogh contribution	$100,000	$100,000	$100,000	$100,000
Capital gains ($30,000)	12,000	30,000	30,000	30,000
Keogh contribution	(15,000)	—	—	—
Municipal bond interest	—	15,000	15,000	—
Gifts and inheritances	—	125,000	—	—
Adjusted gross income	97,000	270,000	145,000	130,000
Deductions				
Medical expense	900	—	—	900
Taxes paid	10,000	—	—	10,000
Interest expense	8,300	—	—	—
Home mortgage interest	4,200	—	—	4,200
Charitable contributions	5,000	—	—	5,000
	28,400	—	—	20,100
Zero bracket amount	3,400	—	—	4,600
Net deductions	25,000	—	—	15,500
Personal exemptions (4)	4,000	8,000	—	5,000
Taxable income	$ 68,000	$262,000	$145,000	$109,500
Tax thereon	$ 21,625	$ 26,200	$ 27,550	$ 14,686
Personal exemption credit	—	—	(2,400)	—
Surtax	—	—	—	11,100
Total taxes	$ 21,625	$ 26,200	$ 25,150	$ 25,786
Example II				
Income before capital gain and IRA contribution	$ 50,000	$ 50,000	$ 50,000	$ 50,000
Employer-paid insurance benefits	—	800	800	800
Capital gains ($300,000)	120,000	300,000	300,000	300,000
IRA contribution	(4,000)	—	—	—
Municipal bond interest	—	5,000	5,000	—
Gifts and inheritances	—	75,000	—	—
Adjusted gross income	166,000	430,800	355,800	350,800
Deductions				
Casualty loss	600	—	600	—
Taxes paid	15,000	—	—	15,000
Interest expense	1,000	—	—	—
Home mortgage interest	3,200	—	—	3,200
Charitable contributions	1,800	—	—	1,800
	21,600	—	600	20,000
Zero bracket amount	3,400	—	—	4,600
Net deductions	18,200	—	600	15,400
Personal exemptions (4)	4,000	8,000	—	5,000
Taxable income	$143,800	$422,800	$355,200	$330,400
Tax thereon	$ 59,349	$ 42,280	$ 67,488	$ 45,612
Personal exemption credit	—	—	(2,400)	—
Surtax	—	—	—	42,012
Total taxes	$ 59,349	$ 42,280	$ 65,088	$ 87,624

Exhibit 2

Comparison of Individual Taxes under Flat-Rate Tax Proposals

	Present Law	Bradley	De Concini*
Compensation			
Salary	$ 350,000	$ 350,000	$ 350,000
Employer contribution to pension plan ($30,000)	—	—	30,000
Employer paid health and life insurance ($2,500)	—	2,500	2,500
Interest & dividends	20,000	20,000	—
Capital gain ($400,000)	160,000	400,000	—
Business Income			
Income from rental property (below)	(25,000)	(25,000)	—
Income (loss) from oil & gas partnership #1 (below)	(425,000)	45,000	—
Income (loss) from oil & gas partnership #2 (below)	200,000	290,000	—
Adjusted gross income	280,000	1,082,500	382,500
Deductions			
State & local real property and income taxes	40,000	40,000	—
Sales tax	4,000	—	—
Home mortgage interest	18,000	18,000	—
Other interest	25,000	20,000	—
Charitable contributions	30,000	30,000	—
	117,000	108,000	-0-
Zero bracket amount	(3,400)	(4,600)	-0-
Net deductions	113,600	103,400	-0-
Personal exemptions (joint return, plus 2 dependents)	(4,000)	(5,000)	(6,200)
Taxable income	$ 162,400	$ 974,100	$ 376,300
Tax thereon	$ 68,649	$ 135,730	$ 71,497
Surtax	—	144,450	—
Business tax (below)	—	—	59,750**
Total taxes	$ 68,649	$ 280,180	$ 131,247

Business Income

	Present Law	Bradley	De Concini*
Rental Property — ($1.2 million cost)			
Gross rents	$ 250,000	$ 250,000	$ 250,000
Operating expenses/taxes	(25,000)	(25,000)	(25,000)
Depreciation/ACRS	(80,000)	(80,000)	—
Interest expense	(170,000)	(170,000)	—
Net income (loss)	$ (25,000)	$ (25,000)	$ 225,000
Business tax (at 19% rate)	n/a	n/a	$ 42,750
Less: Carryforward of prior year negative tax on net losses (assumed)			(40,000)***
Net business tax			$ 2,750
Oil & gas partnership (#1)			
Income less expenses	$ 100,000	$ 100,000	$ 100,000
Depletion	(25,000)	(5,000)	—
Intangible drilling costs (producing wells)	(500,000)	(50,000)	(500,000)
Net income (loss)	$(425,000)	$ 45,000	$(400,000)
Business tax (credit for carryover at 19% rate)	n/a	n/a	$ (76,000)
Oil & gas partnership (#2)			
Income less expenses	$ 300,000	$ 300,000	$ 300,000
Depletion	(100,000)	(10,000)	—
Net income (loss)	$ 200,000	$ 290,000	$ 300,000
Business tax (at 19% rate)	n/a	n/a	$ 57,000
Total business tax			$ 59,750**

*The De Concini bill sets guidelines only. The detailed calculations are based on a more complete description of the underlying concepts contained in a paper from the Hoover Institution.

**Assumes that each business is computed separately. If businesses of individuals could be combined under the proposal, the tax would be reduced (not less than zero) by $76,000. (Bill does not clarify this point.)

***Primarily due to expensing cost of rental property when acquired.

Exhibit 3

Comparison of Present Law Treatment of Individual Income, Deduction, Exclusion and Credit Items With Various Flat-Rate Tax Proposals

Present Law	Helms (S. 2200)	Panetta (HR 6070)	Bradley/Gephardt (S. 2817)	De Concini (S. 2147)*
Tax Rate **Graduated from 12%-50%**	**Flat-rate of 10%**	**Flat-rate of 19%**	**Basic tax rate of 14%** **Progressive surtax 6-14%**	**"Not more than 20%"**
Income — "From whatever source" Includes: ☐ Compensation ☐ Interest and dividends ☐ Rents and royalties ☐ Alimony ☐ Pensions and annuities ☐ Gross income from business ☐ Gains from dealing in property	☐ Same treatment as present law	☐ Same treatment as present law	☐ Same treatment as present law	Includes only: ☐ Compensation ☐ Pensions paid directly by employer ☐ FMV of employer contributions to pension/profit-sharing plans
Exemptions and Exclusions ☐ 60% of long-term capital gains ☐ Unemployment compensation ☐ Life insurance proceeds ☐ Gifts and inheritances ☐ Interest on gov't. obligations (including IDBs) ☐ Compensation for injuries/sickness ☐ Scholarships ☐ Income of states, municipalities, etc. ☐ Meals & lodging furnished by employer ☐ One-time exclusion of gain from sale of principal residence ☐ Contributions by employer to qualified pension or profit sharing plans ☐ Earnings of IRAs, Keogh plans, qualified plans ☐ Social Security and Veterans' benefits ☐ Various other exclusions	All are eliminated	All eliminated except: ☐ Gifts and inheritances ☐ Income of states, municipalities, etc.	Following are retained: ☐ Life insurance proceeds ☐ Gifts and inheritances ☐ Interest on gov't. obligations (not IDBs) ☐ Compensation for sickness/injuries ☐ Income of states, municipalities, etc. ☐ Meals & lodging furnished by employer ☐ Exclusion of gain on sale of personal residence (retained for normal tax only) ☐ Contributions by employers to qualified plans ☐ Social Security and Veterans' benefits	Excludes only: ☐ Capital gains (100%) ☐ Interest ☐ Dividends

Deductions				
☐ Personal exemption ☐ Zero bracket amount ☐ Trade or business expenses ☐ Employee business expense ☐ Interest ☐ Taxes ☐ Losses ☐ Bad debts ☐ Depreciation (ACRS) ☐ Charitable contributions ☐ Medical expense ☐ Alimony payments ☐ Moving expense ☐ Retirement savings (IRAs) ☐ Expenses for producing income ☐ Intangible drilling costs ☐ Mining exploration ☐ Percentage/cost depletion ☐ Travel and entertainment ☐ Various other deductions	Repeals all deductions except: ☐ Personal exemption	Converts personal exemptions to credit and repeals all other deductions except: ☐ Trade or business expenses ☐ Losses ☐ Expenses for producing income ☐ Alimony payments	Retains most deductions but modifies the following. ☐ Interest (home mortgage only) ☐ Taxes (state & local income and real property only) ☐ Losses (not casualty & theft) ☐ Depletion (cost only) ☐ Intangible drilling costs (repealed) ☐ Child care (deduction allowed rather than credit) ☐ Medical expense (excess over 10% of AGI allowed)	Would provide only a deduction for "a fixed amount."
Credits				
☐ Foreign taxes ☐ Investment tax credit ☐ Earned income credit ☐ Child care ☐ Targeted jobs credit ☐ Residential energy credit ☐ Research ☐ Various other credits	All credits repealed	Allows only: ☐ Personal exemption	Repeals most credits except: ☐ Foreign taxes ☐ Work incentive program ☐ Earned income	Credits not mentioned

* The De Concini bill provides only guidelines. Detailed treatment is drawn from Hoover Institution paper on which the bill is based.)

Statement of Gerald W. McEntee
International President, AFSCME
to the Senate Finance Committee
on Flat Tax and Major Tax Reform Proposals
October 14, 1982

The American Federation of State, County, and Municipal Employees (AFSCME) represents over one million public employees throughout the country. Clearly, they have a direct interest in the financial resources available for the public services America needs. As citizens and wage earners, we have a direct interest in how the tax burden is shared. Over the years AFSCME has been a strong advocate for progressive tax reform at the state and local level as well as the federal level.

Developments in federal tax policy are also of particular importance to AFSCME since most state and local governments conform in whole or in part to the federal tax code - especially with regard to personal income and corporate income taxes. For instance, in taxing personal income many states adopt federal tax rules regarding deductions and income exclusions, while a few states actually determine their personal income tax as a percentage of federal income tax. In addition, the federal government often influences the direction of state and local tax policy. As a result, major revisions in federal tax policy can spill-over to subnational jurisdictions.

We welcome this opportunity to present our views on the appropriate course for reforming our nation's federal tax system. Of great concern is the fact that working people have lost confidence in the fairness and the efficiency of the federal tax system.

Recent Advisory Commission on Intergovernmental Relations polls show that in September, 1981 36 percent of the public felt that the federal income tax was our nation's least fair tax up from 28 percent in May, 1977.

We must act to restore confidence in the federal tax system and the process of tax policy making. Tax reform involves adherence to the underlying principles of fairness, economic efficiency and simplicity - and requires abandoning attempts to use the tax system as the provider of subsidies and special allowances.

The lack of confidence in the federal tax system which we face today can be traced to several developments:

- o A trend towards less progressive taxation
- o The growth of tax expenditures
- o Shifts in the distribution of the tax burden from businesses to individuals.

Less Progressive Tax System

The notion that individuals with higher incomes should pay proportionately more of their incomes in taxes than those with lower incomes is a critical underpinning of our tax system. Even before the passage of the Economic Recovery Tax Act (ERTA) of 1981, which reduced the progressivity of the federal income tax, a clear trend toward a less progressive income tax was evolving (see Table 1). The passage of ERTA, meanwhile, was a major set-back for taxation based on ability to pay. According to the Congressional Budget Office, the tax reductions embodied in ERTA will increase the after tax income for households earning above $50,000 by 6.7% compared to only 1.3% for households earning less than $10,000 in 1983! (See Table 2).

Much of recent tax policy debate has centered on the merits of substituting the current tax system with some form of a single rate tax scheme. Advocates would have us sacrifice progressivity for the sake of simplicity. According to the Joint Committee on Taxation, an 18.5 percent flat tax on the current tax base would increase taxes by about 30 percent for taxpayers in the $15-20,000 income bracket, but decrease taxes by over 20 percent for taxpayers in the $50-$100,000 income bracket (See Table 3). As Assistant Secretary Chapoton stated in his testimony before this committee, "Any single-rate tax would inevitably result in a major redistribution of the tax burden from high income to low and middle income families." A single rate flat tax should be rejected if we are to preserve any semblance of a fair and equitable tax system.

In the future, we must look to ensure that the progressivity of the tax system is improved. We must resist simplistic solutions to complex tax problems that would introduce greater inequities in the tax structure and shift the tax burden to working people.

Growth of Tax Expenditures

The federal income tax base has been shot full of holes by the growth in tax expenditures. By Fiscal Year 1987, the Joint Committee Taxation estimates that the percent of taxes forgone through tax expenditures will reach 42% for personal income taxes and 65% for corporate income taxes (See Table 4). This growth in tax expenditures compromises the economic efficiency of the tax system by requiring higher tax rates to collect any given amount of revenues and results in a complex and time consuming tax compliance process.

One need only point to the Senate's recent approval of legislation that reduced the period an asset must be owned before it qualifies for preferential capital gain tax treatment to demonstrate that the pressure to expand tax loopholes is still with us. Congress must take a firm stand against new tax loopholes if we are ever to get serious about restoring a reasonable base for taxation and restore equity and public confidence in the federal tax system.

Shrinking Corporate Tax Burden

Over the years, corporate taxes have been drastically reduced. In 1960 corporate income taxes accounted for 4.2% of GNP while by 1981 they composed only 2.2% of GNP. It is estimated by the Joint Committee on Taxation that by 1987 only 7.1% of all federal revenues will come from corporate income taxes compared to 15.1% in 1981.

The shift of the federal tax burden away from corporations was greatly accelerated by the passage in 1981 of the Accelerated Cost Recovery System for determining business depreciation deduction. The new depreciation system and the liberalized Investment Tax Credit will dramatically reduce the effective corporate tax rate and, additionally, will distort the economic returns to different classes of assets. According to the Urban Institute, at an 8% annual rate of inflation ACRS will reduce the effective corporate tax rate on plant and equipment from 40% to 18% by 1986 (See Table 5). Moreover, ACRS distorts the economic returns to different classes of assets by favoring short lived assets more than long lived assets.

The 1982 Tax Equity and Fiscal Responsibility Act was an important step toward redressing the sharp decline in corporate income taxation and the economic distortions introduced by ERTA. Particularly, eliminating safe harbor leasing after 1984 and reducing the basis for depreciation by half the value of the ITC were needed reforms.

Much more remains to be done. As corporate tax receipts decline, individuals will be forced to bear heavier burdens in order to finance services. We must act to reverse this disturbing trend.

Future Course of Tax Reform

In approaching tax reform we must not act hastily or imprudently, as there are no simple solutions to the complex problems facing our tax system. A tax reform agenda should:

- Ensure that federal taxes be based on ability-to-pay
- Broaden the tax base by holding fast against new tax expenditures and by eliminating unproductive and inefficient tax loopholes
- Reinstate effective corporate taxation

Improving the efficiency of the tax system or simplifying the tax system need not conflict with ensuring that taxes are based on ability to pay and tax burdens are shared equitably. We have already pointed out that a greater degree of economic efficiency and a less complex tax system can be achieved by eliminating tax expenditures.

The challenges we face in pursuing tax reform are significant. The debate will be a difficult one for our nation. In the course of this debate we must resist simple, one-dimensional solutions that ignore the full breadth of our tax problems such as a single rate flat-tax proposal. AFSCME will continue to promote equity as the major objective of federal tax reform and support progressive proposals that do not unfairly burden working men and women.

Table 1

Increase In Average Federal Tax Rates
for Four-Person Families
(Percent change from 1960-1980)

	Change from 1960-1980
One-Half the Median Income	+114%
Median Income	+46.1%
Twice Median Income	+50.4%

Source: Hutton and O'Neill,"Tax Policy", in Urban Institute's The Reagan Experiment, p. 105

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Table 2

Change In Federal Individual Income Taxes
Due to Economic Recovery Act of 1981

By Household Income for Calendar Year 1983
(in dollars)

	All Households	Less than $10,000	$10,000 to $20,000	$20,000 to $40,000	$40,000 to $80,000	$80,000 or more
Dollars per Household	940	120	440	950	1,830	15,250
As a Percentage of Income	3.5	1.3	1.9	3.2	4.6	6.7

Source: "Effects of Tax and Benefit Reductions Encacted in 1981 For Households In Different Income Categories", Congressional Budget Office, (February, 1982)

Table 3

Charge in Distribution of Tax Liabilities Under
an 18.5 percent flat tax compared
to 1984 Tax Law at 1981 Income Levels

Income (in thousands of $)	Percent Change	Dollar per Return Change
5	290.7	180.71
5-10	51.6	197.91
10-15	40.6	388.31
15-20	30.0	484.54
20-30	19.9	523.28
30-50	4.1	190.61
50-100	-21.2	-2,290.90
100-200	-42.4	-16,540.20
200	-56.5	-56,438.05

Source: Joint Committee on Taxation

AFSCME Public Policy Department

Table 4
Percent of Taxes Foregone through Tax Expenditures

Fiscal Year	Corporate	Individual	Total
1977	34%	35%	35%
1978	36%	36%	36%
1979	38%	35%	36%
1980	40%	38%	39%
1981	44%	39%	40%
1982	54%	40%	42%
1983	58%	41%	43%
1984	54%	41%	44%
1985	57%	41%	44%
1986	62%	42%	46%
1987	65%	42%	46%

Source: Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987
Budget of the U.S. Government, special analysis, Fiscal Year 1979 and Fiscal Year 1980

Table 5

Effective Corporate Tax Rate
(percentage)

Industry Division	1980 Tax Law	ACRS
Agriculture	28.6	8.7
Mining	50.4	33.3
Construction	28.2	8.2
Manufacturing	36.6	14.3
Transportation, Communication, and Utilities	42.3	18.4
Trade	37.3	17.5
Finance and Insurance	38.8	20.7
Services	38.5	20.5
Total nonresidential business	39.6	17.8

Source: C.R. Hulten, J.W. Robertson, S.M. Davies, unpublished.

Rates refer to Accelerated Cost Recovery System (ACRS) when fully phased in and assume an 8 percent expected rate of inflation.

OFFICE OF THE GENERAL SECRETARY ■ ABC
Valley Forge, Pennsylvania 19481

Written Statement for Inclusion in Printed Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982.)

American Baptist Churches USA

October 14, 1982

Dear Senators:

As American Baptists we are called to "Participate actively in the political, social and economic life in our society seeking to bring to all of life the insights of our Christian faith while recognizing that our wisdom is finite and that free and open discussion in church and society can enable our understanding to grow and change and deepen." (American Baptist Resolution on Citizen Responsibility in the Political Process, Adopted by the General Board, June 1982.)

We wish to bring to the attention of the Sendate Finance Committee our grave concerns about the proposed elimination of the charitable contribution deduction if a flat-rate tax is enacted.

Such a proposal would remove all tax incentives to charitable giving at the same time that Federal Government cut-backs are curtailing or eliminating programs and services to the poor and the elderly thus increasing the demand on religious organizations to provide care.

We will appreciate your careful consideration of this matter.

R C Campbell
Robert C. Campbell, General Secretary
American Baptist Churches, USA

William K. Cober
William K. Cober, Executive Director
Board of National Ministries

C J Jump Jr.
Chester J. Jump, Jr., Executive Director
Board of International Ministries

Grant W. Hanson
Grant W. Hanson, Acting Executive Director
Board of Educational Ministries

STATEMENT BY DANIEL J. PILIERO II, PRESIDENT

AD HOC COMMITTEE
FOR A RESPONSIBLE TAX POLICY

The Flat-Rate Tax Idea Is a Bad One

The Ad Hoc Committee For a Responsible Tax Policy is an organization representing the interests of investors and members of the business community throughout the country. The Committee opposes the flat-rate tax idea in general, and is specifically opposed to the flat-rate tax bills and modified progressive tax bills now pending before Congress.

We support responsible tax reform but we strongly object to the elimination of important deductions including those for medical expenses, home mortgage interest and other investment interest, real estate taxes, charitable contributions, energy exploration incentives and other investment incentives.

We are also concerned that the flat-rate tax proposals may simply be a device to raise the real tax burden on individuals and businesses by taxing unemployment compensation, social security and other transfer payments, employer contributions to employee benefit plans, such as pension and medical plans, gifts and inheritances, even unrealized increases in the value of pensions, life insurance policies, and other assets. Taxing currently untaxed receipts would also mean complicating the already difficult tasks of computing and reporting gross income.

We doubt very much that the American people will support "broadening the tax base" under a new system when they discover that "base-broadening" is merely a euphemism for eliminating important deductions such as those for home mortgage interest, real estate taxes and charitable contributions, and for making social security and unemployment compensation subject to the income tax. Rather than reducing taxes, a flat-rate tax will actually increase the tax liability of individuals and businesses by increasing an individual's taxable income. Even if a taxpayer is subject to lower marginal rates under a flat-rate tax system, he faces a greatly expanded tax base because of the elimination of deductions and exclusions and the taxation of more items of income. The result is that people will pay out more in taxes. Senator Bob Dole, Chairman of the Senate Finance Committee, recently came to this same conclusion, "the loss of major deductions outweighs the promise of a lower rate. When such facts are carefully considered, the flat rate itself may go flat."

In addition to "broadening the tax base," a flat-rate system would impose a single rate of taxation on all individuals and, under some plans, all corporations. Economists, members of Congress, and others have repeatedly concluded that such a single rate tax would increase the overall tax burden on middle-income taxpayers. A reform that produces this kind of result is unfair and inequitable and completely contrary to views of the American public. Furthermore, a single rate of taxation could easily be manipulated to raise taxes in order to produce greater revenues and ward off increasing budget deficits. Consequently, the Ad Hoc Committee opposes the single rate bracket which the flat-rate tax bills propose.

We want to emphasize that the present income tax laws are constantly being improved and are not as unfair as some would suggest. Congress has already acted to increase the equity and efficiency of the current tax system. One major reform recently took place with passage of the Tax Equity and Fiscal Responsibility Act of 1982. A revised minimum tax is now in effect which guarantees that all individuals pay a certain level of taxes. Generally, 20% of all income will be paid as taxes by middle income and wealthy taxpayers after certain very limited exclusions. The wealthy are not allowed to escape their fair share of tax liability. This applies even to those who are risking their capital in areas such as real estate and energy exploration. Such responsible tax reform was and is supported by the Ad Hoc Committee For a Responsible Tax Policy. The flat-rate tax idea, however, is not a fair or responsible proposal.

The Flat-Rate Tax Is an Effort To Eliminate Important Deductions Including Home Mortgage Interest, Medical Expenses, Real Estate Taxes, Charitable Contributions and Energy Exploration Costs. The Ad Hoc Committee Believes This Proposal For Reform Is Wrong.

The flat-rate tax bills propose eliminating deductions for employee business expenses, home mortgage interest and other investment interest, charitable contributions, property taxes, losses, and medical expenses. These deductions are not loopholes but rather benefits that individuals depend upon for their financial stability. These deductions are also incentives for persons to engage in economic and social activity which is productive and helpful and essential to the country's well-being.

In the past, Congress has considered it important to encourage such things as energy exploration, home-building and home-buying, business investment, contributions by employers to employee benefit plans and charitable giving. There is no reason why Congress should not continue to utilize the tax laws to benefit these activities. There is a dire need for bolstering investment, real estate, and energy exploration, especially at the present time. Broadening the tax base by eliminating deductions related to these industries and by taxing additional items of income such as employee fringe benefits would be far more harmful than helpful to the nation's economy and to the financial situation of many individual taxpayers.

Senator Dole recently explained the problems of shifting to a flat-rate tax: "On top of everything else, we must weigh the impact of so major a policy shift on certain sectors of the economy. For example, the housing industry and charitable institutions have a significant interest at stake in the form of tax deductions for mortgage interest and charitable giving. Similarly, any proposal that ended deductions for rapid capital cost recovery could mean far-reaching changes in the composition and level of capital investment. We accelerated those write-offs last year in order to spur growth. And we ought to think long and hard before switching signals again on investment policy. For example, the energy industry, both in terms of exploration and development and use of new conservation methods and alternative sources, could be greatly affected if we jettisoned every tax incentive in present law."

Furthermore, many of the currently available deductions are included in the Code to help people who are faced with the financial burdens of heavy medical and other expenses and losses. To eliminate or reduce the medical expense deduction, casualty loss deduction or interest deduction would do nothing to improve the tax system and instead would work a hardship on many persons, especially low-and middle-income taxpayers. Deductions of these types do not permit tax avoidance, but rather they reflect sound social policy. Senator Dole recently reaffirmed the objectives of the present tax system:

"It upholds the principle of progressivity. It effectively accommodates both the need to raise revenue and the desire to use tax incentives as tools of social and economic policy, from encouraging home ownership with mortgage interest deductions to using tax credits to stimulate industrial research and development."

The Flat-Rate Tax Is an Effort To Tax Previously Untaxed Receipts Such As Unemployment Compensation, Employer Contributions To Employee Benefit Plans and Social Security. The Ad Hoc Committee Opposes These "Base-Broadening" Measures.

Broadening the tax base would mean taxing such items as employer contributions to employee pension plans, health and life insurance, subsidized parking and meals and educational expenses, reimbursement of certain items now treated as business expenses. Furthermore, social security, unemployment compensation, and pensions would be fully subject to the income tax. It is not difficult to perceive that by eliminating deductions and exclusions, and taxing more items of income, the tax base for a particular individual would often significantly exceed his current tax base. The result, once again, is higher taxes. Moreover, many of these items of income are now exempt as a matter of social policy. The American people are opposed to taxing unemployment compensation and social security. A flat-rate tax, however, would tax these items and many others including employee fringe benefits. We believe this is economically and socially unsound.

In addition, broadening the tax base would add complexity to the already complicated tax system. The intricacy of the present internal revenue laws derives not from deduction and exclusion provisions, but from the difficult task of determining what constitutes income. Any "base-broadening" efforts, any attempt to include presently untaxed receipts such as social security or certain employee benefits would further complicate the already difficult job of computing and reporting individual or corporate income. Hence, a simplified tax system would not be attained by by moving to a flat-rate tax structure.

<u>The Flat-Rate Tax Would Impose a Single Rate of Taxation on All Taxpayers and Thereby Increase the Middle Income Taxpayers' Share of the Overall Tax Burden.</u>

The Ad Hoc Committee For a Responsible Tax Policy also objects to the imposition of a single rate of tax on all taxpayers. Economic studies have consistently concluded that a flat-rate tax would increase the overall tax burden on middle income taxpayers. A single rate of taxation would inevitably lower the marginal tax rate for current upper income brackets and raise the marginal rate for middle income taxpayers. In reducing the tax rate for the upper tax brackets a greater portion of the tax burden is shifted to lower income taxpayers. Joseph M. Minarik, Deputy Assistant Director of the Tax Analysis Division of the Congressional Budget Office, stated in clear terms: "A flat-rate tax would inevitably shift more of the tax burden to middle-income families --- and possibly, depending on how it was constructed, to low-income families as well."

Admittedly, many of the proposed bills provide for personal exemptions or specifically exempt very low wage earnings from the income tax. But this does nothing more than create the need to impose a higher tax rate on the remaining taxpayers in order to generate sufficient revenues. The result, once more, is to raise taxes on already-burdened middle income taxpayers.

Moreover, our present progressive income tax structure is based on the "ability to pay" principle. Those having substantially more income than others pay a higher percentage of their income in taxes. Under a pure flat-rate tax, an individual who is the sole wage-earner for a family and earns $15,000 annually would pay the same percentage of his income in taxes as would an individual with $150,000 annual income. This situation is inconsistent with our notions of fairness and justice, especially when one considers that those earnings presently taxed in higher marginal brackets, 40% to 50%, are not needed for the basics of food, clothing and housing. Most economists agree that a dollar's "marginal utility" is higher in the hands of a lower-or middle-class family than in the hands of the wealthy. Second, those who pay the higher marginal tax rates under the present system are, by definition, deriving substantial incomes from the capitalist system. Given that they are prospering under that system, it is certainly fair to require that they pay more to support the system.

Senator Russell B. Long recently stated the following:

"In my view, simplification of the tax system and flat rates are completely separate issues. If it is desirable to close loopholes in order to reduce tax rates that can be done without the massive shift in tax burden involved in a flat-rate tax. I am concerned that some proponents of a flat-rate system are using simplification as a convenient slogan to justify big tax cuts for the rich at the expense of middle- and lower-income taxpayers."

A Single Rate of Tax Could Easily Become a Device For Raising Large Amounts of Revenue By a Simple Manipulation of the Tax Rate.

The Ad Hoc Committee is further concerned that a single tax bracket could easily become a tool for Congress to raise revenues by a simple adjustment of the tax rate. This would subject all taxpayers to potentially large increases in their rate of taxation over a relatively short period of time in order to compensate for budget deficits. A progressive tax structure does not threaten taxpayers in this manner. We recognize the need to generate sufficient revenue, but we believe that a progressive system more equitably distributes the tax burden. Moreover, we are concerned that a single tax bracket could be easily manipulated to excessively raise the tax burden on individuals and businesses. This is yet another reason that the Ad Hoc Committee opposes the flat-rate tax.

Conclusion

Attempting to broaden the tax base and to impose a single rate of taxation on all taxpayers are the two primary hallmarks of the flat-rate tax proposals. For the reasons noted above, for reasons of fairness and economic stability, the Ad Hoc Committee For a Responsible Tax Policy is opposed to the flat-rate tax idea. We object to the concept as a general framework for reforming the tax laws and we specifically oppose the various flat-rate tax and modified progressive rate tax bills that have been introduced to Congress. Our position represents the views of the investment and business communities throught the Country, and the American people overall. We, therefore, urge members of Congress and private groups and individuals to join us in opposing the flat-rate tax.

American Hospital Association

AHA

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STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
TO THE SENATE COMMITTEE ON FINANCE
ON
FLAT-TAX RATE PROPOSALS

October 14, 1982

The American Hospital Association, which represents over 6,300 hospitals and other health care institutions, as well as more than 35,000 personal members, is pleased to have the opportunity to comment on the concept of a flat-tax rate system.

Although the flat-tax rate concept has immediate and strong political appeal to some because of its simplicity, we have very serious concerns regarding its potential impact on the ability of hospitals to continue providing high quality health care services.

We have two principal concerns: first, the impact that these proposals would have on the treatment of tax deductable charitable contributions, which are a major source of support, and second, how these proposals would affect the treatment of tax-exempt bonds which are used by non-profit hospitals as a major tool in financing capital projects and major equipment purchases.

Need and Use of Charitable Contributions

During the early history of health and hospital care in this country, private contributions comprised a substantial proportion of funds for building and operating hospitals. While other sources, including government, now provide a greater share of funds for these activities, non-profit hospitals and health care institutions, which represent the largest portion of our health care resources, continue to rely on charitable contributions for a variety of purposes.

These funds are used for replacement of obsolete facilities and equipment; support for health research and education programs; assistance in maintaining and improving community health care through assuming such responsibilities as subsidization of care for indigent patients; and helping to finance experimental and innovative approaches to the delivery of health care.

In 1980, the hospital and health care field received a total of $6.49 billion in charitable contributions. The American Association of Fundraising Counsel estimates that this represents 13.6 percent of all philanthropy during that year provided by individuals in the United States. For many years, the health and hospitals category of philanthropy ranked as the second largest recipient of charitable dollars behind religious organizations. However, between 1978 and 1980 the field of education overtook health and hospitals in the number two spot.

Clearly, the activities supported by charitable contributions are merited and in the public interest. Moreover, during times of reductions in governmental support, these funds diminish the financial burden on all levels of government. In addition, private philanthropy reflects and fosters a highly desirable attitude by individuals toward the needs of their communities. The encouragement of private giving is also consistent with the policy of the Reagan Administration to rely on increased charitable giving by individuals and corporations to help finance social, educational and health programs, particularly those that have suffered substantial reductions in federal support.

Tax Policy Implications

Perhaps the most important federal policy affecting charitable giving is the deduction allowed for charitable contributions in the individual income tax. This policy has provided an incentive for voluntary giving and has served society well. It has also been an effective mechanism for promoting other social goals whether they be in the area of improved health and hospital care or support for education, the arts or the humanities. According to Martin Feldstein, a former Harvard University economist who now serves as Chairman of the President's Council on Economic Advisors, tax subsidies for charitable giving is generally a more efficient method of achieving a desired purpose than a direct government expenditure.[1/]

However, charitable giving has not kept pace with our economic growth, in part because of other federal tax policies. In fact, according to a study published by the Urban Institute, private contributions to churches, universities, hospitals, service organizations and other non-profit charitable institutions will decline over the next four years by $18.3 billion in current dollar terms, and $9.9 billion in constant dollar terms, below what they would have been under prior law as a result of the recently enacted Economic Recovery Act of 1981. These reductions in private contributions will exacerbate the revenue losses non-profit organizations are already expected to experience as a result of declining government support.[2/] As a result of the Tax Equity and Fiscal Responsibility Act of 1982 which was enacted this past summer, hospitals will be forced to absorb cuts in Medicare and Medicaid of $13 billion over the next three years.

While the Economic Recovery Act of 1981 contains several key features that will discourage charitable giving in large amounts this same law also included two other provisions that are likely to encourage giving. However, these provisions such as making charitable deductions available to non-itemizers, and increasing the minimum allowable corporate contribution aren't likely to make up the losses resulting from the other major changes enacted in the 1981 measure.

Flat-Tax Rate Proposals

There have been several bills introduced during the Second Session of the 97th Congress that would implement a flat-tax rate system. Some of these proposals would eliminate deductions for charitable giving while others would not.

The American Hospital Association is strongly opposed to any flat-tax rate proposal that would either eliminate the deduction for charitable contributions or substantially discourage charitable giving.

Charitable contributions are a very important and much needed source of income for the health and hospitals field as well as other important areas that are in the public interest. The charitable deduction that currently exists is in the public interest and is an important element of national social policy.

Impact on Tax-Exempt Bonds

The other major concern to AHA regarding the flat-tax rate concept is the impact that such a system would have on the ability of private, non-profit hospitals to continue their use of tax-exempt bonds.

Tax exempt financing is vitally important to minimizing the cost of hospital capital projects. In the recent past, the interest rate for tax-exempt bonds is about 3 percentage points lower than comparable taxable obligations. During part of 1981, there was as much as a 30 percent differential between interest rates for tax-exempt and taxable bonds.

There has been a great deal of misinformation regarding the growing use of tax-exempt financing by hospitals with many arguing that this has contributed to a growth in capital expenditures. However, this simply is not true and hospitals have only turned to tax-exempt bonds to replace other sources of financing which have been reduced, such as government programs and philanthropy.

In a recent study entitled the "Future Capital Needs of Community Hospitals," by Harold Ting and John Valiante, they stated that "the ability of community hospitals to meet their plant and equipment investment needs during the 1980's --an amount estimated to total more than $160 billion or about three times the investments made during the 1970's--is emerging as a issue of central concern to the industry and some government officials. At the same time that capital needs of community hospitals are growing, these institutions are facing a potentially sharp relative decline in the necessary funds to finance these investments, creating the possibility of a capital shortage." The study also states that "community hospitals with large Medicare and Medicaid populations will be unable to generate the operating cash flow required to maintain plant and equipment."3/

As a matter of social policy, here again, the use of tax-exempt bonds for hospital construction plays an important role. If this source of financing were not available then Medicare, Medicaid and other payers would be forced to absorb these capital costs because of the crucial need of allocating resources to capital projects in order to maintain our nation's hospital infrastructure in a rapidly changing technological and medical environment.

In summary, the AHA has serious concerns in regard to the concept of a flat-tax rate system and appreciates the opportunity to share them with you.

FOOTNOTES

1/ Martin Feldstein, "A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving," The Economics of Taxation (Washington, D.C.: The Brookings Instituion , 1980), pg. 102.

2/ Charles T. Clotfelter and Lester M. Salamon, "The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving, A Study for Independent Sector," (Washington, D.C.: The Urban Institute, 1981), pgs. ii-iii.

3/ Harold M. Ting and John D. Valiante, "The Future Capital Needs of Community Hospitals," Health Affairs (Millwood, Virginia: Project Hope, Summer 1982), pgs. 14-15.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

FEDERAL TAX DIVISION

COMMENTS ON THE FLAT-RATE INCOME TAX SYSTEM

The Federal Tax Division of the American Institute of Certified Public Accountants is the senior technical body of the Institute authorized to speak for the AICPA on matters involving federal income taxation. There are over 180,000 CPAs who are members of the AICPA and many of them devote a high percentage of their efforts to the federal taxation area.

General

The Chairman is to be commended for holding hearings to consider proposals to move to a flat-rate or other simplified system of taxation. The terms "flat rate," and "flat tax," and "simplified tax" connote elements of simplicity and perceived fairness, which have encouraged numerous individuals and groups to provide vigorous support for such a change in our form of income taxation.

Although we support the desirability of hearings to consider these proposals, we are not, at this time, prepared to either support or oppose one or more of such proposals. Rather, we believe that the matter deserves substantially more research and analysis to determine whether such a basic change in our system of taxation will serve our fiscal needs, while at the same time improving the essential elements of any desirable tax system. In other words, an overhaul of the existing system must proceed cautiously to ensure that it may provide simplicity, fairness and efficiency in operation. Also relevant is the fact that the tax system has been used effectively in the past to promote specific economic or social goals: presumably, this function would continue in any modified system. Major proposed changes from the present system should be analyzed as to their impact on these goals, particularly on saving and investment.

For these reasons, we urge that you proceed slowly and carefully in this effort. As a responsible professional organization, we plan to participate actively and objectively in that research and analysis. To do so, we have appointed a task force to study this area and anticipate that it will provide a well-reasoned analysis and recommendations which will be provided to you and your staff within the next six months.

Comments below relate to some of the more specific preliminary thoughts the Federal Tax Division has had on this matter.

Simplification

There can be no question of the need for simplification in our tax laws. Tales of professional tax advisers having difficulty completing their own individual income tax returns are commonplace. The thickness of the Internal Revenue Code and regulations volumes expands at what seems to be an exponential rate of growth.

A flat-tax system could create a very substantial simplification of the tax laws after the necessary transition period. However, we do not believe that the only way to achieve simplification is to adopt a new tax system. Simplification could also be gained through a concerted effort to identify and reduce complexities in the current tax system. Although simplification is a very desirable goal for any tax system, before embarking on a completely new system to achieve that goal, we should have concluded that alternative means are either not available or are not politically feasible. Such a comprehensive evaluation has thus far not been attempted.

Change itself is complicating. We have seen the effects of proliferating change in all facets of life, and income taxation is certainly no exception.

The consequences of changing the tax laws year after year - with compounding results - must be considered. Continued change increases the uncertainty and hence the riskiness of business investment at a time when increased saving and investment is needed.

National Commission on Tax Simplification

We have no doubt that improvement in the area of simplification is an achievable goal within the context of our present tax system. But it will take the clear resolve of the Congress, the Administration and knowledgeable professional groups to do so. For this reason, we urge the formation of a National Commission on Tax Simplification which should explore issues in addition to the flat-rate tax, including:

- a new Internal Revenue Code
- the use of the tax system for social and economic incentive purposes and the impact on simplification
- the procedures for drafting and adopting tax legislation and their impact on simplicity.

The AICPA Federal Tax Division would be pleased to participate in such an effort.

Equity or Fairness of the System

The question of fairness of any tax system is essentially a political issue. Some would argue that a single flat rate of taxation on a comprehensive base is the fairest method of taxation. Others would argue that ability to pay is critical to fairness, and that the rate system therefore must be progressive, in a manner similar to our present system. If a single flat-rate system were adopted, the primary beneficiaries in terms of rate reduction would likely be those who pay at the currently high marginal rates of up to 50% of taxable income. To achieve the same level of funding of government spending, presumably the middle and lower level income individuals would have to pay at an increased percentage rate under a flat-rate system as compared with the present system.

On the other hand, if multi-level rates were adopted under a new system, it might eliminate some of the perceived advantage of simplification. Moreover, simplification of the rate structure could be achieved by decreasing the number of rate brackets without altering the overall revenue to be derived under our present income tax system.

Transition Period Problems

If a flat-tax structure were adopted, we believe a lengthy transition period would have to be provided to shift from the old to the new system. Changing the tax rules abruptly by eliminating current tax benefits from investments held by millions of taxpayers in reliance upon existing tax laws, would be grossly inequitable.

For example, deductions for home mortgage interest and property taxes affect a great number of taxpayers. Eliminating these tax deductions would lower the value of homes significantly. A transition measure would be needed to protect those currently owning homes. The length of the transition measure would have to be very long, perhaps 10 to 15 years.

Equity demands that appropriate transition measures be included for all taxpayer groups with investments made in reliance on current law. In each case it would be necessary to make the difficult decision concerning a proper cutoff point in the future, beyond which the tax benefits provided by current law would not be available.

Economic Readjustment

Related to the need for a lengthy transition period is the severe economic readjustment we could expect if a flat-tax system were adopted. Market prices that are based to a significant degree on tax treatment would vary widely depending on the changes relative to each item in question. This economic readjustment might or might not be beneficial in the long run, but it would certainly be unpredictable.

A flat-tax system, with a low top marginal rate, would go a long way toward eliminating tax shelter investments, particularly those based heavily on tax benefits. This would appear desirable from the standpoint of encouraging investment activities based more on economic rather than tax criteria. On the other hand, some of the largest categories of tax shelter investment now available - e.g., real estate and oil and gas, - were given special tax benefits to encourage that very type of economic activity. Most of the flat-tax systems, as proposed, would not allow for this targeting of tax benefits to achieve economic goals.

This committee, and its counterpart in the House, have often used the tax laws -- and we believe appropriately so -- to encourage or to discourage certain economic activity by businesses and individuals. While the tax laws are replete with illustrations of such provisions, clear examples would include tax-favored treatment of employer sponsored medical reimbursement plans, retirement savings (IRAs, Keoghs, corporate qualified plans, etc.), charitable deductions and targeted job tax credits. Your consideration of a flat-tax system, therefore, should also take into account the impact of such a system on the ability of the Congress to make desirable tax changes in the future to encourage or discourage specific economic activity.

Industries and Groups Affected

Economic readjustment would likely be hardest for those industries and groups now receiving significant tax benefits in one form or another. Some of the groups and industries included in this category are real estate; oil, gas and mining; state and municipal bonds (both general purpose and industrial development); social security recipients; and investors in securities.

Theoretical economic arguments can be made that this type of readjustment will be healthy and will cause less distortion from tax effects in making economic decisions. While this may well be true, we must not overlook the tangible and real cost, effort, and pain that the dislocated segments of our economy will have to endure in making such changes. Careful and thorough attention to necessary transition mechanisms for each of these segments are necessary before radical change should be attempted.

Flat-Tax Benefits

If the extremely difficult transition problems could be adequately dealt with, a low rate system with a broadened tax base has a number of benefits. As we mentioned before, the tax structure could be simplified and its appearance of fairness improved. An increased level of taxpayer compliance might also be achieved.

A low marginal tax rate on investment income should cause considerable expansion in saving and investment. The low marginal rate should also cause increased productivity as it becomes more profitable to earn additional income.

Conclusion

We strongly urge that you endorse the establishment of a national commission on tax simplification to address ways and means of improving our tax system on a systematic basis.

Changing to a flat-tax system would involve major, prolonged economic readjustments. A valuable fiscal tool of government, the targeting of tax benefits, would be weakened. Before making such a change, the very difficult transition problems must be dealt with in a way that protects investments made by taxpayers relying on the current tax system.

We are not ready to endorse or oppose a flat-tax system. However, we believe that the transitional problems, economic readjustments, and other question areas should be given long and careful study before such a fundamental change is made.

Flat-Rate Income Taxation

C. Lowell Harriss, Executive Director, Academy of Political Science; Professor Emeritus of Economics, Columbia University; Economic Consultant, Tax Foundation, Inc.; Associate, Lincoln Institute of Land Policy. Presented to the Committee on Finance, U. S. Senate, October 1982. Views expressed are the author's and not necessarily those of any organization with which he is associated.

High marginal rates of taxation influence behavior and have non-revenue effects. Some of the results may be welcome (more charitable donations), but many must create distortions and impose costs ("excess burdens") which by reasonable standards are undesirable. Differences in tax rates also produce non-revenue effects by providing incentives to alter behavior.

Proposals to reduce drastically the level of rates and even to substitute a two-rate--zero and one other--schedule for one of many steps have received serious and informed attention. "Failure" to date by no means indicates that such suggestions are now futile. Or that on balance the defects outweigh the merits.Yet, as your recent HEARINGS have shown, fundamentally difficult problems of principle and of implementation exist. They are by no means insuperable if the goal is to improve on the present system as distinguished from achieving some ideal.

<u>Rate Uniformity or Simplification</u>

Differences among individuals and families in sharing the costs of government are inevitable--in any single year or over lifetimes. Regressivity, proportionality, and progressivity (relative to income, wealth, or consumption) can lead to differences (large, medium, or small) whereby those with the larger amount pay more toward the common, collective expenses of government. Most of us, I expect, have been brought up with the notion that progressivity is better than proportionality or regressivity. The bases for such a conclusion are "more uneasy" than often assumed. Intuitively, my own preference is for some progressivity; but I submit that the bases for such a conclusion do seem less solid than unsophisticated, popular statements suggest.

A flat-rate, more correctly a dual-rate (zero and one other), tax can provide appreciable progressivity for very large numbers of taxpayers. In fact, with a rather large exemption and zero-rate bracket most Americans can experience considerable progressivity. The minority, tiny or small, in the higher ranges would in fact bear proportional rather than progressive burdens. Their total tax would be reduced under any conceivable shift to a flat-rate system. Such a change, even if put into effect over a period of, say, five years would make me uneasy.

Yet the present system also makes me uneasy. Federal plus state rates of over 50 percent at the margin deserve criticism. Significant reduction, however, does not require a shift to a single rate.

Any consideration of progressivity and related matters should take explicit note of recent changes which seem to receive little attention. Federal estate and gift taxation has been altered so that most families once potentially subject will in the future bear no such tax. Many states are reducing, even eliminating, such taxes on the transfer of wealth. Expensive government--and all must agree that American government is indeed expensive--may "need" more financing from the prosperous than would eventuate. Complex will arise. Should we not do our best to consider them thoroughly and early and as realistically as possible? For example, with a modest rate of income tax there could be no small number of families a few years hence living very well indeed on inherited wealth as distinguished from their own industry and thrift. Desirable?

Broadening the Tax Base

Half a century ago, almost, I began to study Federal taxation. Broadening the base was even then proposed. Two distinguishable benefits are expected. (1) Enlarging the base would facilitate rate reduction and the advantages that would follow. (2) The measure (base) for sharing the costs of government could be improved. Note that I use the word "could," not "would," because improvement is not inherently a product of base-broadening.

Some present omissions seem to me inappropriate--most of Social Security benefits and the imputable income from owner-occupancy of housing, for example. Others ~~probably~~ necessary or desirable for obtaining in an appropriate measure of the base for sharing the cost of national are government--interest associated with obtaining income and state-local taxes, for example. And so on.

Each deserves attention on its own merits. Historical experience includes more of narrowing than broadening the concept of taxable income. If new discussions were to include explicitly broad rate reduction as a result of base-broadening, just conceivably some general public support might develop.

Concluding Comment

Dozens of distinguishable and important issues arise in the examination of "flat-rate" taxation. You and your successors will have available an accumulation of evidence and analysis, including fine work from your own staff. Progress is possible.

BEDROS ODIAN
Attorney-at-Law
400 Chemical Bank Building
Buffalo, New York 14202
(716) 856-2865

September 1, 1982

Robert E. Lighthizer, Esquire
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510.

Re: Hearing on flat-rate income tax and on alternative suggestions such as a tax on a consumption base, etc., September 27, 28, 29, 1982.

Dear Mr. Lighthizer:

Enclosed are five sets of my letters to the Buffalo Evening News and the Buffalo Courier-Express, advocating the value-added tax [VAT] to replace all present forms of federal taxes.

Would you insert this letter and the enclosures in the printed record of the hearing.

Thank You.

Yours respectfully,
Bedros Odian

ENCLOSURES:

EVERYBODY'S COLUMN

VAT Should Replace Other Taxes

The value-added tax should replace all existing federal taxes: income tax, estate and gift tax, and excise tax. Let me dispel some myths about VAT.

It is said that it is "regressive," that it hurts the poor. The present "progressive" income tax system is hardly beneficial for the poor. All taxes are ultimately paid by the consumer through the price structure.

Some members of Congress and the tax-related professions would have us believe that a VAT system would be too difficult to administer. The present system — with its depreciation schedules, tax shelters, deductions, etc. — is hardly a model of simplicity. Another factor is the ever-growing underground economy. Compliance is a failure. The simplicity of VAT will facilitate administration and compliance.

VAT is economically neutral — it is neither inflationary nor deflationary. It permeates the entire economy. No one escapes the tax. It is self-checking. Each taxpayer collects VAT on his sales or services, takes a credit for VAT payments to suppliers and gives the net VAT to the government.

In the field of international trade, VAT will place us on an equal footing with our trading partners. Currently, our industry is at a disadvantage because VAT is rebated on exports and assessed on imports. Income taxes are not amenable to such treatment.

BEDROS ODIAN

The News welcomes letters. Write to Everybody's Column, Buffalo Evening News, One News Plaza, P.O. Box 100, Buffalo, N.Y. 14240. Letters must include signature, address and a phone number for verification. Letters should be brief and are subject to editing and condensation. Because of space limitations, we cannot publish all letters received.

BUFFALO EVENING NEWS

AUGUST 20, 1982.

Value Added Tax Only True Reform

Buffalo Courier-Express

AUG. 24, 1982.

Editor: The value-added tax should replace all existing federal taxes: income, estate and gift, and excise.

Let me dispel some myths about VAT. It is said that it is "regressive," that it hurts the poor. The present "progressive" income tax system is hardly beneficial to the poor. All taxes are ultimately paid by the consumer through the price structure.

Some members of Congress and the tax-related professions would have us believe that a VAT system would be too difficult to administer. The present system — with its depreciation schedules, tax shelters, deductions, etc. — is hardly a model of simplicity. Another factor is the ever-growing underground economy. Compliance is a failure. The very simplicity of VAT will facilitate administration and compliance.

It is economically neutral — neither inflationary nor deflationary.

VAT permeates the entire economy. No one escapes the tax. It is self-checking. Each taxpayer collects VAT on his sales or services, takes a credit for VAT payments to suppliers and gives the net VAT to the government.

Yes, I would exempt food purchased in a food store, medical services and prescription drugs.

In the field of international trade, VAT will place us on an equal footing with our trading partners. Presently, our industry is at a disadvantage because VAT is rebated on exports and assessed on imports. Income taxes are not amenable to such treatment.

Congress is finally listening to the voices of real tax reform. Now is the time to eliminate all present forms of federal taxes and to install the VAT in one stroke, without complicated phase-ins.

Bedros Odian

Amherst

CALIFORNIA STATE UNIVERSITY, HAYWARD

HAYWARD, CALIFORNIA 94542

SCHOOL OF BUSINESS AND ECONOMICS
Department of Accounting
Telephone (415) 881-3316

September 27, 1982

Senator Robert Dole
House Ways and Means
1100 Longworth Building
Washington, D.C. 20515

Dear Senator Dole:

I have enclosed copies of correspondence which I hope you will find helpful in connection with your hearings on the flat tax.

I am an advocate of the flat tax. We must do it or lose the war with the underground economy. A system of exemptions, exclusions, adjustments, deductions, and credits does nothing but foster special interest legislation to make one exception after another. The climate is right. If we miss this opportunity, we will live to regret it. I have previously sent a copy of more extensive testimony presented before House Ways and Means which demonstrates the impossibly complex and unworkable nature of the system.

I would welcome the opportunity to testify more fully or respond more pointedly to issues or questions you may have.

Thank you very much.

Sincerely,

Philip P. Storrer
Philip P. Storrer
Professor

PPS/gr
Enc.

9/16/82

Dear Prof. Stover,

I heard you on radio discussing Income Tax. It was most interesting and I wondered if I could bother you with a series of the things that are worrying to me.

1st - The amount of personal exemption
2nd - The zero-bracket.

The personal exemptions do not keep pace with inflation.

Compare them with the poverty level. A recent report I read said the official 1981 poverty level for elderly singles was $4360

The zero bracket of $2300 is an injustice to all of those on modest incomes, whose itemized deductions on Schedule A do not total the $2300.

My sister-in-law spends $2000 in medical expense and $250.00 in contributions — but does not get credit for these items. Her income for the year was 7200.

I am a veteran of World War I. no pension. I retired in 1962 on a fixed pension of $3000 a year.

The life savings of my wife (she passed away 10 years ago) and myself bring in about $3500

Am wondering what will happen with the new flat rate tax.

Would appreciate hearing what you have to say about this and thank you for your patience trying to read it.

J.M. FARLEY
2935 LAKE DR.
CONCORD, CALIF.
94518

CALIFORNIA STATE UNIVERSITY, HAYWARD

HAYWARD, CALIFORNIA 94542

SCHOOL OF BUSINESS AND ECONOMICS
Department of Accounting
Telephone 415/881-3311

September 27, 1982

Mr. J.M. Farley
2935 Lane Drive
Concord, CA 94518

Dear Mr. Farley:

Thank you very much for your recent letter. I share your deep concern regarding the effect of a flat tax on your financial health. My personal feeling is that the first $10,000 to $12,000 of income should be tax free and that the flat rate of 18% to 20% be phased in ratably as income rises from $10,000 to $12,000.

Please take time to share your concerns with members of Congress, most notably:

Representative Fortney (Pete) Stark
Chairman Select Subcommittee
House Ways and Means
1100 Longworth Building
Washington, D.C. 20515

Senator Robert Dole
House Ways and Means
1100 Longworth Building
Washington, D.C. 20515

Both men are holding hearings this month on the flat tax as an alternative. I have taken the liberty of sharing your letter with them.

Thank you very much for your concern and call me the next time I'm on the Owen Spann Show. We will talk more then.

Sincerely,

Philip P. Storrer

Philip P. Storrer
Professor

PPS/gr

STATEMENT
on
FLAT-RATE TAXES
for submission to the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Kenneth D. Simonson*
October 14, 1982

The 250,000 members of the U.S. Chamber of Commerce are extremely interested in improving the tax system. Taxes pose a severe and growing financial and paperwork burden for both our corporate and our individual members. Any proposal which would significantly lessen either of these burdens deserves careful consideration. Most proposals for "flat-rate" taxes or other tax alternatives promise to do both. But no bill introduced so far is likely to deliver as much relief as its sponsors suggest. In addition, there are drawbacks as well as advantages to each proposal.

The Chamber, while endorsing simplification and reduction in marginal rates, does not have a position for or against flat tax proposals now before this Committee. But we wish to draw attention to several issues that Congress should weigh carefully before revolutionizing the tax code. Moreover, frequent and drastic revisions of the tax law, such as have occurred in the last several years, chill investment by increasing uncertainty and adding to the cost of doing business. Consequently, many taxpayers would prefer a moratorium on tax changes over any further restructuring.

Simplification

One of the most seductive arguments for a flat tax is that it would vastly simplify the tax system. A true flat tax would tax all income once at a single rate with no exclusions, deductions, or credits. But such a system may not be as simple or as desirable as it sounds. Translating the principle into legislative language leads immediately to considerable complexity. Decisions must be made as to whether fringe benefits and other noncash

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*Senior Tax Economist, Tax Policy Center, Chamber of Commerce of the United States

payments are income and if so how to value them. Should capital gains be treated as income? If so, what is the proper time to tax them--as accrued or upon realization? Should the cost of capital assets be deductible immediately or over the useful life of the asset?

Dozens of equally troublesome questions arise in the construction of any tax system. These problems cannot necessarily be simplified merely by adopting a broad base and a single rate. Furthermore, a flat tax that expands the definition of income to include items not received in cash or eliminates legitimate business deductions may introduce more distortions, unfairness, and taxpayer resentment than it removes.

On the other hand, there are ways in which a flat tax can improve both simplicity and some taxpayers' perceptions of the fairness of the tax system. Income averaging becomes unnecessary, because receiving a large increment of income in a particular year does not push the taxpayer into a higher bracket. For the same reason, indexing, income splitting, separate schedules for different household situations, and "marriage penalty" relief can be eliminated. Taxpayers will no longer suffer "bracket creep" from inflation (although inflation may still cause problems with the tax treatment of capital). Wage withholding can be simplified and made more precise, since taxpayers can more easily calculate taxable income and tax liability when there are no deductions and only one bracket. However, these forms of simplification are sacrificed as soon as one moves away from a pure, single-rate tax without deductions or exemptions.

Incentives

Much of the complexity in the tax system arises from efforts to use the tax system to achieve social or economic objectives, such as encouraging home ownership, energy conservation, charitable contributions, and, of course, income redistribution. Before revolutionizing the tax system, Congress should consider carefully whether these goals are still appropriate for federal policy and whether the tax system should be used to advance them. If the answer to both questions is yes, then a switch to flat-rate taxation may not be desirable.

On the other hand, the combination of a broader base and lower rates could lessen the penalty against saving and encourage other worthwhile goals that the tax system now hinders. The tax system is currently heavily biased against saving, and contains very unequal treatment of different forms of saving. Corporate shareowners pay corporate income tax plus tax at the individual level on dividends. They are taxed again if they receive capital gain when they sell the stock. Investors in municipal bonds and "all-savers certificates" are at the other extreme: they pay no federal income tax. In between are savings bonds and individual retirement accounts, which accumulate tax-free but are taxed upon distribution. Such differential treatment not only adds great complexity to the tax code, it creates major distortions in the allocation of capital.

Thus, a simplified income tax could do much to improve neutrality and efficiency in the allocation of capital. A consumption tax, which exempts either investments or the income from them, would do even more. But a "reform" which treats all capital gains, interest and dividends as income while maintaining graduated rates would make the tax system still more discriminatory against saving.

Corporate Taxation

The economy would benefit if businesses did not have to consider tax reasons in deciding whether to incorporate. Taxing income one time, at either the corporate or the individual level (as opposed to taxing individuals at one rate), would greatly reduce existing distortions affecting investment. But achieving integration of corporate and individual taxation is not a straightforward task and may not make the tax system appreciably simpler.

Partial relief from double taxation can be granted by enlarging the $100 dividend exclusion. Congress should not adopt a flat tax plan which eliminates this exclusion unless it provides other relief from double taxation of corporate income.

Restructuring corporate taxes presents many of the same difficulties as with personal taxes. How should income be defined and measured? Should credits and other incentives which were enacted to serve social goals be abandoned for the sake of simplicity? Should graduated rates be replaced by a single rate, given that a revenue-neutral rate would have to be set much higher than the reduced rates now paid by the vast majority of small companies? We look forward to helping the Committee work on these problems, but there will be losers and gainers from any change in corporate taxation as well as individual.

<u>Tax rates and tax revenues</u>

Most flat tax proposals are advertised as being revenue-neutral, that is, they would initially raise the same amount of revenue as the present income tax. But some proponents contend that most taxpayers would pay less than at present, while some (sometimes the same speakers) say they would raise additional revenue and help reduce the deficit.

These claims appear contradictory, yet there may be a grain of truth to them. With a high enough exemption level, it is possible to reduce taxes for a majority of taxpayers. But this implies that those people remaining in the system will pay much more than before. At the same time, reducing the top rates can lead to more investment, to a switch from less-productive, tax-motivated investments to ones chosen on economic grounds, and to more reporting of income. All of these changes can produce more revenues with a lower rate.

However, we urge the Committee to be suspicious of these claims. In general, the lower the single rate is, the more taxpayers and the broader the income base that must be included. If a high exemption level is chosen, a relatively high flat rate must be imposed on remaining taxpayers. That reduces the incentive to earn enough (or report enough) to move from nontaxable to taxable status, and it lessens the incentives for investing.

Finally, if a rate, base, and exemption level are chosen which do not bring in as much revenue as under current law, many business people fear that the difference will be made up through higher taxes on business. Likewise, there is fear that a flat rate would be too easy to raise any time Congress feels the need for higher revenues.

<u>Income distribution</u>

Despite the claims of some flat-tax proponents that they would make the rich pay more, the reality is that the federal income tax system <u>is</u> progressive. Therefore, substituting a flat rate for the current graduated rates would <u>lower</u> taxes for high-income taxpayers on average and raise taxes for lower- or middle-income taxpayers. Raising the basic exemption level would help out taxpayers at the bottom, but necessarily increases the burden on the middle still further.

Broadening the base significantly is likely to mean higher taxes on the middle class, too, since many of the largest personal deductions or untaxed income sources are used predominantly by middle-income individuals, including deductions for property taxes, mortgage and consumer interest, and tax-free social security benefits. In 1981, taxpayers with income between $15,000 and $50,000 filed 75 percent of the returns which claimed itemized deductions, even though their income class accounted for only 43 percent of all returns. Thus, eliminating these deductions would mean higher taxes for many people in the middle.

The so-called "fair tax" introduced by Sen. Bill Bradley (D-N.J.) and Rep. Richard Gephardt (D-Mo.) attempts to maintain the current income distribution. But to do so, this bill abandons both the single rate (it has four, ranging from 14 to 28 percent) and the no-deduction concept (property taxes, mortgage interest, and charitable contributions remain deductible). In addition, it penalizes saving by making capital gains taxable as income and taxing pensions as they accumulate.

Taxpaying population

There is a good case to be made for requiring all households to pay some tax. Such an approach enables use of a lower tax rate than with a smaller number of taxpayers, and it makes individuals more aware of the high cost of government than if someone else is paying the bill. Eliminating personal exemptions and the zero bracket amount also allows some simplification of the tax return. Finally, when everyone owes tax, some people may be less inclined to cheat on the grounds that "Other people don't have to pay, so why should I?"

However, the combination of a zero exemption level, a broad base and a single rate eliminate all progressivity from the income tax. Some bills maintain progressivity by raising the exemption level. For instance, Sen. Dan Quayle's (R-Ind.) bill would tax only individuals with incomes over $17,500, more than five times the current cutoff. This approach leaves low-to-middle income taxpayers with a low effective rate. But by dropping tens of millions of taxpayers out of the system, it may increase resentment on the part of those who are left in, and it results in a higher marginal rate for the first dollar of taxable income (18 percent in Sen. Quayle's bill).

The current law uses a very bad approach to increasing the number of taxpayers: the alternative minimum tax. This tax will be paid by only a few hundred thousand taxpayers, but it requires them and many others who will not owe the tax to make an extremely complex calculation of their "alternative minimum taxable income" in addition to their regular tax computation. Many of those who wind up paying the alternative tax would pay some regular tax anyway, so this tax will add much complexity at a gain of little revenue and little base-broadening. It should be promptly repealed.

Transition problems

Switching from the current system to a substantially different one is likely to entail severe transition problems. The one which has received the most publicity is the effect on homeowners if their deductions for property tax and mortgage interest are terminated. Many of them would no longer be able to afford their homes. At the same time, the potential pool of buyers would be sharply curtailed. Similar problems would affect all capital assets and all purchases and investments financed with borrowing.

Many transition problems may not be apparent immediately. Therefore, before implementing a wholesale change in the tax system, Congress should allow adequate time for discussion and for familiarization by taxpayers.

Conclusion

The U.S. Chamber welcomes public discussion of tax alternatives, and hopes that Congress can achieve significant improvement in simplicity, fairness, and removal of bias against productive economic activity. But Congress should recognize that no flat tax or other new system is a panacea. There will be losers as well as winners from any tax change, and it is important to decide whether the change is worth making in light of the costs it would impose. In fact, many taxpayers would prefer a moratorium on new tax laws to any change, minor or major.

WRITTEN STATEMENT OF GENERAL BOARD OF THE CHURCH OF THE NAZARENE FOR INCLUSION IN PRINTED RECORD OF SENATE FINANCE COMMITTEE HEARINGS ON FLAT-RATE TAX PROPOSALS (SEPTEMBER 27-29, 1982)

The Church of the Nazarene is an international denomination with approximately 550 missionaries and 10,498 ministers in the United States. The United States constituency is represented by 4,888 congregations with a membership of 492,203 and Sunday School enrollment totalling 819,941 in 74 Districts. The Church of the Nazarene operates 8 liberal arts colleges, one Bible college, and one Seminary in the United States (see attached list).

We have followed with great interest the recent discussion regarding a flat-rate tax. Although we recognize that there are several variations of a flat-rate tax system being considered, each with varying degrees of impact, we would support the concept of a simplified system of taxation and would favor any move in this direction.

Of concern to us, however, are the provisions of current tax law designed to encourage charitable giving. Although individuals make charitable gifts because they are philanthropic and wish to benefit society, they oftentimes give more than they would otherwise be able due to the favorable tax treatment they receive. This is an important benefit given to charitable organizations in a psychological as well as a material sense. That the government supports and encourages charitable giving in a tangible way is an impacting factor not to be taken lightly. This would seem to be of significant importance in view of reduced government spending and greater reliance on charitable organizations.

Therefore, we are opposed to any proposal that would no longer encourage charitable giving. This is not to say that the current charitable deduction could not be simplified or replaced with another means of encouraging gifts to charity. Any change in this area would need to be compatible to the new system.

Our suggestion would be a tax credit equal to 50% of the amount of charitable gifts. The benefit of such a credit would be two-fold. It would be simple. It would encourage charitable giving of all income levels equally. A criticism of the current charitable deduction is the added benefit derived by those in higher tax brackets. These givers are the ones with the resources to make substantial gifts, however, and should not be discouraged. Those in lower tax brackets should receive the same encouragement. A 50% tax credit would not discourage givers in high tax brackets and would also give equal benefits to those in lower brackets.

Thank you for the opportunity of expressing our views on this subject. We are grateful for the representative government that God has given us and for the religious freedoms so carefully protected by our Constitution and our government.

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September 28, 1982

Mr. Robert E. Lighthizer, Chief Counsel
Committee on Finance, Rm. 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lighthizer:

On behalf of the students and faculty of Concordia College, Bronxville, New York I offer the following:

"Written Statement for Inclusion in Printed Record of Senate Finance Committee Hearings on Flat-rate Tax Proposal (Sept. 27-29, 1982)"

I am not opposed to a flat-rate tax or simplified tax system. However, if a flat-rate tax or simplified tax system or a combination of the two is enacted, a credit should be allowed for charitable gifts. The tax incentives then would not be dependent on a taxpayer's bracket. If Congress would be unwilling to allow a 50% credit for all taxpayers, a progressive credit -- based on a taxpayer's adjusted gross - could be allowed. A ceiling could be placed on the credit to assure that taxpayers do not entirely avoid paying taxes by making charitable gifts. The present five-year carryover rate should continue to apply.

Concordia College, Bronxville, New York is, like other small independent liberal arts colleges, dependent upon gifts from donors to meet current operating and capitol expenses. Tax incentives for donors to continue this support should not be removed, especially in lighft of President Reagan's call for greater support from the private sector to take up the work the federal government has undertaken in the past. We must be able to assure students that money will be available from private sources of support for financial aid which is no longer available from public sources. Education is, after all, still America's investment in the future. We should not and cannot afford to discourage investment in our future.

Sincerely,

Hans G. Springer
Director of Development

HGS/raj

Request to Testify
United States Senate
Committee on Finance
September 27, 28, 29, 1982
Flat-Rate Tax And Major Tax Reform Proposals

Summary of Testimony:

A FISCAL SYSTEM FOR THE TWENTY-FIRST CENTURY
by
Michael J. Daillak, CPA

Can the U.S. Hitch a Ride on the Velocity of Money
And Suddenly Turn Into a Superhero Among World Economies?

Imagine a federal government with a tax base broad enough to fund all reasonable expenditures without levying unreasonable taxes. Imagine a world in which you are taxed only on what you spend -- not on what you save or invest legitimately. The millenium? No, a "flat-rate" tax system which embodies a before-the-fact consumption tax. A broad base transaction tax that would eliminate the filing of tax returns for almost all taxpayers. Involving a tax rate in the range of 1 percent to 2.5 percent, it would reorient the sources of tax revenues (yet, exceptions are easily provided for) to encompass every economic entity within our nation's borders, and represent a substantial tax reduction to the majority of those taxpayers presently paying taxes. Its administration would require no more of most taxpayers than that which they already do. As for the banking-savings-investment industries which would be the fiscal intermediaries and the IRS, it requires far less of them than the interest-dividend withholding provisions of the Tax Equity and Fiscal Responsibility Act of 1982.

The required economic base at these low rates is in the range of 29 to 75 trillion dollars. The only base in our economic system which approaches this range is the total of all deposits to checking accounts from any type of transaction -- (i.e., the velocity of money). (See Table I.) Because the tax base is not net income, the flat rate applied to it is not as implicitly regressive as the flat-rate systems presently being considered by Congress.

It will stimulate savings and investments which will ultimately lower interest rates.

I do not propose to tax deposits to savings accounts or deposits to specific types of investment accounts such as the general accounts of brokerage houses. Quite the contrary, I propose the corollary: If checks are drawn and deposited to savings accounts or to qualified investment accounts, there would be a restoration of the "flat-rate" tax previously deducted.

This is a before-the-fact consumption tax, because the assumption is made that the purpose of holding money in a checking account is solely for the purpose of consumption of one type or another. Since the tax has been taken out before the actual fact of consumption is accomplished, the party taxed has the opportunity to reconsider and transfer those after-tax funds to a savings account or investment situation and have the amount of the tax restored. The thrust of this proposal is conservatism in terms of economic decision-making in its ultimate form, as opposed to the present situation, which induces lavish consumption by taxpaying entities. (The more wealthy the entity, the more lavish the consumption.) The current system spites the taxing authority and contributes to the characterization of our's being a "disposable society".

Some of the effects this system would have are as follows:

1. Major cuts, or elimination, of all (not just the income tax) presently existing federal tax rates. For example, the 6.7 percent individual and employer social security tax is implicit in the rate range assumed.

Summary of Testimony: Page 2

2. Since the tax is levied by a function of deposit to checking accounts, there is no self-informing, after-the-fact reporting required -- with the attendant opportunity and temptation to alter the facts. The national conscience would become clearer.

3. There would probably be one-time effects such as:

   a. Creating a surplus funds flow to the federal government, taking the government out of the demand side of the credit markets.

   b. A diffuse reduction of disposable income of all presently non-taxpaying sources by 1 to 2.5 percent, thereby abating demand side inflationary pressure on the one hand; while on the other hand.....

   c. Creating a stimulative inflationary impetus from the net effective tax reductions for most individual taxpayers.

Finally, this flat-rate concept does not require the abandonment of our present "progressive" system of taxation; it can be used in combination with the present system as either the primary or a secondary fiscal system. But, the so-called "tax shelter" should disappear. Therefore, there should be more prudent risk evaluation with regard to potential investments.

I offer for your consideration a "flat-rate" tax on the deposits made <u>only</u> to checking accounts. As Table I indicates, there is a favorable downward trending to any rate applied to this base.

TABLE I

The relationship of the Federal Budget to Annual Bank Debits to Demand Deposit (Checking) Accounts of Individuals, Partnerships, Corporations, States and Their Political Subdivisions, excluding Accounts of the Federal Government (in billions of dollars):

Fiscal Year	Federal Budget	Annual Debits to Checking Accounts	Budget as a % of Debits
1955	$ 68.5	$ 2,044	3.35%
1960	92.2	2,839	3.25%
1965	118.4	5,162	2.26%
1970	196.6	10,237	1.92%
1975	326.2	23,565	1.38%
1980	579.6	63,013	.92%
1981	662.0	86,430	.77%
1982 (est.)	722.3	84,000	.86%

(Assumption: That bank debits (i.e., checks clearing) equal bank deposits.)

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Request to Testify
United States Senate
Committee on Finance
September 27, 28, 29, 1982
Flat-Rate Tax And Major Tax Reform Proposals

Approximation of Testimony
(a manuscript recently submitted to the
Journal of Accountancy
published by the
American Institute of Certified Public Accountants, Inc.):

A FISCAL SYSTEM FOR THE TWENTY-FIRST CENTURY

by

Michael J. Daillak, CPA

Can the U.S. Hitch a Ride on the Velocity of Money And Suddenly Turn Into a Superhero Among World Economies?

Imagine a federal government with a tax base broad enough to fund all reasonable expenditures without levying unreasonable taxes. Imagine a world in which you are taxed only on what you spend -- not on what you save or invest legitimately. Further, imagine that your tax is only 1 to 2½ percent of what you designate for consumption through your bank deposits. And to top all of that, the government would cease to reward unsuccessful ventures. Furthermore, it would have enough money in its coffers to provide the governmental services we have come to expect.

The millenium? No, a "flat-rate tax" system that would be fair to Americans on all steps of the economic ladder.

I believe there is a "flat-rate" system that could service our country's political-economic needs well into the Twenty-First Century. I further believe the 1 to 2½ percent rate would be acceptable -- at least in concept -- by the 700 individuals and 60-plus corporations served by my two-office firm as a tax preparer.

The required economic base to meet government needs at these low rates is in the range of 29 to 75 trillion dollars (one trillion = 1,000 billion). The only base in our economic system which approaches this range is the total of all deposits to checking accounts from any type of transaction -- (i.e., the velocity of money). Because the tax base is not net income, the flat rate applied to it is not as implicitly regressive as the flat-rate systems presently being considered by Congress. In addition, it is a before-the-fact consumption tax. It therefore encourages investment and savings, especially since the tax is automatically refunded if consumption does not occur.

At least 100 million taxpayers would be relieved of the annual tax filing responsibility, because reporting and collecting of the tax would become by-products of the normal banking transactions most Americans carry out on a regular basis. Employers would be relieved of withholding and social security tax responsibilities. (Social security would become a part of this "single tax" and no longer would be a mandatory deduction from each paycheck.)

But, how could a government which finds itself facing annual deficits in excess of $100 billion through its present taxing systems suddenly become self-supporting using only a single tax at a significantly lower rate level? The answer is a much broader tax base. If the 84 trillion dollars expected to be deposited to checking accounts in 1982 were taxed at only .86 percent (i.e., less than nine-tenths of one percent), it would raise the 722.3 billion dollars the federal budget would require. (See Table I.) That, of course, is too simplistic an answer. Later in the article I will suggest adjustments which would be required.

The next question is: Why would a Certified Public Accountant, a member of an industry which earns 35 to 50 percent of its income from tax preparation services, propose a system that would eliminate these services?

First of all, I believe there are alternative areas into which our practices can expand -- such as operational auditing, long-range planning, other innovative management services, and, perhaps, prescribed additional accounting services in connection with federal banking legislation regarding borrower's credit presentations and accounting systems -- which would be cost effective to our clients.

Second, in good conscience as a citizen, I must offer my best opinion of a solution to the problems that beset our present tax system.

This flat-rate concept does not require the abandonment of our present "progressive" system of taxation; it can be used in combination with the present system as either the primary or a secondary fiscal system as follows:

a. As a primary "flat-rate" fiscal system, the present progressive system would be amended so that it was applicable only when either certain rates of return were exceeded or when certain very high levels of net income were attained, thus preserving the overall progressive nature of our tax system.

b. As a secondary "flat-rate" fiscal system, the "flat-rate" would range from as little as two-tenths of one percent up to one-half of one percent with the objective of providing sufficient supplementary revenues to offset unwanted projected budget deficits, in a manner that was optimally diffuse as far as the overall impact on the economy.

Taxpayers would not have the temptation to subvert the flat-rate system if it were the primary system. Instead, they would have a vested interest in making it work, because for probably 98 percent of the 126 million-plus taxpayers today, this system represents a potential substantial reduction in their effective tax rate. For example, all individuals and employers subject to our present 6.7 percent social security tax would realize a savings/reduction equal to the entire tax, since it is implicit in the flat-tax range assumed in this article.

Most importantly, with the adoption of a flat-rate tax, the so-called "tax shelter" would disappear. With regard to economic decision making, there would be no benefit to be derived from losses. There would be no subsidization by the federal government for losses. Therefore, there would be more prudent risk evaluation with regard to potential investments.

This revised tax system would reduce the insidious subversion implicit in the present system's seductive treatment of losses so that our economic system, which is the dollar vote allocating scarce resources, could return to optimum operation. There should be no decrease in the entrepreneurial spirit or the tendency to take valid risks in search of real profits that has always existed in our economy. Therefore, the enabling legislation which must accompany this system, requiring most cash receipts to be deposited to either checking or savings/investment accounts, would be accepted, since it requires no more of most taxpayers than that which they already do.

One of the advantages of a revised tax system of this nature is that it will stimulate savings and investments which will ultimately lower interest rates and improve the productive capacity, which is the strength of the economy and the nation.

I do not propose to tax deposits to savings accounts or deposits to specific types of investment accounts such as the general accounts of brokerage houses. Quite the contrary, I propose the corollary: If checks are drawn and deposited to savings accounts or to qualified investment accounts, there would be a restoration of the "flat-rate" tax previously deducted. This restoration would be the immediate responsibility of the party in receipt of the deposit. The federal government would, of course, reimburse the savings/banking institution or the brokerage firm for this restoration of the tax.

What we're talking about here is a before-the-fact consumption tax. We would tax potential consumption, because the assumption is made that the purpose of holding money in a checking account, usually non-interest bearing, is solely for the purpose of consumption of one type or another. Since the tax has been taken out before the actual fact of consumption is accomplished, the party taxed has the opportunity to reconsider and transfer those after-tax funds to a savings account or investment situation and have the amount of the tax restored. The thrust of this proposal is conservatism in terms of economic decision-making in its ultimate form, as opposed to the present situation, which induces lavish consumption by taxpaying entities. (The more wealthy the entity, the more lavish the consumption.) The current system spites the taxing authority and contributes to the characterization of our's being a "disposable society".

This before-the-fact consumption tax would induce alterations in the components of the velocity of money, the tax base -- but it should have no adverse effect on real production or the value added from productive efforts.

The velocity of money presently includes checking accounts which are set up purely for convenience and represent simply transfers of money for purposes of allocations. Commonly, in households one member has a checking account into which he deposits his check and then immediately takes part of it out and gives it to another member to put into that member's household account. There may be accounts for the children, with lesser sums shifted to them to again be redeposited. Also, businesses quite frequently have multiple accounts; there may be a pooling account where money from various sources is received and then redistributed into a payroll account, a general account, a specific reserve account, or a trust account. This is simply a matter of convenience, and of course, it is a major distortion involved in the base to which I have chosen to relate this "flat-rate" tax.

In order to approximate an adjustment to the proposed tax base for this distortion, we should bring into perspective the taxpaying entities of this country.

There are, of course, estates and trusts, but in terms of volume, they represent the lowest. Next comes business tax reporting, either in the form of individual tax returns (Schedule C and F), partnership returns, or corporate returns. As of 1980, there were estimated to be 15 million businesses in the United States, of which 14,000 had revenues in excess of $100 million annually -- that is, gross revenues before deductions. There were 140,000 that had gross revenues, before deducting expenses, of between $1 million and $99 million per year. And then there were the 14 million-plus businesses in this country that had gross revenues, before deducting expenses, of less than $1 million per year. Of course, there were the 95 million individual taxpayers. This is a significant number of people and when related to the electorate or to the adult population of this country, it involves just about everyone.

Admittedly, one of the most significant consequences of this type of tax system would be a reorienting of the use of checking accounts away from those that are purely for convenience purposes. And this, of course, would affect the revenue to be derived from such a tax system. Let's take a moment to consider this potential shifting away from convenience and multiple checking accounts. Assume that half the population, approximately 110 million people, have an extra checking account into which they deposit an estimated $10,000 annually. If those accounts were eliminated, that would result in a $1.1 trillion reduction in the presently assumed base of $84 to $86 trillion indicated in Table I. Also, if we assume that each of the 14 million businesses, with gross revenues of less than $1 million annually, had a convenience checking account that could be eliminated, and that these accounts had annual deposits averaging $500,000, that would be an additional $7 trillion reduction in the velocity of money in the $84 trillion base. If each of the 140,000 businesses with gross revenues of $1 million to $99 million eliminated an extra account with annual deposits of $50 million, that would be another $7 trillion reduction in the base. Finally, if each of the 14,000 businesses with gross revenues in excess of $100 million eliminated an extra account with annual deposits of $500 million, that would be an additional $7 trillion reduction. After these deductions, the base still would be approximately $63 trillion and a 1 percent flat-rate should yield $630 billion, which is an amount in excess of the total amount collected from all federal taxes (i.e., income, social security, excise, etc.) in fiscal 1981. Therefore, the viability of this proposal still remains.

However, it may be necessary to make a further reduction, for a possible distortion caused by the trading accounts related to government securities. Since the majority of these transactions occur in the New York area, which is the financial capital of this nation, I will, for conservatism, exclude all bank deposits to all major New York City banks, approximately $35 trillion. Although this reduces the tax base to $28 trillion, a "flat-rate" of 2½ percent would produce $700 billion of tax revenues.

The adjustment estimates above will, hopefully, cover any exemptions Congress enacts. In such cases, the individuals or business entitites would simply deposit receipts subject to exemption, or to special rates, in a separate deposit which would indicate the special rate and the appropriate taxpayer I.D. number for immediate IRS followup. IRS audit efforts would now be contemporaneous with each transaction, and therefore much more effective.

This system conceptually would have the following additional permanent effects on the political-economic system:

1. A flexible "flat-rate" would provide a sufficient (also horizontally equitable and politically acceptable) revenue source to allow balanced, surplus or deficit budgets on a discretionary basis.
2. It would provide the opportunity for major cuts, or elimination, of all

(not just the income tax) presently existing federal tax rates. (A means of mitigating the potential inflationary effects of the resultant refunds is discussed below.)

3. It would successfully blunt meat-axe approaches to federal tax reform.

4. Since the tax is levied by a function of deposit to checking accounts, there is no self-informing, after-the-fact reporting required -- with the attendant opportunity and temptation to alter the facts. The national conscience would become clearer.

5. It might prove that taxes which are easier to tolerate (i.e., cheaper, more efficiently administered and imbued with more perceptible equity) will create an increased demand for, and appreciation or tolerance of, the goods and services provided by government.

In additon, there would probably be the following short-term or one-time effects of:

1. Creating a surplus funds flow to the federal government (since normal withholding and tax estimate procedures would not be immediately abandoned, but instead probably reduced by at least 50 percent). This would take the government out of the demand side of the credit markets while it could remain active on the supply side; thereby substantially reducing interest rates and their "cost-push" inflationary impetus.

2. A diffuse reduction of disposable income of all presently non-taxpaying sources by 1 to 2.5 percent, thereby abating demand side inflationary pressure on the one hand; while on the other hand.....

3. Creating a stimulative inflationary impetus in 1984 from 1983 refunds (due in 1984) which would be approximately 4 to 5 times normal. This situation could be mitigated by providing a check-off on the 1983 tax returns which

allow the individual taxpayer to elect to have the government retain the potential refund for a minimum of four years, up to a maximum of ten years, in return for the government providing an inflation-adjusted, real rate of return of between 4 percent and 10 percent, depending upon the length of time of deferment elected.

Of course, a tax revision of this type has further implications, both inside and outside the tax code and there would be a requirement for such enabling legislation, including the following:

1. As previously stated, to require almost all cash receipts to be deposited in either checking or savings/investment accounts (to be enforced on a discretionary basis), if not used to purchase money orders, cashier's checks, etc. (see below).
2. To require the "flat-rate" on checks deposited to checking accounts to be increased by a multiple of the number of endorsements on a check or by the number of days from date of issue in excess of seven, whichever is the greater multiple. Also, to levy an equivalent "sales tax" on money orders, cashier's checks, etc., purchased with cash.
3. To provide for reporting to the IRS those persons consummating a transaction in cash in excess of a certain amount -- say $100.
4. To provide for a confiscatory penalty tax on all cash amounts that could not be traced to a direct withdrawal from a bank checking account by the party in custody of the cash.
5. To provide financial institutions with a remittance lag time -- to be policed by the existing IRS audit forces -- in order to compensate the financial institutions for their cost to administer and report this new withholding system, and to replace any "float" loss due to the abandonment of convenience type checking accounts.

There's also the possibility that this revised system of taxation would encourage covert barter arrangements which would further subvert the assumed tax base. However, barter arrangements discovered could be subject to a confiscatory tax, similar to that for cash hoards which cannot be traced to a bank withdrawal by those in custody of the hoard. And the value of the barter arrangements could also be made subject to the income tax, which, as indicated, would still be in effect, but would normally have a beginning point at a significantly higher level of taxable income.

There is the optimal flat-rate tax system in basic outline, along with suggested means of operations and consideration of some of the problems which could appear in the system.

Would it work? This Certified Public Accountant/tax preparer believes it would. However, it must be sold. It can never work until it becomes law, and it can only become law if the majority of the members of Congress can be pursuaded that it is THE tax for the 21st Century and that it will be a reliable source of funds for all their programs.

TABLE I

The relationship of the Federal Budget to Annual Bank Debits to Demand Deposit (Checking) Accounts of Individuals, Partnerships, Corporations, States and Their Political Subdivisions, excluding Accounts of the Federal Government (in billions of dollars):

Fiscal Year	Federal Budget	Annual Debits to Checking Accounts	Budget as a % of Debits
1955	$ 68.5	$ 2,044	3.35%
1960	92.2	2,839	3.25%
1965	118.4	5,162	2.26%
1970	196.6	10,237	1.92%
1975	326.2	23,565	1.38%
1980	579.6	63,013	.92%
1981	662.0	86,430	.77%
1982 (est.)	722.3	84,000	.86%

(Assumption: That bank debits (i.e., checks clearing) equal bank deposits.)

Thomas J. Donohue
President
Citizen's Choice, Inc.

I am Thomas J. Donohue, president of Citizen's Choice, a national grass-roots taxpayers' organization founded in 1976. Citizen's Choice currently has over 75,000 taxpaying members nationwide, representing all sectors of our society.

I am pleased to have this opportunity to testify before this Committee on the topic of tax alternatives. Citizen's Choice is uniquely qualified to present testimony on this subject. Our National Commission on Taxes and the IRS conducted a nationwide investigation of taxpayers' attitudes toward the IRS. In response to the Commission's finding that our tax system is in need of massive reform, we commissioned a study that addressed the pros and cons of a variety of alternative tax systems and which served as discussion material for two Citizen's Choice-sponsored tax forums on the topic. Today, I will outline the findings and conclusions of our efforts.

The United States has a tax system under which some millionaires can get away with paying no income tax at all, while people who earn $60,000 a year may pay nearly half their income in taxes. It is not surprising, therefore, that the system is viewed by taxpayers as inequitable. We have a system in which each piece of tax legislation passed by Congress is added to the fourteen volume and more than 7,000 pages of rules and regulations comprising the present Internal Revenue Code. Considering this, it is also not surprising that the system is seen as complicated.

Moreover, when revenue loss from "underground" economic activity is estimated at more than $100 billion annually -- almost enough to balance the federal budget -- it is not surprising that the present system is viewed as inefficient. Tax avoidance and tax evasion are becoming a national pastime. And incidents of IRS abuse, borne of frustration in enforcing our tax laws, are becoming commonplace. It is high time for meaningful tax reform.

For this reason, the proposal of a flat rate or broad based tax with low marginal rates has generated considerable legislative and popular interest in the last half year. From tax experts to taxpayers, the opinion is the same -- our present system of voluntary taxation is headed for disaster. It has become extremely complex and unwieldy. It has drifted away from its original purpose of raising revenue and has become a tool for promoting specific social and economic goals. So, whether it is the charitable deduction or the energy credit, the idea is no longer simply to raise revenue, but to help elements of our society to succeed. And, while there is nothing insidious about this policy, it becomes a great problem when exclusions, deductions, exemptions and credits become the norm rather than the exception in the tax code.

The medical expense deduction is a classic example. Congress wished to relieve those taxpayers who incurred large medical expenses. The result was a tax deduction for the amount of medical expenses that exceeds 3 percent of the taxpayer's adjusted gross income. But the medical expense deduction did not cover the cost of prescription drugs. For those individuals whose drug expenses were unduly large, Congress passed a tax deduction for the amount that exceeds one percent of adjusted gross income. Finally, Congress wanted to include a deduction for those individuals who have medical insurance and would normally not spend more than 3 percent of their gross income on medical bills. The result was the recently repealed $150 medical deduction for those who pay for medical insurance.

Each of the above was well intended. But in practice they cause more confusion ~~than anything~~ else. Recent IRS statistics reveal that more than 75 percent of taxpayers who claim any one of these deductions make mistakes in computing the amount of their deduction.

As this example illustrates, there can be no argument on whether meaningful tax reform should be undertaken. There is considable diversity of opinion, however, on what direction tax reform should take. Should the rate structure be flat or graduated? Should the tax be based on income or consumption? What should the actual numbers be?

Setting aside the technical questions that must be addressed when considering alternative tax systems, I would like to address the larger issue of the theoretical advantages of adopting a simplified tax system. Since the present system is complicated, unfair and inefficient, any substitute ought to substantially improve on these flaws and at the same time be sensitive to inflation. In the view of Citizen's Choice, a broad-based tax with a flat or slightly progressive rate, with no deductions, represents a substantial improvement over the present system. In regard to inflation, the flat-rate tax is superior to a graduated rate structure in that it simply eliminates bracket creep once and for all. With a flat rate, there is no higher bracket to be pushed into in the inflationary spiral, so there is no counter-incentive to worker productivity.

Probably the most commonly heard criticism of the present system is that its complexity causes administrative difficulties. At present, the Internal Revenue Service is capable of auditing only 1.5 percent of the returns that are filed annually. The result is that a large percentage of taxpayers overstate the amount of deductions they are entitled to, knowing that they will probably escape an audit. On the other hand, the complexity of the tax code breeds a huge number of mistakes that may or may not be picked up by computer scanning of returns. If an error is detected, it requires human involvement, which once again strains an already overburdened agency.

A simplified tax system in which a flat peroentage is paid on an easily documented amount of personal income could conceivably reduce the IRS to a block full of computers and the technicians necessary to run them. Moreover, with credits and deductions eliminated from the tax code, there wouldn't be any need for taxpayers to employ a tax specialist, accountant or attorney. Since 52 percent of the people who itemize deductions seek professional assistance in preparing their tax returns, a flat-rate system with no deductions would be a vast improvement from an administrative standpoint. It would also result in a higher rate of compliance and equal, if not higher amounts of revenue.

The benefits to our economy under such a system would be even greater. Under the current system, there are incentives to artifically shelter income from taxation at high marginal rates. These tax shelters distort the economy. Under a pure flat-rate tax, investors would not need to consider the tax consequences of their investments. Money would be invested in those areas that would result in the highest pre-tax return, not in areas that have a particular tax advantage.

The obvious advantages of a simplified tax system demand that this idea be given serious consideration. Citizen's Choice has taken the lead in bringing the issue to the forefront and promoting the debate. We have sponsored two tax forums at which distinguished

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legislators, economists, tax specialists and business leaders worked on developing a viable proposal for reforming the federal income tax code. The first meeting of this "National Forum on Tax Alternatives" resulted in a signed resolution calling on this committee to hold hearings on the subject of tax simplification. The second forum focused primarily on the question of how to define the tax base. Both meetings stressed the advantages of simplifying the present system while recognizing the difficult transitional problems to be confronted.

This week's hearings are the most significant step yet in the tax simplification effort. We commend this Committee for recognizing the need for meaningful tax reform and for fostering informed debate on the topic.

We are now at the stage where this debate must turn from the theoretical to the practical aspects of tax reform. This necessitates deferring to the economists and tax experts who must construct a new tax system that has revenue-raising as its primary goal. We recognize that this cannot be done overnight. But we urge you to take whatever action is necessary to see that tax reform is accomplished. On behalf of the members and staff of Citizen's Choice, I offer to this Committee and to any of its members in particular our assistance in any way you might find it helpful in reaching our common goal of a more efficient, equitable and simple system of taxation. We look forward to working with you to this end.

HATTER - WILLIAMS, INC. Insurance

433 8080

808 CASSIDY STREET
OCEANSIDE CALIF 92054

27 September, 1982

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room No. 2227
Dirksen Senate Office Building
Washington, D. C. 20510

RE: The Flat-Rate Tax Bill

Dear Mr. Lighthizer:

I am writing to ask that you consider in your hearings on the Flat-Rate Tax Bill the alternative measure which was proposed by Senator Wm. Bradley of New Jersey instead of the bill being proposed. The reason for this is that I feel we must provide some sort of deduction for charitable contributions in order that our charitable organizations throughout the country can maintain themselves not only today but far into the future as they perform their many good works.

I am a strong Republican but in this particular instance feel that we must salvage what we can very definitely for our charitable organizations throughout the United States.

Thank you.

Sincerely,

Larry W. Hatter

LWH:dh

STATEMENT OF

FORTESCUE W. HOPKINS

BEFORE THE

SENATE COMMITTEE ON FINANCE

HEARINGS ON FLAT RATE TAX AND MAJOR TAX REFORM PROPOSALS

SEPTEMBER 1982

Mr. Chairman:

I am an attorney from Daleville, Virginia. I represent no one but myself. THE FLAT RATE TAX MOVEMENT reflects the conviction of millions of Americans, based on what is now, clear and convincing evidence (a towering babel of tax expenditures about to collapse under its own weight), that a representative form of government which gives its legislative branch (or an oligarchy, therein) the unlimited power to enact discriminatory tax legislation is a failure, and that the obvious abuse of this power has locked this country into an ever descending economic spiral with no end yet in sight.

The principal features of my proposed flat rate income tax Constitutional Amendment, attached hereto are summarized as follows:

1. The sole source of revenue of any kind permitted to the Federal government or to any State government will be a flat rate, equal and non-discriminatory individual income tax. The only prerogative of the Federal government with respect to the regulation, enforcement, collection and amount of this tax will be its sole power, from time to time, to establish whatever the percentage rate of tax it chooses.

2. The taxable income base will include:

(a) All payments (in cash or value) received by any individual regardless of source less a first return of capital. (All Social Security, pension or insurance contributions, made by any individual will be considered a capital investment.)

(b) All presently non-taxable income.

(c) All income presently excluded under 200 billion plus of tax expenditures (Appendix A) except for return of capital.

(d) All gifts, awards, inheritances and insurance payments of any kind less taxpayers basis will be included in income.

3. Exclusions from income: None, except for return of capital

which has previously been subject to tax in the hands of the individual taxpayer.

4. Credits or exemptions: The allowance of any credit or exemption of even $1.00 is not premitted. A single exemption of any amount is highly discriminatory and violates the total non-discrimination and equality principle behind this amendment. The principle that a three month old baby with an income of $10.00 would have a tax return prepared for it is designed to insure (regardless of how diseconomic it may be) that from the cradle to the grave, every American will maintain his self-respect, and the highest possible sense of individual political responsibility knowing that he has always paid his fair, just and equal share towards the support of his government. In the case of *Pollock v. Farmers' Loan & Trust Co.* (1895), 157 U.S.429, the great opinion of Associate Justice Field on the subject of the effect of a $ 4000.00 ~~$400.00~~ exemption on a 2% flat rate income tax is attached hereto as Appendix B.

5. Elimination of all other Federal taxes including Social Security taxes.

(a) A Social Security tax is a highly discriminatory and regressive income tax. In the lower income brackets this tax often amounts to more than the regular income tax. Consequently, any flat rate income tax projection that fails to consider the elimination of this tax presents a highly irrelevant and misleading picture. For those politicians who tremble or rant and rave at the very mention of the words "Social Security" be advised that it is not being suggested here that the amount of Social Security benefits be tampered with in any manner but that (1) the tax will be eliminated and (2) the benefits will be taxable to the extent they first exceed the total amount paid in by the employee. The effect of this amendment will be, for future years, to eliminate any distinction between income and wages and thereby to broaden the base of funds available to pay such future benefits as Congress may decide.

(b) All other taxes and user fees, etc:(1)If a government service requires a fee, the service belongs in the hands of private industry and (2) Excise and import taxes are regressive and, in the end, borne by individuals, mostly our lower income Americans. Whatever Congress seeks to accomplish by excises, import taxes, or duties other than by raising revenue, let them do it directly rather than indirectly. The power has been abused, it should be terminated.

6. State taxes: States are not exempted from the principle of an equal, just and non-discriminatory tax. Under the terms of this amendment, it is intended that States will tax interest on obligations of the Federal government. The determination of taxable income for Federal as well as State purposes will be totally parallel and the State will also be permitted to set whatever rate it chooses.

7. Tax returns: Forms of a combined Federal and State individual and business income tax returns are attached hereto.

Conclusions and observations:

(a) The proposal of a Constitutional Amendment is in accordance with the advice of Alexander Hamilton (The Federalist, No. 28) and Thomas Jefferson, who both said: that if the national government exceeded the limits of its powers (and unrestrained by the Supreme Court) the people should appeal to their State Legislatures to form committees of correspondences between the States with a view to employing the amendment procedure of Article V of the Constitution.

(b) Even though, the Supreme Court has settled the question of the constitutionality of a discriminatory income tax in Brushaber v. Union Pacific R.R.Co (1916) 240 U.S.1 and in the 66 years since that decision has not chosen to reverse or review it, it is my opinion that: "The cumulative effect of the discriminatory tax provisions of the Internal Revenue Code makes the entire title 26 of the U.S. Code unconstitutional". Support for this opinion can be found in the fact of the existence of 200 billion dollars plus of discriminatory tax expenditures (Appendix A), and in the cogent reasoning of Frank Warren Hacket in his article entitled "The Constitutionality of the Graduated Income Tax Law" Yale Law Journal, Vol XXV, April 1916, No.6 (Attached hereto as Appendix C).

(c) For the most comprehensive analysis of the relative merits of a flat tax vs a progressive rate tax your attention is invited to the article contained in the University of Chicago Law Review, Vol 19, Spring 1952, Number 3, entitled "The Uneasy Case for Progressive Taxation" by Walter J. Blum & Harry Kalven, Jr.

(d) I believe that ten years from now or less, the perspective of history will establish that the FLAT RATE TAX MOVEMENT was the most important and significant event or trend in American history since Patrick Henry started the ball rolling against the Stamp Act of England in 1765 with his famous speech "if this be treason, make the most of it". Against a bleak economic and unemployment situation and political turmoil, this non-partisan MOVEMENT holds out the truly exciting and hopeful prospect of achieving for America, in the not too distant future, an unimaginable and undreamed of peace, prosperity, productivity and individual happiness, all sustained by a degree of individual political responsibility that only a totally equal, just, fair and non-discriminatory tax can inspire.

(e) The provisions of the recently enacted Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) will have a most extraordinary impact on fueling the flames of this MOVEMENT. The harshness, oppressiveness and stupidity of the so-called "compliance measures" of this act against the taxpayer and his return preparer are without parallel in the history of this country except for the turning of the British screws on America between 1765 and 1773 (Navigation Acts, Tea Tax, etc) which led, as we all remember, to the Famous Virginia Resolutions of 1773 inspired by Patrick Henry's immortal "Give me liberty or give me death" speech. Patrick Henry opposed ratification of the constitution because of his fear of the abuse of the power to tax. Appendix D.

Respectfully submitted,

Fortescue W. Hopkins

Fortescue W. Hopkins
Box 218
Daleville, Virginia 24083
703-992-3932

PROPOSITION 1776

CONSTITUTIONAL AMENDMENT

ARTICLE XXVI

IN CONNECTION WITH SECURING THE REVENUE OF THE UNITED STATES OR OF ANY STATE, OR FOR ANY OTHER PURPOSE, NO DUTY, EXCISE, IMPOST, TAX, LICENSE OR FEE OF ANY KIND MAY BE LEVIED OR IMPOSED EXCEPT A FLAT RATE, PROPORTIONAL AND NON-DISCRIMINATORY INCOME TAX ON ALL INDIVIDUAL NET INCOME PAID OR AVAILABLE FOR PERSONAL USE. IN DETERMINING SUCH INDIVIDUAL NET INCOME OR TAX, NONE OF THE FOLLOWING SHALL BE PERMITTED: EXEMPTIONS, CREDITS, ANY DISTINCTION BETWEEN ORDINARY INCOME AND CAPITAL GAIN OR ANY KIND OF INCOME OR ANY DEDUCTION OR OTHER PROVISION DESIGNED TO ACHIEVE, IN THE SLIGHTEST DEGREE, A NON-REVENUE RELATED OBJECTIVE. ALSO, IN DETERMINING NET INCOME, BUSINESS EXPENSES SHALL BE ALLOWED, THE CASH BASIS METHOD OF ACCOUNTING SHALL BE USED AND THERE ~~SHALL~~ BE NO ALLOWANCE FOR DEPRECIATION, DEPLETION OR ANY KIND OF AMORTIZATION.COSTS OF ALL BUSINESS RELATED CAPITAL ASSETS SHALL BE ALLOWED AS AN EXPENSE TO THE EXTENT THAT CAPITAL IS NOT ACCUMULATED BEYOND REASONABLE BUSINESS NEEDS. IN CONNECTION WITH THE DETERMINATION OF THIS TAX, NO REGULATIONS, RULES OR PRECEDENTS SHALL BE PROMULGATED BY ANY AUTHORITY. THE NET INCOME OF ALL ENTITIES OTHER THAN AN INDIVIDUAL SHALL BE DETERMINED ON THE SAME BASIS AS INDIVIDUAL NET INCOME AND EACH INDIVIDUAL SHALL INCLUDE IN HIS NET INCOME HIS PROPORTIONATE SHARE OF SUCH ENTITIES INCOME OR LOSS. ENTITIES, INCLUDING SOLE PROPRIETORSHIPS, SHALL, IN THE FORM ATTACHED, FILE QUARTERLY INFORMATION TAX RETURNS WITH THE UNITED STATES AND PROVIDE QUARTERLY INCOME INFORMATION TO ITS EQUITY HOLDERS. ANY DISPUTES AS TO THE DETERMINATION OF NET INCOME PAID OF AVAILABLE FOR PERSONAL USE SHALL BE RESOLVED BY ARBITRATION AND THE RESULTS SHALL BE BINDING ON ALL PARTIES. FOR BOTH FEDERAL AND STATE PURPOSES, A SINGLE INDIVIDUAL INCOME TAX RETURN (PERMITTING BUSINESS LOSSES TO BE CARRIED FORWARD AND APPLIED INDEFINITELY) SHALL BE FILED WITH THE STATE OF RESIDENCE ON A QUARTERLY BASIS IN THE FORM ATTACHED. THE TAX SHALL BE ENFORCED AND COLLECTED BY THE STATE OF RESIDENCE WITH THE FEDERAL SHARE REMITTED WITHIN 30 DAYS LESS COLLECTION COST BASED ON THE RATIO THAT THE FEDERAL TAX BEARS TO THE STATE TAX. THE SUPREME COURT SHALL HAVE ORIGINAL JURISDICTION WITH RESPECT TO ANY DISPUTE BETWEEN STATE AND THE UNITED STATES INVOLVING THE FOREGOING PROVISIONS.

Fortescue W. Hopkins
Daleville, Va. 24083
703-992-3932

FORM 1776

Quarterly for period ended	Individual Income Tax Retur .
Name and address	Name (first, initial, last) Social Security Number
	Present home address
	City, town, or post office, state and ZIP code

Figure your tax	1.	Wages	________
	2.	Cost of benefits provided by employer (no exceptions)	________
	3.	Income or (loss) from business entities (attach list)	________
	4.	Other income paid or available (include gifts and inheritances and all payments or assets received from any source except distributions from business entities and return of capital)	________
	5.	Carry over loss from previous quarter	________
	6.	Add all lines 1,2,3&4 but subtract lines 3&5 if applicable. This is your taxable income (or carry over loss)	________
	7.	Federal income tax (_% x line 6)	________
Amount you owe	8.	State income tax (_% x line 6)	________
	9.	Total tax (attach check or money order payable to State of ________)	==========
Sign you return (individual or parent of minor taxpayer and file with the State of ____________).	10.	____________________ your signature	________ date

FORM 1776

Quarterly for period ended — Business Income Tax Information Return

Name and address

Name ______ Employer Identification Number ______

______
Type of business entity, individual, corporate, trust, partnership, association, etc.

______
Address

______
City, town, or post office, State and ZIP code

______

1. Gross receipts from business ______

2. Subtract business expenses (______)

3. Subtract costs of capital assets (______)

4. Add amounts distributable from other business entities (attach list) ______

5. Other income paid or available (include all payments or value of assets received from any source, except capital investment by equity holders ______

6. Add lines 1,4&5 and subtract lines 2&3. This is your distributable net income or loss (attach list showing distribution of income or loss to each equity holder by States and distribute such information to each equity holder on or before the 15th of the month following the end of the quarterly period) ______

Sign return and file with the Internal Revenue Service

7. ______ ______
signature of responsible person date

REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES BY FUNCTION

Function	[illegible]	[illegible]	[illegible]
National defense			
Exclusion of benefits and allowances to Armed Forces personnel	[illegible]	885	1,942
Exclusion of military disability pensions	155	165	70
International affairs			
Exclusion of income earned abroad by United States citizens	610	985	1,285
Deferral of income of domestic international sales corporations (DISC)	1,595	465	1,475
General science, space, and technology			
Expensing of research and development expenditures	[illegible]	380	[illegible]
Credit for increasing research activities	[illegible]	625	80
Energy			
Expensing of exploration and development costs			
Oil and gas	3,525	4,265	4,570
Other fuels	25	25	30
Excess of percentage over cost depletion			
Oil and gas	1,965	1,965	1,495
Other fuels	260	300	[illegible]
Capital gains treatment of royalties on coal	20	85	15
Exclusion of interest on State and local government industrial development bonds for certain energy facilities	*	5	5
Residential energy credits			
Supply incentives	150	205	260
Conservation incentives	625	[illegible]	[illegible]
Alternative, conservation and new technology credits			
Supply incentives	180	235	290
Conservation incentives	270	285	[illegible]
Alternative fuel production credit	25	55	50
Alcohol fuel credit	5	20	35
Energy credit for intercity buses	5	5	5
Natural resources and environment			
Expensing of exploration and development costs, nonfuel minerals	45	50	55
Excess of percentage over cost depletion, nonfuel minerals	385	405	440
Exclusion of interest on State and local government pollution control bonds	[illegible]	835	[illegible]
Tax incentives for preservation of historic structures	60	80	5
Capital gains treatment of iron ore	20	20	20
Capital gains treatment of certain timber income	505	600	[illegible]
Investment credit and seven-year amortization for reforestation expenditures	5	10	[illegible]
Agriculture			
Expensing of certain capital outlays	525	545	560
Capital gains treatment of certain income	425	400	375
Commerce and housing credit			
Dividend and interest exclusion	1,335	2,185	475
Exclusion of interest on State and local industrial development bonds	1,200	1,650	2,185
Exemption of credit union income	-25	5	40
Excess bad debt reserves of financial institutions	325	250	[illegible]
Exclusion of interest on life insurance savings	4,300	4,525	4,805
Deductibility of interest on consumer credit	8,675	9,205	9,755
Deductibility of mortgage interest on owner-occupied homes	20,145	23,030	25,490
Deductibility of property tax on owner-occupied homes	9,125	10,065	10,635
Exclusion of interest on State and local housing bonds for owner-occupied housing	685	920	1,245
Expensing of construction period interest and taxes	755	765	645
Capital gains (other than agriculture, timber, iron ore and coal)	17,965	18,315	14,390
Deferral of capital gains on home sales	1,100	1,070	1,200
Exclusion of capital gains on home sales for persons age 55 and over	450	415	465
Carryover basis of capital gains at death	2,070	2,190	2,135
Investment credit, other than ESOP's, rehabilitation of structures, energy property, and reforestation expenditures	19,445	20,335	20,150
Safe harbor leasing rules	*	3,560	3,945
Amortization of start-up costs	20	25	[illegible]
Exclusion of interest on certain savings certificates		575	2,[illegible]
Reinvestment of dividends in public utility stock	*	130	365
Transportation			
Deferral of tax on shipping companies	70	65	85
Exclusion of interest on State and local government industrial development bonds for mass transit		*	5
Community and regional development			
Five-year amortization for housing rehabilitation	30	45	55
Investment credit for rehabilitation of structures	220	255	300
Education, training, employment, and social services			
Exclusion of interest on State and local student loan bonds	50	30	[illegible]
Parental personal exemption for students age 19 or over	[illegible]	995	900
Exclusion of employee meals and lodging (other than military)	625	555	600
Employee educational assistance	35	40	40
Exclusion of contributions to prepaid legal services plans	20	20	25
Investment credit for ESOP's	875	[illegible]	[illegible]
Deductibility of charitable contributions (education)	[illegible]	895	925
Deductibility of charitable contributions other than education and health	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]		[illegible]	[illegible]
General jobs credit	[illegible]	[illegible]	[illegible]
Targeted jobs credit	[illegible]	[illegible]	[illegible]
Health			
Exclusion of employer contributions for medical insurance premiums and medical care	[illegible]	[illegible]	[illegible]
Deductibility of medical expenses	[illegible]	[illegible]	[illegible]
Exclusion of interest on State and local hospital bonds	[illegible]	[illegible]	[illegible]
Deductibility of charitable contributions (health)		[illegible]	[illegible]

REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES BY FUNCTION—Continued

(In millions of dollars)

Function	[illegible]	[illegible]	[illegible]
Income security			
Exclusion of social security benefits			
Disability insurance benefits	860	915	910
OASI benefits for retired workers	8,885	9,300	10,525
Benefits for dependents and survivors	[illegible]	1,915	1,970
Exclusion of railroad retirement system benefits	365	380	[illegible]
Exclusion of workmen's compensation benefits	2,770	3,150	3,335
Exclusion of special benefits for disabled coal miners	90	[illegible]	[illegible]
Exclusion of unemployment insurance benefits	1,485	[illegible]	2,210
Exclusion of public assistance benefits	370	355	345
Net exclusion of pension contributions and earnings			
Employer plans	23,390	25,785	27,500
Plans for self-employed and others	2,170	2,560	3,760
Exclusion of other employee benefits			
Premiums on group term life insurance	1,840	1,900	1,895
Premiums on accident and disability insurance	[illegible]	100	30
Income of trusts to finance supplementary unemployment benefits	15	20	25
Additional exemption for the blind	30	30	30
Additional exemption for the elderly	2,250	2,255	2,370
Tax credit for the elderly	130	135	135
Deductibility of casualty losses	775	800	850
Earned income credit	610	555	495
Exclusion of interest on State and local housing bonds for rental housing	435	485	535
Deduction for motor carrier operating rights	*	140	75
Deduction for certain adoption expenses	10	10	10
Veterans benefits and services			
Exclusion of veterans disability compensation	1,255	1,360	1,380
Exclusion of veterans pensions	95	85	90
Exclusion of GI bill benefits	200	175	145
General government			
Credits and deductions for political contributions	130	80	80
General purpose fiscal assistance			
Exclusion of interest on general purpose State and local debt	5,855	6,585	7,505
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	15,385	20,395	21,530
Tax credit for corporations receiving income from doing business in United States possessions	1,120	1,200	1,285
Interest			
Deferral of interest on savings bonds	270	80	50

[illegible]

[illegible]

[illegible]

PROVISIONS PREVIOUSLY DESIGNATED "TAX EXPENDITURES"

Table G-3, which follows, shows "revenue loss" estimates for current provisions of the Internal Revenue Code that were designated as involving "tax expenditures" in last year's budget, but which should be considered part of the reference tax structure rather than as special exceptions to it.

Table G-3. REVENUE LOSS ESTIMATES OF PROVISIONS PREVIOUSLY DESIGNATED "TAX EXPENDITURES"

(In millions of dollars)

Provision	[illegible]	[illegible]	[illegible]
International affairs			
Deferral of income of controlled foreign corporations	480	[illegible]	[illegible]
Natural resources and environment			
[illegible] gas and electric [illegible]	[illegible]	30	[illegible]
Agriculture			
[illegible]			
[illegible]		[illegible]	[illegible]
Commerce and housing credit			
[illegible]	[illegible]	[illegible]	[illegible]
Education, training, employment, and social services			
[illegible]	[illegible]	165	[illegible]
Income security			
[illegible]	[illegible]	345	[illegible]

APPENDIX A

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aries of officers of the United States. Mr. Justice Nelson, in delivering judgment, said: "The general government and the states, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former, in its appropriate sphere, is supreme; but the states, within the limits of their powers not granted, or, in the language of the tenth amendment, 'reserved,' are as independent of the general government as that government within its sphere is independent of the states."

This is quoted in Van Brocklin v. Tennessee, 117 U. S. 151, 178, 6 Sup. Ct. 670, and the opinion continues: "Applying the same principles, this court in U. S. v. Baltimore & O. R. Co., 17 Wall. 322, held that a municipal corporation within a state could not be taxed by the United States on the dividends or interest of stock or bonds held by it in a railroad or canal company, because the municipal corporation was a representative of the state, created by the state to exercise a limited portion of its powers of government, and therefore its revenues, like those of the state itself, were not taxable by the United States. The revenues thus adjudged to be exempt from federal taxation were not themselves appropriated to any specific public use, nor derived from property held by the state or by the municipal corporation for any specific public use, but were part of the general income of that corporation, held for the public use in no other sense than all property and income belonging to it in its municipal character must be so held. The reasons for exempting all the property and income of a state, or of a municipal corporation, which is a political division of the state, from federal taxation, equally require the exemption of all the property and income of the national government from state taxation."

In Mercantile Bank v. City of New York, 121 U. S. 138, 162, 7 Sup. Ct. 826, this court said: "Bonds issued by the state of New York, or under its authority, by its public municipal bodies, are means for carrying on the work of the government, and are not taxable, even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes."

The question in Bonaparte v. Tax Court, 104 U. S. 592, was whether the registered public debt of one state, exempt from taxation by that state, or actually taxed there, was taxable by another state, when owned by a citizen of the latter, and it was held that there was no provision of the constitution of the United States which prohibited such taxation. The states had not covenanted that this could not be done, whereas, under the fundamental law, as to the power to borrow money, neither the United States, on the one hand, nor the states on the other, can interfere with that power as possessed by each, and an essential element of the sovereignty of each.

The law under consideration provides "that nothing herein contained shall apply to states, counties or municipalities." It is contended that, although the property or revenues of the states or their instrumentalities cannot be taxed, nevertheless the income derived from state, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the states or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason; and that reason is given by Chief Justice Marshall, in Weston v. City Council, 2 Pet. 449, 468, where he said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burthen on the operations of government. It may be carried to an extent which shall arrest them entirely. * * * The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the constitution." Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the constitution.

Upon each of the other questions argued at the bar, to wit: (1) Whether the void provisions as to rents and income from real estate invalidated the whole act; (2) whether, as to the income from personal property, as such, the act is unconstitutional, as laying direct taxes; (3) whether any part of the tax, if not considered as a direct tax, is invalid for want of uniformity on either of the grounds suggested,—the justices who heard the argument are equally divided, and therefore no opinion is expressed.

The result is that the decree of the circuit court is reversed and the cause remanded, with directions to enter a decree in favor of the complainant in respect only of the voluntary payment of the tax on the rents and income of the real estate of the defendant company, and of that which it holds in trust, and on the income from the municipal bonds owned or so held by it.

Mr. Justice FIELD.

I also desire to place my opinion on record upon some of the important questions discussed in relation to the direct and indirect taxes proposed by the income tax law of 1894.

Several suits have been instituted in state and federal courts both at law and in equity, to test the validity of the provisions of the law, the determination of which will necessitate careful and extended consideration.

The subject of taxation in the new government which was to be established created great interest in the convention which framed the constitution, and was the cause of much difference of opinion among its members, and earnest contention between the states. The great source of weakness of the confederation was its inability to levy taxes of any kind for the support of its government. To raise revenue it was obliged to make requisitions upon the states, which were respected or disregarded at their pleasure. Great embarrassments followed the consequent inability to obtain the necessary funds to carry on the government. One of the principal objects of the proposed new government was to obviate this defect of the confederacy, by conferring authority upon the new government, by which taxes could be directly laid whenever desired. Great difficulty in accomplishing this object was found to exist. The states bordering on the ocean were unwilling to give up their right to lay duties upon imports, which were their chief source of revenue. The other states, on the other hand, were unwilling to make any agreement for the levying of taxes directly upon real and personal property, the smaller states fearing that they would be overborne by unequal burdens forced upon them by the action of the larger states. In this condition of things, great embarrassment was felt by the members of the convention. It was feared at times that the effort to form a new government would fail. But happily a compromise was effected by an agreement that direct taxes should be laid by congress by apportioning them among the states according to their representation. In return for this concession by some of the states, the other states bordering on navigable waters consented to relinquish to the new government the control of duties, imposts, and excises, and the regulation of commerce, with the condition that the duties, imposts, and excises should be uniform throughout the United States. So that, on the one hand, anything like oppression or undue advantage of any one state over the others would be prevented by the apportionment of the direct taxes among the states according to their representation, and, on the other hand, anything like oppression or hardship in the levying of duties, imposts, and excises would be avoided by the provision that they should be uniform throughout the United States. This compromise was essential to the continued union and harmony of the states. It protected every state from being controlled in its taxation by the superior numbers of one or more other states.

The constitution, accordingly, when completed, divided the taxes which might be levied under the authority of congress into those which were direct and those which were indirect. Direct taxes, in a general and large sense may be described as taxes derived immediately from the person, or from real or personal property, without any recourse therefrom to other sources for reimbursement. In a more restricted sense, they have sometimes been confined to taxes on real property, including the rents and income derived therefrom. Such taxes are conceded to be direct taxes, however taxes on other property are designated, and they are to be apportioned among the states of the Union according to their respective numbers. The second section of article 1 of the constitution declares that representatives and direct taxes shall be thus apportioned. It had been a favorite doctrine in England and in the colonies, before the adoption of the constitution, that taxation and representation should go together. The constitution prescribes such apportionment among the several states according to their respective numbers, to be determined by adding to the whole number of free persons, including those bound to service for a term of years, and excluding Indians not taxed, three-fifths of all other persons.

Some decisions of this court have qualified or thrown doubts upon the exact meaning of the words "direct taxes." Thus, in Springer v. U. S., 102 U. S. 586, it was held that a tax upon gains, profits, and income was an excise or duty, and not a direct tax, within the meaning of the constitution, and that its imposition was not, therefore, unconstitutional. And in Insurance Co. v. Soule, 7 Wall. 433, it was held that an income tax or duty upon the amounts insured, renewed, or continued by insurance companies, upon the gross amounts of premiums received by them and upon assessments made by them, and upon dividends and undistributed sums, was not a direct tax, but a duty or excise.

In the discussions on the subject of direct taxes in the British parliament, an income tax has been generally designated as a direct tax, differing in that respect from the decision of this court in Springer v. U. S. But, whether the latter can be accepted as correct or otherwise, it does not affect the tax upon real property and its rents and income as a direct tax. Such a tax is, by universal consent, recognized to be a direct tax.

As stated, the rents and income of real property are included in the designation of direct taxes, as part of the real property. Such has been the law in England for centuries, and in this country from the early settlement of the colonies; and it is strange that any member of the legal profession should at this day question a doctrine which has always been thus accepted by common-law lawyers. It is so declared in approved treatises upon real property and in accepted authorities on particular branches of real estate law, and has been so announced in decisions in the English courts and our own courts without number. Thus, in Washburn on Real Property, it is said that "a devise of the rents and profits of land, or the income of land, is equivalent to a devise of the land itself, and will be for life or in fee, according to the limitation expressed in the devise." Volume 2, p. 605, § 30.

In Jarman on Wills it is laid down that "a devise of the rents and profits or of the income of land passes the land itself, both at law and in equity; a rule, it is said, founded on the feudal law, according to which the whole beneficial interest in the land consisted in the right to take the rents and profits. And since the act 1 Vict. c. 26, such a devise carries the fee simple: but before that act it carried no more than an estate for life, unless words of inheritance were added." Mr Jarman cites numerous authorities in support of his statement. South v. Alleine, 1 Salk. 228; Goldin v. Lakeman, 2 Barn. & Adol 42; Johnson v. Arnold, 1 Ves. Sr. 171; Baines v. Dixon, Id. 42; Mannox v. Greener, L. R. 14 Eq 456; Blann v. Bell, 2 De Gex, M. & G 781; Plenty v. West, 6 C. B. 201.

Coke upon Littleton says: "If a man seised of lands in fee by his deed graunteth to another the profits of those lands, to have and to hold to him and his heires, and maketh livery secundum formam chartae, the whole land itselfe, doth passe; for what is the land but the profits thereof?" Lib. 1, p. 4b, c. 1, § 1.

In Goldin v. Lakeman, Lord Tenterden, Chief Justice of the court of the king's bench, to the same effect, said, "It is an established rule that a devise of the rents and profits is a devise of the land." And, in Johnson v. Arnold, Lord Chancellor Hardwicke reiterated the doctrine that a "devise of the profits of lands is a devise of the lands themselves."

The same rule is announced in this country, —the court of errors of New York, in Patterson v. Ellis, 11 Wend. 259, 298, holding that the "devise of the interest or of the rents and profits is a devise of the thing itself, out of which that interest or those rents and profits may issue;" and the supreme court of Massachusetts, in Reed v. Reed, 9 Mass. 372, 374, that "a devise of the income of lands is the same, in its effect, as a devise of the lands." The same view of the law was expressed in Anderson v. Greble, 1 Ashm. 136, 138; King, the president of the court, stating, "I take it to be a well-settled rule of law that by a devise of the rent, profits, and income of land, the land itself passes." Similar adjudications might be repeated almost indefinitely. One may have the reports of the English courts examined for several centuries without finding a single decision or even a dictum of their judges in conflict with them. And what answer do we receive to these adjudications? Those rejecting them furnish no proof that the framers of the constitution did not follow them, as the great body of the people of the country then did. An incident which occurred in this court and room 20 years ago may have become a precedent. To a powerful argument then being made by a distinguished counsel, on a public question, one of the judges exclaimed that there was a conclusive answer to his position, and that was that the court was of a different opinion. Those who decline to recognize the adjudications cited may likewise consider that they have a conclusive answer to them in the fact that they also are of a different opinion. I do not think so. The law, as expounded for centuries, cannot be set aside or disregarded because some of the judges are now of a different opinion from those who, a century ago, followed it, in framing our constitution.

Hamilton, speaking on the subject, asks, "What, in fact, is property but a fiction, without the beneficial use of it?" and adds, "In many cases, indeed, the income or annuity is the property itself." 3 Hamilton, Works (Putnam's Ed) p. 34.

It must be conceded that whatever affects any element that gives an article its value, in the eye of the law, affects the article itself.

In Brown v. Maryland, 12 Wheat. 419, it was held that a tax on the occupation of an importer is the same as a tax on his imports, and as such was invalid. It was contended that the state might tax occupations and that this was nothing more; but the court said, by Chief Justice Marshall (page 444): "It is impossible to conceal from ourselves that this is varying the form without varying the substance. It is treating a prohibition which is general as if it were confined to a particular mode of doing the forbidden thing. All must perceive that a tax on the sale of an article imported only for sale is a tax on the article itself."

In Weston v. Council, 2 Pet. 449, it was held that a tax upon stock issued for loans to the United States was a tax upon the loans themselves, and equally invalid. In Dobbins v. Commissioner, 16 Pet. 435, it was held that the salary of an officer of the United States could not be taxed, if the office was itself exempt. In Almy v. California, 24 How. 169, it was held that a duty on a bill of lading was the same thing as a duty on the article transported. In Cook v. Pennsylvania, 97 U. S. 566, it was held that a tax upon the amount of sales of goods made by an auctioneer was a tax upon the goods sold. In Philadelphia & S. S. S. Co. v. Pennsylvania, 122 U. S. 326, 7 Sup. Ct. 1118, and Leloup v. Port of Mobile, 127 U. S. 640, 648, 8 Sup. Ct. 1380, it was held that a tax upon the income received from interstate commerce was a tax upon the commerce itself, and equally unauthorized. The same doctrine was held in People v. Commissioners of Taxes, etc., 90 N. Y. 63; State Freight Tax Case, 15 Wall. 232, 274; Welton v. Missouri, 91 U. S. 275, 278; and in Fargo v. Michigan, 121 U. S. 230, 7 Sup. Ct. 857.

The law, so far as it imposes a tax upon land by taxation of the rents and income thereof, must therefore fail, as it does not follow the rule of apportionment. The constitution is imperative in its directions on this subject, and admits of no departure from them.

(5) But the law is not invalid merely in its disregard of the rule of apportionment of the direct tax levied. There is another and an equally cogent objection to it. In taxing incomes other than rents and profits of real estate it disregards the rule of uniformity which is prescribed in such cases by the constitution. The eighth section of the first article of the constitution declares that "the congress shall have power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defence and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States." Excises are a species of tax consisting generally of duties laid upon the manufacture, sale, or consumption of commodities within the country, or upon certain callings or occupations, often taking the form of exactions for licenses to pursue them. The taxes created by the law under consideration, as applied to savings banks, insurance companies, whether of fire, life, or marine, to building or other associations, or to the conduct of any other kind of business, are excise taxes, and fall within the requirement, so far as they are laid by congress, that they must be uniform throughout the United States.

The uniformity thus required is the uniformity throughout the United States of the duty, impost, and excise levied; that is, the tax levied cannot be one sum upon an article at one place, and a different sum upon the same article at another place. The duty received must be the same at all places throughout the United States, proportioned to the quantity of the article disposed of, or the extent of the business done. If, for instance, one kind of wine or grain or produce has a certain duty laid upon it, proportioned to its quantity, in New York, it must have a like duty, proportioned to its quantity, when imported at Charleston or San Francisco; or if a tax be laid upon a certain kind of business, proportioned to its extent, at one place, it must be a like tax on the same kind of business, proportioned to its extent, at another place. In that sense, the duty must be uniform throughout the United States.

It is contended by the government that the constitution only requires an uniformity geographical in its character. That position would be satisfied if the same duty were laid in all the states, however variant it might be in different places of the same state. But it could not be sustained in the latter case without defeating the equality, which is an essential element of the uniformity required, so far as the same is practicable.

In U. S. v. Singer, 15 Wall. 111, 121, a tax was imposed upon a distiller, in the nature of an excise, and the question arose whether in its imposition upon different distillers the uniformity of the tax was preserved, and the court said: "The law is not in our judgment subject to any constitutional objection. The tax imposed upon the distiller is in the nature of an excise, and the only limitation upon the power of congress in the imposition of taxes of this character is that they shall be 'uniform throughout the United States.' The tax here is uniform in its operation; that is, it is assessed equally upon all manufacturers of spirits, wherever they are. The law does not establish one rule for one distiller and a different rule for another, but the same rule for all alike."

In the Head Money Cases, 112 U. S. 580, 594, 5 Sup. Ct. 247, a tax was imposed upon the owners of steam vessels for each passenger landed at New York from a foreign port, and it was objected that the tax was not levied by any rule of uniformity, but the court, by Justice Miller, replied: "The tax is uniform when it operates with the same force and effect in every place where the subject of it is found. The tax in this case, which, as far as it can be called a tax, is an excise duty on the business of bringing passengers from foreign countries into this, by ocean navigation, is uniform, and operates precisely alike in every port of the United States where such passengers can be landed." In the decision in that case, in the circuit court (18 Fed. 135, 139), Mr. Justice Blatchford, in addition to pointing out that "the act was not passed in the exercise of the power of laying taxes," but was a regulation of commerce, used the following language: "Aside from this, the tax applies uniformly to all steam and sail vessels coming to all ports in the United States, from all foreign ports, with all alien passengers. The tax being a license tax on the business, the rule of uniformity is sufficiently observed if the tax extends to all persons of the class selected by congress; that is, to all owners of such vessels. Congress has the exclusive power of selecting the class. It has regulated that particular branch of commerce which concerns the bringing of alien passengers," and that taxes shall be levied upon such property as shall be prescribed by law. The object of this provision was to prevent unjust discriminations. It prevents property from being classified, and taxed as classed, by different rules. All kinds of property must be taxed uniformly or be entirely exempt. The uniformity must be coextensive with the territory to which the tax applies.

Mr. Justice Miller, in his lectures on the constitution, 1889-1890 (pages 240, 241), said of taxes levied by congress: "The tax must be uniform on the particular article; and it is uniform, within the meaning of the constitutional requirement, if it is made to bear the same percentage over all the United States. That is manifestly the meaning of this word, as used in this clause. The framers of the constitution could not have meant to say that the government, in raising its revenues, should not be allowed to discriminate between the articles which it should tax." In discussing generally the requirement of uniformity found in state constitutions, he said: "The difficulties in the way of this construction have, however, been very largely obviated by the meaning of the word 'uniform,' which has been adopted, holding that the uniformity must refer to articles of the same class; that is, different articles may be taxed at different amounts, provided the rate is uniform on the same class everywhere, with all people, and at all times."

One of the learned counsel puts it very clearly when he says that the correct meaning of the provisions requiring duties, imposts, and excises to be "uniform throughout the United States" is that the law imposing them should "have an equal and uniform application in every part of the Union."

If there were any doubt as to the intention of the states to make the grant of the right to impose indirect taxes subject to the condition that such taxes shall be in all respects uniform and impartial, that doubt, as said by counsel, should be resolved in the interest of justice, in favor of the taxpayer."

Exemptions from the operation of a tax always create inequalities. Those not exempted must, in the end, bear an additional burden or pay more than their share. A law containing arbitrary exemptions can in no just sense be termed "uniform." In my judgment, congress has rightfully no power, at the expense of others, owning property of the like character, to sustain private trading corporations, such as building and loan associations, savings banks, and mutual life, fire, marine, and accident insurance companies, formed under the laws of the various states, which advance no national purpose or public interest, and exist solely for the pecuniary profit of their members.

Where property is exempt from taxation, the exemption, as has been justly stated, must be supported by some consideration that the public, and not private, interests will be advanced by it. Private corporations and private enterprises cannot be aided under the pretense that it is the exercise of the discretion of the legislature to exempt them. Association v. Topeka, 20 Wall. 655; Parkersburg v. Brown, 106 U. S. 487, 1 Sup. Ct. 442; Barbour v. Board, 82 Ky. 645, 654, 655; City of Lexington v. McQuillan's Heirs, 9 Dana, 513, 516, 517; and Sutton's Heirs v. City of Louisville, 5 Dana, 28–31.

Cooley, in his treatise on Taxation (2d Ed. 215), justly observes that "it is difficult to conceive of a justifiable exemption law which should select single individuals or corporations, or single articles of property, and, taking them out of the class to which they belong, make them the subject of capricious legislative favor. Such favoritism could make no pretense to equality; it would lack the semblance of legitimate tax legislation."

The income tax law under consideration is marked by discriminating features which affect the whole law. It discriminates between those who receive an income of $4,000 and those who do not. It thus vitiates, in my judgment, by this arbitrary discrimination, the whole legislation. Hamilton says in one of his papers (the Continentalist): "The genius of liberty reprobates everything arbitrary or discretionary in taxation. It exacts that every man, by a definite and general rule, should know what proportion of his property the state demands; whatever liberty we may boast of in theory, it cannot exist in fact while [arbitrary] assessments continue." 1 Hamilton's Works (Ed. 1885) 270. The legislation, in the discrimination it makes, is class legislation. Whenever a distinction is made in the burdens a law imposes or in the benefits it confers on any citizens by reason of their birth, or wealth, or religion, it is class legislation, and leads inevitably to oppression and abuses, and to general unrest and disturbance in society. It was hoped and believed that the great amendments to the constitution which followed the late Civil War had rendered such legislation impossible for all future time. But the objectionable legislation reappears in the act under consideration. It is the same in essential character as that of the English income statute of 1691, which taxed Protestants at a certain rate, Catholics, as a class, at double the rate of Protestants, and Jews at another and separate rate. Under wise and constitutional legislation, every citizen should contribute his proportion, however small the sum, to the support of the government, and it is no kindness to urge any of our citizens to escape from that obligation. If he contributes the smallest mite of his earnings to that purpose, he will have a greater regard for the government and more self-respect for himself, feeling that, though he is poor in fact, he is not a pauper of his government. And it is to be hoped that, whatever woes and embarrassments may betide our people, they may never lose their manliness and self-respect. Those qualities preserved, they will ultimately triumph over all reverses of fortune.

There is nothing in the nature of the corporations or associations exempted in the present act, or in their method of doing business, which can be claimed to be of a public or benevolent nature. They differ in no essential characteristic in their business from "all other corporations, companies, or associations doing business for profit in the United States." Section 32, Law of 1894.

A few words as to some of them, the extent of their capital and business, and of the exceptions made to their taxation:

(1) As to Mutual Savings Banks. Under income tax laws prior to 1870, these institutions were specifically taxed. Under the new law,

certain institutions of this class are exempt, provided the shareholders do not participate in the profits, and interest and dividends are only paid to the depositors. No limit is fixed to the property and income thus exempted,—it may be $100,000 or $100,000,000. One of the counsel engaged in this case read to us during the argument from the report of the comptroller of the currency, sent by the president to congress, December 3, 1894, a statement to the effect that the total number of mutual savings banks exempted were 646, and the total number of stock savings banks were 378, and showed that they did the same character of business and took in the money of depositors for the purpose of making it bear interest, with profit upon it in the same way; and yet the 646 are exempt, and the 378 are taxed. He also showed that the total deposits in savings banks were $1,748,000,000.

(2) As to Mutual Insurance Corporations. These companies were taxed under previous income tax laws. They do business somewhat differently from other companies; but they conduct a strictly private business, in which the public has no interest, and have been often held not to be benevolent or charitable organizations.

The sole condition for exempting them under the present law is declared to be that they make loans to or divide their profits among their members or depositors or policy holders. Every corporation is carried on, however, for the benefit of its members, whether stockholders, or depositors, or policy holders. If it is carried on for the benefit of its shareholders, every dollar of income is taxed; if it is carried on for the benefit of its policy holders or depositors, who are but another class of shareholders, it is wholly exempted. In the state of New York the act exempts the income from over $1,000,000,000 of property of these companies. The leading mutual life insurance company has property exceeding $204,000,000 in value, the income of which is wholly exempted. The insertion of the exemption is stated by counsel to have saved that institution fully $200,000 a year over other insurance companies and associations, having similar property and carrying on the same business, simply because such other companies or associations divide their profits among their shareholders instead of their policy holders.

(3) As to Building and Loan Associations. The property of these institutions is exempted from taxation to the extent of millions. They are in no sense benevolent or charitable institutions, and are conducted solely for the pecuniary profit of their members. Their assets exceed the capital stock of the national banks of the country. One, in Dayton, Ohio, has a capital of $10,000,000, and Pennsylvania has $65,000,000 invested in these associations. The census report submitted to congress by the president, May 1, 1894, shows that their property in the United States amounts to over $628,000,000. Why should these institutions and their immense accumulations of property be singled out for the special favor of congress, and be freed from their just, equal, and proportionate share of taxation, when others engaged under different names, in similar business, are subjected to taxation by this law? The aggregate amount of the saving to these associations, by reason of their exemption, is over $600,000 a year.

If this statement of the exemptions of corporations under the law of congress, taken from the carefully prepared briefs of counsel and from reports to congress, will not satisfy parties interested in this case that the act in question disregards, in almost every line and provision, the rule of uniformity required by the constitution, then "neither will they be persuaded, though one rose from the dead." That there should be any question or any doubt on the subject surpasses my comprehension. Take the case of mutual savings banks and stock savings banks. They do the same character of business, and in the same way use the money of depositors, loaning it at interest for profit, yet 646 of them, under the law before us, are exempt from taxation on their income, and 378 are taxed upon it. How the tax on the income of one kind of these banks can be said to be laid upon any principle of uniformity, when the other is exempt from all taxation, I repeat, surpasses my comprehension.

But there are other considerations against the law which are equally decisive. They relate to the uniformity and equality required in all taxation, national and state; to the invalidity of taxation by the United States of the income of the bonds and securities of the states and of their municipal bodies; and the invalidity of the taxation of the salaries of the judges of the United States courts.

As stated by counsel: "There is no such thing in the theory of our national government as unlimited power of taxation in congress. There are limitations, as he justly observes, of its powers arising out of the essential nature of all free governments; there are reservations of individual rights, without which society could not exist, and which are respected by every government. The right of taxation is subject to these limitations." Citizens' Savings Loan Ass'n v. Topeka, 20 Wall. 655, and Parkersburg v. Brown, 106 U. S. 487, 1 Sup. Ct. 442.

The inherent and fundamental nature and character of a tax is that of a contribution to the support of the government, levied upon the principle of equal and uniform apportionment among the persons taxed, and any other exaction does not come within the legal definition of a "tax."

This inherent limitation upon the taxing power forbids the imposition of taxes which are unequal in their operation upon similar kinds of property, and necessarily strikes down the gross and arbitrary distinctions in the income law as passed by congress. The

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law, as we have seen, distinguishes in the taxation between corporations by exempting the property of some of them from taxation, and levying the tax on the property of others, when the corporations do not materially differ from one another in the character of their business or in the protection required by the government. Trifling differences in their modes of business, but not in their results, are made the ground and occasion of the greatest possible differences in the amount of taxes levied upon their incomes, showing that the action of the legislative power upon them has been arbitrary and capricious, and sometimes merely fanciful.

There was another position taken in this case which is not the least surprising to me of the many advanced by the upholders of the law, and that is that if this court shall declare that the exemptions and exceptions from taxation, extended to the various corporations mentioned, fire, life, and marine insurance companies, and to mutual savings banks, building, and loan associations, violate the requirement of uniformity, and are therefore void, the tax as to such corporations can be enforced, and that the law will stand as though the exemptions had never been inserted. This position does not, in my judgment, rest upon any solid foundation of law or principle. The abrogation or repeal of an unconstitutional or illegal provision does not operate to create and give force to any enactment or part of an enactment which congress has not sanctioned and promulgated. Seeming support of this singular position is attributed to the decision of this court in Huntington v. Worthen, 120 U. S. 97, 7 Sup. Ct. 469. But the examination of that case will show that it does not give the slightest sanction to such a doctrine. There the constitution of Arkansas had provided that all property subject to taxation should be taxed according to its value, to be ascertained in such manner as the general assembly should direct, making the same equal and uniform throughout the state, and certain public property was declared by statute to be exempt from taxation, which statute was subsequently held to be unconstitutional. The court decided that the unconstitutional part of the enactment, which was separable from the remainder, could be omitted and the remainder enforced; a doctrine undoubtedly sound, and which has never, that I am aware of, been questioned. But that is entirely different from the position here taken, that exempted things can be taxed by striking out their exemption.

The law of 1894 says there shall be assessed, levied, and collected, "except as herein otherwise provided," 2 per centum of the amount, etc. If the exceptions are stricken out, there is nothing to be assessed and collected except what congress has otherwise affirmatively ordered. Nothing less can have the force of law. This court is impotent to pass any law on the subject. It has no legislative power. I am unable, therefore, to see how we can, by declaring an exemption or exception invalid, thereby give effect to provisions as though they were never exempted. The court by declaring the exemptions invalid cannot, by any conceivable ingenuity, give operative force as enacting clauses to the exempting provisions. That result is not within the power of man.

The law is also invalid in its provisions authorizing the taxation of the bonds and securities of the states and of their municipal bodies. It is objected that the cases pending before us do not allege any threatened attempt to tax the bonds or securities of the state, but only of municipal bodies of the states. The law applies to both kinds of bonds and securities, those of the states as well as those of municipal bodies, and the law of congress we are examining, being of a public nature, affecting the whole community, having been brought before us and assailed as unconstitutional in some of its provisions, we are at liberty, and I think it is our duty, to refer to other unconstitutional features brought to our notice in examining the law, though the particular points of their objection may not have been mentioned by counsel. These bonds and securities are as important to the performance of the duties of the state as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the states. As stated by Judge Cooley in his work on the Principles of Constitutional Law: "The power to tax, whether by the United States or by the states, is to be construed in the light of and limited by the fact that the states and the Union are inseparable, and that the constitution contemplates the perpetual maintenance of each with all its constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the federal government does not therefore extend to the means or agencies through or by the employment of which the states perform their essential functions; since, if these were within its reach, they might be embarrassed, and perhaps wholly paralyzed, by the burdens it should impose. 'That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, in respect to those very measures, is declared to be supreme over that which exerts the control,—are propositions not to be denied.' It is true that taxation does not necessarily and unavoidably destroy, and that to carry it to the excess of destruction would be an abuse not to be anticipated;

but the very power would take from the states a portion of their intended liberty of independent action within the sphere of their powers, and would constitute to the state a perpetual danger of embarrassment and possible annihilation. The constitution contemplates no such shackles upon state powers, and by implication forbids them."

The internal revenue act of June 30, 1864, in section 122, provided that railroad and certain other companies specified, indebted for money for which bonds had been issued, upon which interest was stipulated to be paid, should be subject to pay a tax of 5 per cent. on the amount of all such interest, to be paid by the corporations, and by them deducted from the interest payable to the holders of such bonds; and the question arose in U. S. v. Baltimore & O. R. Co., 17 Wall. 322, whether the tax imposed could be thus collected from the revenues of a city owning such bonds. This court answered the question as follows: "There is no dispute about the general rules of the law applicable to this subject. The power of taxation by the federal government upon the subjects and in the manner prescribed by the act we are considering is undoubted. There are, however, certain departments which are excepted from the general power. The right of the states to administer their own affairs through their legislative, executive, and judicial departments, in their own manner, through their own agencies, is conceded by the uniform decisions of this court, and by the practice of the federal government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other."

And, again: "A municipal corporation like the city of Baltimore is a representative not only of the state, but it is a portion of its governmental power. It is one of its creatures, made for a specific purpose, to exercise within a limited sphere the powers of the state. The state may withdraw these local powers of government at pleasure, and may, through its legislature or other appointed channels, govern the local territory as it governs the state at large. It may enlarge or contract its powers or destroy its existence. As a portion of the state, in the exercise of a limited portion of the powers of the state, its revenues, like those of the state, are not subject to taxation."

In Collector v. Day, 11 Wall. 113, 124, the court, speaking by Mr. Justice Nelson, said: "The general government and the states, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former, in its appropriate sphere, is supreme; but the states, within the limits of their powers not granted, or, in the language of the tenth amendment, 'reserved,' are as independent of the general government as that government within its sphere is independent of the states."

According to the census reports, the bonds and securities of the states amount to the sum of $1,243,268,000, on which the income or interest exceeds the sum of $65,000,000 per annum, and the annual tax of 2 per cent. upon this income or interest would be $1,300,000.

The law of congress is also invalid in that it authorizes a tax upon the salaries of the judges of the courts of the United States, against the declaration of the constitution that their compensation shall not be diminished during their continuance in office. The law declares that a tax of 2 per cent. shall be assessed, levied, and collected, and paid annually upon the gains, profits, and income received in the preceding calendar year by every citizen of the United States, whether said gains, profits, or income be derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation carried on within the United States or elsewhere, or from any source whatever. The annual salary of a justice of the supreme court of the United States is $10,000, and this act levies a tax of 2 per cent. on $6,000 of this amount, and imposes a penalty upon those who do not make the payment or return the amount for taxation.

The same objection, as presented to a consideration of the objection to the taxation of the bonds and securities of the states, as not being specially taken in the cases before us, is urged here to a consideration of the objection to the taxation by the law of the salaries of the judges of the courts of the United States. The answer given to that objection may be also given to the present one. The law of congress, being of a public nature, affecting the interests of the whole community, and attacked for its unconstitutionality in certain particulars, may be considered with reference to other unconstitutional provisions called to our attention upon examining the law, though not specifically noticed in the objections taken in the records or briefs of counsel that the constitution may not be violated from the carelessness or oversight of counsel in any particular. See O'Neil v. Vermont, 144 U. S. 359, 12 Sup. Ct. 693.

Besides, there is a duty which this court owes to the 100 other United States judges who have small salaries, and who, having their compensation reduced by the tax, may be seriously affected by the law.

The constitution of the United States provides in the first section of article 3 that "the judicial power of the United States shall be vested in one supreme court, and in such inferior courts as the congress may from time to time ordain and establish. The judges, both of the supreme and inferior courts, shall hold their offices during good behavior, and shall, at stated times, receive for their services a compensation, which shall not be diminished during their continuance in office." The act of congress under discussion imposes, as said, a tax on $6,000 of this compensation, and therefore diminishes each year the compensation provided for every justice. How a similar law of congress was regarded 30 years ago may be shown by the following incident, in which the justices of this court were assessed at 3 per cent. upon their salaries. Against this Chief Justice Taney protested in a letter to Mr. Chase, then secretary of the treasury, appealing to the above article in the constitution, and adding: "If it [his salary] can be diminished to that extent by the means of a tax, it may, in the same way, be reduced from time to time, at the pleasure of the legislature." He explained in his letter the object of the constitutional inhibition thus:

"The judiciary is one of the three great departments of the government created and established by the constitution. Its duties and powers are specifically set forth, and are of a character that require it to be perfectly independent of the other departments. And in order to place it beyond the reach, and above even the suspicion, of any such influence, the power to reduce their compensation is expressly withheld from congress, and excepted from their powers of legislation.

"Language could not be more plain than that used in the constitution. It is, moreover, one of its most important and essential provisions. For the articles which limit the powers of the legislative and executive branches of the government, and those which provide safeguards for the protection of the citizen in his person and property, would be of little value without a judiciary to uphold and maintain them which was free from every influence, direct or indirect, that might by possibility, in times of political excitement, warp their judgment.

"Upon these grounds, I regard an act of congress retaining in the treasury a portion of the compensation of the judges as unconstitutional and void."

This letter of Chief Justice Taney was addressed to Mr. Chase, then secretary of the treasury, and afterwards the successor of Mr. Taney as chief justice. It was dated February 16, 1863; but as no notice was taken of it, on the 10th of March following, at the request of the chief justice, the court ordered that his letter to the secretary of the treasury be entered on the records of the court, and it was so entered. And in the memoir of the chief justice it is stated that the letter was, by this order, preserved "to testify to future ages that in war, no less than in peace, Chief Justice Taney strove to protect the constitution from violation."

Subsequently, in 1869, and during the administration of President Grant, when Mr. Boutwell was secretary of the treasury, and Mr. Hoar, of Massachusetts, was attorney general, there were in several of the statutes of the United States, for the assessment and collection of internal revenue, provisions for taxing the salaries of all civil officers of the United States, which included, in their literal application, the salaries of the president and of the judges of the United States. The question arose whether the law which imposed such a tax upon them was constitutional. The opinion of the attorney general thereon was requested by the secretary of the treasury. The attorney general, in reply, gave an elaborate opinion advising the secretary of the treasury that no income tax could be lawfully assessed and collected upon the salaries of those officers who were in office at the time the statute imposing the tax was passed, holding on this subject the views expressed by Chief Justice Taney. His opinion is published in volume 13 of the Opinions of the Attorney General, at page 161. I am informed that it has been followed ever since without question by the department supervising or directing the collection of the public revenue.

Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the government. If the provisions of the constitution can be set aside by an act of congress, where is the course of usurpation to end? The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich,—a war constantly growing in intensity and bitterness. "If the court sanctions the power of discriminating taxation, and nullifies the uniformity mandate of the constitution," as said by one who has been all his life a student of our institutions, "it will mark the hour when the sure decadence of our present government will commence." If the purely arbitrary limitation of four thousand dollars in the present law can be sustained, none having less than that amount of income being assessed or taxed for the support of the government, the limitation of future congresses may be fixed at a much larger sum, at five or ten or twenty thousand dollars, parties possessing an income of that amount alone being bound to bear the burdens of government; or the limitation may be designated at such an amount as a board of "walking delegates" may deem necessary. There is no safety in allowing the limitation to be adjusted except in strict compliance with the mandates of the constitution, which require its taxation, if imposed by direct tax-

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es, to be apportioned among the states according to their representation, and, if imposed by indirect taxes, to be uniform in operation and, so far as practicable, in proportion to their property, equal upon all citizens. Unless the rule of the constitution governs, a majority may fix the limitation at such rate as will not include any of their own number.

I am of opinion that the whole law of 1894 should be declared void, and without any binding force,—that part which relates to the tax on the rents, profits, or income from real estate, that is, so much as constitutes part of the direct tax, because not imposed by the rule of apportionment according to the representation of the states, as prescribed by the constitution; and that part which imposes a tax upon the bonds and securities of the several states, and upon the bonds and securities of their municipal bodies, and upon the salaries of judges of the courts of the United States, as being beyond the power of congress; and that part which lays duties, imposts, and excises, as void in not providing for the uniformity required by the constitution in such cases.

APPENDIX C

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THE CONSTITUTIONALITY OF THE GRADUATED INCOME TAX LAW

Whether under the constitutional power to levy a tax Congress may impose upon incomes of larger amount a higher rate of tax than upon smaller incomes, is a question of very grave importance. The Tariff Act of 1913, in subdivision two, provides for levying, assessing and collecting an additional income tax. This additional tax is commonly known as a "surtax." In the opinion of a great many lawyers this feature of the income tax law violates that principle of equality which requires that all taxable incomes, so far as amount is concerned, be treated alike. To accept without question the doctrine of an existence of this power in Congress falls little short of conceding that Congress may legally confiscate the property of a citizen.

The following article was prepared a year or more ago, before announcement by the Supreme Court of the United States (January 24, 1916) of a decision that appears to sustain the constitutionality of the power to impose a surtax. We refer to *Brushaber v. Union Pacific R. R. Co.*, in which the opinion is delivered by the Chief Justice. The Bar had reason to expect that this long-looked for opinion would discuss the question that had been raised as to equality; that it would point out the reasons why such a principle does not forbid Congress from imposing a higher rate of income tax, based on the ground that the owner of the income can afford to pay a larger tax. Their expectation has been disappointed. All that the opinion of the learned Chief Justice vouchsafes to remark upon the subject is comprised in the following extract:

> "It is true that it is elaborately insisted that although there be no express constitutional provision prohibiting it, the progressive feature of the tax causes it to transcend the conception of all taxation and to be a mere arbitrary abuse of power which must be treated as wanting in due process. But the proposition disregards the fact that in the very early history of the government a progressive tax was imposed by Congress and that such authority was exerted in some, if not all, of the various income taxes enacted prior to 1894 to which we have previously adverted. And over and above all this the contention but disregards the further fact that its absolute want of foundation in reason was plainly pointed out in *Knowlton v. Moore*, 178 U. S. 41, and the right to urge it was necessarily foreclosed by the ruling in that case made."

Since this vital question has nowhere been discussed by the Court with an approach to fulness, we are persuaded that it may be profitable to set forth the argument which challenges the statement of the Chief Justice that there is an "absolute want of foundation in reason" for the unconstitutionality of the assumed power to levy a surtax. Interesting as the subject is from a political and historical point of view, no less than in its legal aspect, it is well to let the reader decide for himself whether the Supreme Court has really disposed of the question to the satisfaction of the student of constitutional law.

In order to determine whether Congress has exceeded its powers in undertaking to impose a progressive income tax, one must rightly apprehend the origin and the nature of a property tax. For what reason, we may ask, has the legislature a right to levy a tax upon the property of a citizen?

The usual answer is—for the support of the government. That indeed is the object of collecting the money: but why has the government a right to compel each citizen to pay something? To what source do we trace the justification of laying a tax? The reply is obvious:

Every citizen enjoys the protection of his government, as respects his property. It is fair then that he pay a proportionate share of tax to meet the expense of what it shall cost to maintain that government. The amount he is called upon to pay represents a *quid pro quo*. A secure holding of property is furnished by the government. The value of a citizen's property supplies a standard, according to which his share of the general expense can be estimated. To be sure, an assessment may not be accurate in every instance; but in a rough kind of way property value may be arrived at, and a fairly just estimate ascertained, upon which to base the amount to be paid.

Writers upon political economy, as well as judges in their opinions, are in the habit of designating a tax as a "burden." Nobody, it is true, derives pleasure from paying a tax-bill. The circumstance is in some measure to be accounted for by the fact that seldom has the taxpayer anything to do with deciding how money raised by taxation shall be expended. There has been, and there always will be, room for complaint that the tax might have been lighter, or the money might have been laid out to better advantage. Hence, we have become used to the expression "burden of taxation."

The term "burden of taxation" is apt, however, to mislead us when we come to view the tax from a legal standpoint. An ordinary tax upon property ought no more to be styled a burden, than a man's bill for his groceries, or for keeping an automobile, or—to instance the sharing of a common expense—for his annual dues at the club. A tax, of course, is an expense; but the taxpayer has received, or will receive, something for it. He may not be sensible that the government, all through the twenty-four hours, has been protecting his life and his property. Yet if he but stop and think, he will perceive that, provided he is required to pay his proportionate share, and no more, it is only right that he furnish the government with the means to meet such expenses as the state shall incur in his behalf.

An alien, who resides elsewhere than in the United States, receives the protection of our government, as respects his income earned in the United States. He is taxed in recognition of that measure of protection. No one will be found to dispute the fairness of this plan of procedure.

We repeat that we must not allow ourselves to be led astray by the use of the term, "burden of taxation." Let us admit that the proper way of looking at the subject is, to conceive that the state requires of the citizen a payment of taxes, because the state has given, or will give, to him, something of value, namely, protection afforded to his property, and to his right to acquire property.

This "something of value" naturally enough can be laid hold of as a standard by which to measure the tax to be levied, assessed, and collected. The amount of protection in general afforded a citizen by his government is necessarily incapable of exact measurement. But the value in the rough of a man's property is in most cases attainable. So too the amount of a person's annual income may in a fair degree be computed. A normal tax, in the Act of 1913, is levied on net income—irrespective of what that income may be worth to the individual who has received it. So far as the normal tax is concerned, all are treated alike who have to pay one. We may dismiss a consideration of the size of the exemption. The present effort is directed solely to a proper estimate of the character of the additional tax, which is sought to be collected under the system of a graduated income tax.

With this proposal in mind, let us look into the nature of the additional income tax which the act undertakes to levy, assess, and collect, in order to ascertain, if we may, whether it be in harmony with that principle which affords assurance to every citizen that he shall enjoy the equal protection of the law.[a]

Subdivision 2 enacts that besides a tax of one per centum upon the entire net income arising or accruing from all sources, "an additional income tax shall be collected of one per centum upon the amount by which the total net income exceeds $20,000, and does not exceed $50,000," and so on through $75,000, $100,000, $250,000, until six per cent per annum is reached on the amount by which the total net income exceeds $500,000. How the progressive feature of this plan of taxation works may be illustrated as follows:

A has an income of $20,000. B, of $100,000. They are married men, and each is entitled to an exemption of $4,000. A is required to pay a normal tax of $160. B pays a normal tax of $960. B pays more than A in proportion as his income is larger than A's.

Under the scheme thus set in operation of levying a tax, we discover that B is compelled to pay a great deal more than that which his proportion demands. This sum of $960 pays the government for all the protection which B has received for his

[a] The terms "due process of law," and "the equal protection of the laws," so far as they relate to the property rights of a citizen, may be regarded as identical in meaning. They can be used interchangeably as denoting the protection afforded by an application of that fundamental principle of our polity which assures to every man a treatment by the legislature of his state, or by the Congress of the United States, which shall be of a character precisely similar to that accorded every other man situated in like circumstances. In a word, each term spells equality.

$100,000. He owes the government nothing further on that score. Yet B is compelled to pay an additional tax of $300 and $500, and $750, or a total surtax of $1,550.

One is at a loss to find out upon what principle this requirement to pay $1,550 is founded. Clearly, B has received no larger amount of protection from the government proportionately than has A. From one point of view it looks as though a penalty were imposed upon B for enjoying a larger income than $20,000 a year, per annum. Indeed, no other reason for the exaction seems to exist. This conception of what B ought to pay is all the more inexplicable when we see that a very large number of citizens, whose income is $4,000 or a little less than that sum, are not required to pay anything whatever for the protection which they have received from the government in respect of their annual income. Thought of an equality of payment in this act seems to have been abandoned.

When we turn to other departments of the government, where the citizen is treated upon a *quid pro quo* basis, we discover no inequality. B does not have to pay any higher rate of postage on his letters, or upon parcels sent by mail, than A.

What larger service has been rendered B as to each dollar of his income, than has been rendered A? Clearly none. In every aspect of the case, therefore, an imposition of a greater percentage upon a larger amount of income is found to be an arbitrary and an unjust exaction.

> "A pretended classification that is based solely on a difference in quantity of precisely the same kind of property is necessarily unjust, arbitrary, and illegal. For example, a division of personal property into three classes with a view of imposing a different tax rate on each, class 1 consisting of personal property exceeding in value the sum of $100,000; class 2 consisting of personal property exceeding in value $20,000, and not exceeding $100,000; and class 3 consisting of personal property not exceeding in value $20,000, would be so manifestly arbitrary and illegal that no one would attempt to justify it."[1]

Let us turn to the case of *Knowlton v. Moore*, 178 U. S. 41, decided in 1900. The legacy tax imposed by the Act of June 13, 1898 (20 Stat. 448) was there brought under review. The Court held that the tax was laid upon the right of transmitting property from the dead to the living; and that the fact that this privilege

[1] Per Sterrett, C. J., in *Cope's Appeal*, 191 Pa. St. 22.

is granted by a state does not deprive the United States of the right to impose the tax.

Says Mr. Justice White at page 109:

> "Lastly it is urged that the progressive rate feature of the statute is so repugnant to fundamental principles of equality and justice that the law should be held to be void, even although it transgresses no express limitation in the Constitution. Without intimating any opinion as to the existence of a right in the courts to exercise the power which is thus invoked, it is apparent that the argument as to the enormity of the tax is without merit. It was disposed of in *Magoun v. Illinois Trust & Savings Bank*, 170 U. S. 283, 293.[1]

This language would signify that the objection of a want of equality as urged in the Knowlton case is without force since the Magoun case had disposed of any such argument. Such, we apprehend, is the decision of the Court upon the question of a progressive tax.

When one comes to examine the Magoun case, he finds that the Court rest their decision upon the power of the state to attach any condition it pleases to a grant of the right to inherit, or to receive property under a testamentary disposition. The privilege granted to an heir, or legatee, to become the owner of an estate left by the deceased, is the creation of the state. The state, therefore, is free to tax that privilege in such manner and to such extent as it shall see fit.

> "The tax is not on money; it is on the right to inherit; and hence a condition of inheritance, and it may be graded according to the value of that inheritance." Per McKenna, J., p. 300.[2]

Mr. Justice Brewer, dissenting in the Magoun case, remarks:

> "It seems to be conceded that if this were a tax upon property such increase in the rate of taxation could not be sustained, but being a tax upon succession it is held that a different rule prevails. The argument is that

[1] Mr. Justice Brewer dissented, in the Knowlton case, from so much of the opinion as holds that a progressive rate of tax can be validly imposed. (P. 110.)

[2] It is worthy of mention that when the Magoun case was argued, the Solicitor General, in his additional brief, at page 11, frankly admitted as follows: "If this tax be a property tax, it is clearly invalid."

because the state may regulate inheritances and the extent of testamentary dispositic ı it may impose thereon any burdens, including therein taxes, and impose them in any manner it chooses." P. 302.[4]

[4] The decision in the Knowlton case, it is to be observed, goes no farther than to declare that a tax upon a right to inherit, or to take a legacy, may be sustained, though the tax be graduated, or progressive. In circumstances of this nature the state may well enough seek to share the good fortune of a recipient. Probably no one cares to object to handing over to the state such an amount as the statute names, even though there be a departure from the strict rule of equality in fixing the amount to be paid by way of a tax.

The learned Chief Justice, as we have seen, declares in language that comes very near being a rebuke to him who would think otherwise, that the "absolute want of foundation in reason" of the objection that the principle of equality is violated, was plainly pointed out in *Knowlton v. Moore*. Yet many lawyers had entertained a belief that *Knowlton v. Moore* deals solely with a tax on the right of inheritance, or the right to receive a legacy—and that it decided nothing with regard to a progressive tax on property.

The editors of the Columbia Law Review appear to have failed to discover what it now seems had been "plainly pointed out" by Mr. Justice White in his opinion in the Knowlton case. In May, 1912, speaking of the Income Tax law, they observe:

> "It is apparent that the constitutionality of progressive income taxation has never been passed upon with reference to the Fifth and Fourteenth Amendments; that such a rate has been judicially sanctioned only when applied to an inheritance tax; and that an *obiter dictum*, unsupported by authority, is the only Supreme Court utterance on the question of applying such a rate to a tax on property." Vol. XII, p. 445.

It is fitting that the remarks be appended here which the writer of the opinion in *Knowlton v. Moore* adds after stating what *Magoun v. Illinois Trust & Savings Bank* had "disposed of." The words with which Mr. Justice White continues may serve to explain what the Columbia Law Review had in mind when speaking of an *obiter dictum*:

> "The review which we have made exhibits the fact that taxes imposed with reference to the ability of the person upon whom the burden is placed to bear the same have been levied from the foundation of the government. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is legislative and not judicial. The grave consequences which it is asserted must arise in the future if the right to levy a progressive tax be recognized involves in its ultimate aspect the mere assertion that free and representative government is a failure, and that the grossest abuses of power are foreshadowed unless the courts usurp a purely legislative function. If a case should ever arise, where an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford a remedy by applying inherent

While writers upon law or economics may differ as to the meaning of the terms "just and equal," when applied to the operation of a statute imposing a tax, it may be said to be generally admitted that at least a semblance of equality should characterize every enactment that lays a direct tax upon the property of a citizen of the United States. Chief Justice Sterrett, in the opinion already cited, has quoted with approval the following language of authoritative text-writers:

> "It is of the very essence of taxation that it should be relatively equal and uniform, and where the burden is common there should be a common contribution to discharge it: Cooley's Constitutional Limitations, 495. In his Treatise on Taxation the same learned author says: 'In an exercise of the power to tax, the purpose always is that a common burden shall be sustained by common contributions, regulated by some fixed general rule and apportioned by the law according to some uniform ratio of equality. The power is not, therefore, arbitrary, but rests on fixed principles of justice, which have for their object the protection of the taxpayer against exceptional and invidious exactions, and is to have effect through established rules operating impartially.'
>
> 'Equality in the imposition of the burden is of the very essence of the right, and though absolute equality and absolute justice may not be attainable, the adoption of some rule, tending to that end is indispensable. Equality as far as practicable and security of property against irresponsible power are principles which underlie the power of taxation as declared ends and principles of fundamental law.' Desty on Taxation, 29, and cases there cited."

In considering what has been cited from the opinion of Sterrett, C. J., it is well to remember that the constitution of Pennsylvania, of 1874, prescribes that "all taxes shall be uniform upon

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> and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so. That the law which we have construed affords no ground for the contention that the tax imposed is arbitrary and confiscatory is obvious." (P. 109.)

There has thus been laid before the reader the entire language devoted to the question of the constitutionality of a progressive tax in the sixty-six printed pages of the reported opinion in *Knowlton v. Moore*. That there are those who are slow to discover just where the learned Justice in this expression of views has "plainly pointed out" what is now termed "the absolute want of foundation in reason" of the position maintained by Mr. Justice Brewer, will, we conjecture, be conceded by not a few members of the bar, and perhaps, here and there, by an editor of a law review.

the same class of subjects within the territorial limits of the authority levying the taxes, and shall be levied and collected under general laws."[5]

The requirement of uniformity but expresses a fundamental principle that everywhere prevails in respect to the taxing power. That a favored class should exist under the law is abhorrent to the sense of equality which must ever animate the motive power of a government by the people.

As Mr. Justice Brewer happily phrases it:

> "Equality in right, in protection, and in burden is the thought which has run through the life of this Nation and its constitutional enactments from the Declaration of Independence to the present hour."[6]

This clear-thinking Justice likewise pronounced the inheritance tax unconstitutional, since, in his opinion, it was,

> "a tax unequal because not proportioned to the amount of the estate; unequal because based upon a classification purely arbitrary, to-wit, that of wealth—a tax directly and intentionally made unequal. I think the Constitution of the United States forbids such inequality." P. 303.

The scheme of a progressive tax on income appears to have originated in the Parliament of Great Britain. Its existence is to be traced in British statutes as far back as 1797. Yet inequality we find did not become acquiesced in until after a strong protest. Justification for the adoption of such a feature is to be accounted for because of a conception in the British mind that there existed in the Kingdom distinct classes of people—an upper class with rights and duties growing out of the ownership of the land (chiefly by inheritance), and the enjoyment of a large amount of personal property. "Press lightly on the lower orders of the people," is a phrase to be met with in Dowell's History of Taxation. It was the upper classes that held the offices. Naturally enough the favored few felt that it was only right and proper that they should pay a larger share of the taxes, than that which a proportionate scale would prescribe. In other words, the distinction between the higher and the lower orders of the people suggested an easy step toward rating a man's tax by his capacity

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[5] Purdon's Digest (11th Ed.), p. 41.

[6] Dissenting opinion in *Magoun v. Trust Co.*, 170 U. S. 301.

to pay. Consequently the British taxpayer acquiesced in the plan of imposing a larger percentage of the "burden" upon men of wealth.[7]

The power of Parliament to impose a graduated tax, of course is not questioned. Says Mr. Lecky, speaking of a taxation upon inheritance:

> "No doubt the Supreme Legislature in England has the power of confiscation. But moral right and constitutional power are different things; and it is one of the worst consequences of the English doctrine of the omnipotence of Parliament that it tends to confuse them."[8]

Another explanation of the ready acceptance in England of the doctrine of a graduated tax upon income may be found in the theory that the citizen contributes of his means to the support of the government. It is the Commons that votes money. The Lords have no part in the procedure. The idea prevails that the vote signifies "a free gift" from the people to the King.

Where the underlying thought is that of a gift, it naturally comes about that a man of wealth feels it his duty to be governed by a spirit of generosity. He takes it to be a matter of course that a gentleman should respond with unhesitating liberality. One sees how inequality in respect to a tax on income may thus have come to characterize a usage without its appearing to the body of taxpayers to be unjust or unfair.

At the same time the British legislature does not fail to recognize equality as an indispensable factor in the framing of tax laws in general. Wharton, in his English Law Dictionary, defines a tax by employing the words of Adam Smith (Wealth of Nations, book V, chap. II):

> "The subjects of every state ought to contribute to the support of the government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the pro-

[7] A similar disparity had long existed in the British Navy in regard to prize-money. It is related of a British man-of-war's-man, of the olden time, that just after the decks had been sanded down, preliminary to going into action, he knelt for a brief prayer. To a ship-mate who asked him for what he was praying, he replied:

"I was asking that the cannon-balls, like prize-money, may be distributed chiefly among the officers."

[8] II Democracy and Liberty, 501.

tection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint-tenants of a great estate, who are all obligated to contribute in proportion to their respective interests in the estate."

Mr. Lecky's treatment of the subject of taxation in England is worthy of examination, since it helps to a better understanding of the principles involved in the present discussion. Speaking of equality, this acute observer and fair-minded writer remarks:

> "The great majority of serious economists have, I believe, agreed that, as a matter of strict right, this doctrine is the true one. Adam Smith, however, clearly saw that human affairs cannot, or will not, be governed by the strict lines of economic science, and he fully recognized that it may be expedient that taxes should be so regulated that the rich should pay in proportion something more than the poor. In England, the system of graduated taxation which I have described has passed fully into the national habits, and is accepted by all parties."*

It is clear, therefore, that a departure from strict equality, as illustrated by the English graduated income law, is properly to be referred to the willingness evinced by the upper classes to take upon themselves a larger "burden," to make a larger "gift," in view of the fact that they had retained to themselves a right to govern. From a like honorable sense of obligation is it that members of Parliament, until recent times, served without compensation, as did magistrates in the country districts. The system, moreover, is the outcome of a stand taken at the time of the French Revolution, a century earlier, when the democratic idea had made but slight headway in England. It is a system that may not be appealed to, at the present day, as indicating a rigid adherence to the principle of equality.

These few words of explanation are sufficient to dispel any lurking thought that a graduated income tax is in itself consistent with a design of extending to taxpayers an equal treatment. The system to which England has accustomed herself cannot be held up as exhibiting a just and fair method which the United States may follow to advantage. With us it is hardly necessary to declare there are no upper classes that govern; or "lower orders of the people," who are not admitted to take part in the

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* I Democracy and Liberty, 342.

administration of public business. We must not for a moment forget the salutary rule that we are bound to treat all taxpayers alike.

After this peculiar method of levying a tax in England had come to be a familiar practice, writers upon political economy, who analyzed the income tax law critically, found themselves hard put to it to demonstrate its fairness and justice. They were driven to invent an explanation which should reconcile "progressive" taxation with a due observance of the principle of equality. At last, with a display of not a little ingenuity, some one appears to have hit upon the term, "equality of sacrifice."

A progressive tax, we are told, is to be supported upon the plausible theory that ability to pay is the true test of a citizen's duty to the state, in respect to bearing the burden of taxation. One does not have to look far to discover that "equality of sacrifice" is, in truth, no equality at all. The term disguises an untenable proposal that a man's ability to pay ought to be taken as a measure of what he should be made to pay. So fantastic an idea, we need hardly repeat, is wholly at variance with a sound theory of governmental protection. It is out of harmony with the genius of our institutions.

The principle of equality in taxation is in itself so just and so reasonable, and so generally has it been acquiesced in, that no argument is needed to sustain the position that the legislature in deliberately violating this principle does nothing else than convert what purports to be a statute law into an exercise of arbitrary power, which in reality is no law at all. When the question is put, does a graduated tax conform to the rule of equality, but one answer can be returned.

Sometimes in judicial opinions it is stated, rather unnecessarily, that absolute equality is not attainable. Of course, the rule at most demands only such a measure of equality as the nature of the case shall admit. Where equal treatment can be assigned to every person coming under the law, the rule is imperative. For example, a tax upon the realty has always been, and always will be, laid according to the assessed value of the land. In like manner a tax upon income ought to be imposed upon the money value which the income represents. Why should not a citizen pay a tax precisely according to his income—no more, and no less? A man whose income is $50,000 should pay twice as much as his neighbor whose income is $25,000. So clear is this proposal that it seems a waste of time to advance it. Yet, there are legislators who have succeeded in convincing themselves that the enjoyment of so large an income as $50,000 demands of its owner a larger proportionate payment to the state by way of tax than is to be required of a less fortunate neighbor. We confess that we are unable to comprehend how such a departure from the ordinary course of reasoning on the subject can be rested upon any logical basis.

To declare that in respect to his income a citizen shall pay a tax, to be determined not by the amount of that income, but by his capacity to pay, is to rely upon specious reasoning that will not bear analysis. Such a proposal is a mere device to hide the arbitrariness with which the tax is imposed. Levying upon a man a tax whose amount shall be larger only because he is seen to be able to pay that larger amount, is an example of empirical legislation not to be countenanced under our form of government. It strikes down equality before the law.

Right here is it that the constitutionality of a graduated income tax enactment hinges. That a case of unequal taxation is presented cannot be denied. That the enactment violates a fundamental principle in the levying of taxes in order to meet the expenses of government, is perfectly clear. Once let it be conceded that Congress can impose a tax, measured not by the amount of property which is protected by the government, but by the capacity of the citizen to pay, and the door is opened for confiscation. Hardly can a situation be conceived where a thoughtful well-wisher for the health of the body politic must more keenly feel it his duty to sound a note of caution against yielding to temptation in its earliest stages, than in the present instance. The first step taken, a steady progress thereafter toward confiscation may not readily be resisted. Nor is the danger of that character which may be met by the familiar reasoning that we are not to press an argument founded upon a possible abuse by the legislature of a power which they possess, and which they are expected wisely to exercise.

Confiscation, we repeat, may be reached, though disguised under another name.

Here we may take notice of the language, *ut supra,* of Mr. Justice White in his opinion in the Knowlton case. After declaring that the decision in the Magoun case disposes of the argument as to inequality, the learned Justice is reported as saying:

> "The review which we have made exhibits the fact that taxes imposed with reference to the ability of the person

> upon whom the burden is placed to bear the same have been levied from the foundation of the government. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or not is legislative and not judicial."

A graver question confronts us than the inquiry whether a progressive tax is more just and equal than a proportional tax. That question is: Can a progressive tax be pronounced to be an *equal* tax at all?

As regards the weight to be given to the views of "economic writers," we need only repeat the remarks of Mr. Justice Peckham, in *Nichol v. Ames*, 173 U. S. 516, which remarks Mr. Justice White already (at page 83 of the Knowlton case) has cited with approval:

> "Taxation is eminently practical, and is in fact brought to every man's door, and for the purpose of deciding upon its validity a tax should be regarded in its actual, practical results, rather than with reference to those theoretical or abstract ideas, whose correctness is the subject of dispute and contradiction among those who are experts in the science of political economy."

A further excerpt from the opinion of Mr. Justice Peckham denotes in fitting terms a fundamental principle of taxation.

> "The question always is, when a classification is made, whether there is any reasonable ground for it, or whether it is only and simply arbitrary, based upon no real distinction and entirely unnatural." 173 U. S. 521.

What sound reason, we inquire, can be brought forward for treating the payment of taxes after a different manner than payment for anything else that is received from the hands of the government,—service of the post, for example. A man pays for what he gets. A simple rule, which applies throughout the range of one's expenditures. At times, a rich man buying in large quantities may pay at a less rate than a poor man. On the other hand, wealthy parents will reward with a very handsome fee a physician who has saved the life of their child—an expression on their part of grateful recognition of the skill and devotion which he has displayed. But instances such as these do not affect the rule of which we are speaking.

If there be any such sentiment as that of "sacrifice" in paying a tax-bill, a true equality will be discovered in an application of proportionate figures. To treat as a factor in formulating a rule, the existence of a superior ability to pay is, as we have already observed, but to prepare the way for admitting a right to confiscate. We say nothing of the pernicious effect which this strange doctrine of "equality of sacrifice" would inevitably have upon the habits of thrift and industry among our people. We are content with declaring that it is a theory which has no place in a state where the property of men is equally protected under a system of law that in the field of a duty to maintain the government, knows no rich man and no poor man.

We are not called upon to point out express words in the Constitution that condemn an attempt to exact a disproportionate payment. In interpreting the language of the Constitution, it has long been a settled rule that that which is implied is as much a part of its provisions as that which is expressed.[10]

So we may observe of the injunction "nor shall private property be taken for public use without just compensation"—that even had it not been brought into the Constitution by way of an amendment, the principle would have been applied just the same in the administration of governmental affairs. An enactment levying a tax beyond a just and equitable limit is clearly obnoxious to the principle of this amendment.

The section providing for a graduated tax, we repeat, is in our opinion unconstitutional because it violates that rule of equality which governs every imposition of a tax. The words of Mr. Justice Brewer deserve to be repeated:

> [Such a tax is] "a tax unequal because based upon a classification purely arbitrary, to-wit, that of wealth—a tax distinctly and intentionally made unequal. I think the Constitution of the United States forbids such inequality."[11]

It may be urged, however, in opposition to these views, that Congress enacted a graduated income tax law in 18[illegible] and in

[10] *Ex parte Yarbrough*, 110 U. S. 651; *South Carolina v. U. S.*, 199 U. S. 437. Says Judge Cooley:

> "The Constitution of Wisconsin provides that 'the rule of taxation shall be uniform,' which if we are correct in what we have already stated, is no more than an affirmance of a settled principle of constitutional law." Constitutional Limitations, p. 302.

[11] 170 U. S. 303.

1864; that its power to that effect was admitted by a general acquiescence on the part of the people. But a season of war then existed. Every man who owned a dollar of property stood ready, in that perilous hour, to contribute to the utmost in order that he might help save the Union. Nobody entertained a thought of questioning the right of Congress to adopt such war measures as it should see fit for paying our soldiers and our sailors, and for meeting all other expenses of the rebellion.

Is it not clear that no argument in favor of the additional income tax feature of the Act of 1913, can be derived from the general acquiescence of the people in legislation peculiar to the war period, and deemed by Congress needful for the safety of the state?

The Supreme Court have unanimously decided that the Congress is empowered by the Constitution to levy and collect a super-tax. Unfortunately, the opinion of the Chief Justice fails to present a convincing reason (or, indeed any reason) why the doctrine of equality does not discountenance this legislation. The decision stands. Already certain leaders in the House of Representatives have proposed that the enormous sums of money which will be needed for the increase of the army and the navy shall be raised by imposing a very heavy tax upon those citizens who chance to have the largest incomes. No wonder that not a few people find themselves unable to reconcile such a scheme of taxation with the principle of an equal protection of the laws.

With no lack of respect for the learning and for the foresight of the jurists now occupying the bench, we are constrained to repeat that an answer has not been brought forward to the objection that a graduated income tax enactment sets up a classification purely arbitrary, and does violence to that principle of equality before the law upon which the safety of our institutions depends. In view of this palpable omission, one is well warranted in calling to mind the familiar saying that no question is ever settled until it is settled right.

Frank Warren Hackett.

Washington, D. C.

to the community, have the right of suffrage, and *cannot* be *taxed* or *deprived* of *their property* for public uses, without their own consent, or that of their representatives so elected, nor bound by any law to which they have not in like manner assented for the public good." But what does this constitution say? The clause under consideration gives an unlimited and unbounded power of taxation. Suppose every delegate from Virginia opposes a law laying a tax, what will it avail? They are opposed by a majority; eleven members can destroy their efforts: those feeble ten cannot prevent the passing the most oppressive tax-law. So that in direct opposition to the spirit and express language of your declaration of rights, you are taxed, not by your own consent, but by people who have no connection with you.

The next clause of the bill of rights tells you, "That all power of suspending law or the execution of laws, by any authority without the consent of the representatives of the people, is injurious to their rights, and ought not to be exercised." This tells us that there can be no suspension of government, or laws without our own consent: yet this constitution can counteract and suspend any of our laws, that contravene its oppressive operation; for they have the power of direct taxation; which suspends our bill of rights; and it is expressly provided, that they can make all laws necessary for carrying their powers into execution; and it is declared paramount to the laws and constitutions of the states. Consider how the only remaining defence we have left is destroyed in this manner. Besides the expenses of maintaining the senate and other house in as much splendor as they please, there is to be a great and mighty president, with very extensive powers;—the powers of a king. He is to be supported in extravagant magnificence: so that the whole of our property may be taken by this American government, by laying what taxes they please, giving themselves what salaries they please, and suspending our laws at their pleasure: I might be thought too inquisitive, but I believe I should take up but very little of your time in enumerating the little power that is left to the government of Virginia; for this power is reduced to little or nothing: their garrisons, magazines, arsenals, and forts, which will be situated in the strongest places within the states: their ten miles square, with all the fine ornaments of human life, added to their powers, and taken from the states, will reduce the power of the latter to nothing.

The voice of tradition, I trust, will inform posterity of our struggles for freedom: if our descendants be worthy the name of Americans, they will preserve and hand down to their latest posterity, the transactions of the present times; and though, I confess, my exclamations are not worthy the hearing, they will see that I have done my utmost to preserve their liberty: for I never will give up the power of direct taxation, but for a scourge: I am willing to give it conditionally: that is, after non-compliance with requisitions: I will do more, sir, and what I hope will convince the most sceptical man, that I am a lover of the American union; that in case Virginia shall not make punctual payment, the control of our custom-houses, and the whole regulation of trade, shall be given to congress, and that Virginia shall depend on congress even for passports, till Virginia shall have paid the last farthing: and furnished the last soldier. Nay, sir, there is another alternative to which I would consent: even that they should strike us out of the union, and take away from us all federal privileges till we comply with federal requisitions: but let it depend upon our own pleasure to pay our money in the most easy manner for our people. Were all the states, more terrible than the mother country, to join against us, I hope Virginia could defend herself; but, sir, the dissolution of the union is most abhorrent to my mind: the first thing I have at heart is American *liberty;* the second thing is American *union;* and I hope the people of Virginia will endeavor to preserve that union. The increasing population of the southern states, is far greater than that of New-England: consequently, in a short time, they will be far more numerous than the people of that country; consider this, and you will find this state more particularly interested to support American liberty and not bind our posterity by an improvident relinquishment of our rights. I would give the best security for a punctual compliance with requisitions; but I beseech gentlemen, at all hazards, not to give up this unlimited power of taxation. The honorable gentleman has told us that these powers given to congress, are accompanied by a judiciary which will correct all: on examination you will find this very judiciary oppressively constructed; your jury-trial destroyed, and the judges dependent on congress.

In this scheme of energetic government, the people will find two sets of tax-gatherers—the state and the federal sheriffs. This it seems to me will produce such dreadful oppression, as the people cannot possibly bear: the federal sheriff may commit what oppression, make what distresses he pleases, and ruin you with impunity: for how are you to tie his hands? Have you any sufficient decided means of preventing him from sucking your blood by speculations, commissions and fees? Thus thousands of your people will be most shamefully robbed: our state sheriffs, those unfeeling blood-suckers, have, under the watchful eye of our legislature, committed the most horrid and barbarous ravages on our people: it has required the most constant vigilance of the legislature to keep them from totally ruining the people: a repeated succession of laws has been made to suppress their iniquitous speculations and cruel extortions; and as often has their nefarious ingenuity devised methods of evading the force of those laws: in the struggle they have generally triumphed over the legislature. It is a fact that lands have sold for five shillings, which were worth one hundred pounds: if sheriffs thus immediately under the eye of our state legislature and judiciary, have dared to commit these outrages, what would they not have done if their masters had been at Philadelphia or New York? If they perpetrate the most unwarrantable outrage on your persons or property, you cannot get redress on this side of Philadelphia or New York: and how can you get it there? If your domestic avocations could permit you to go thither, there you must appeal to judges sworn to support this constitution, in opposition to that of any state, and who may also be inclined to favor their own officers. When these harpies are aided by excise-men, who may search at any time your houses and most secret recesses, will the people bear it? If you think so, you differ from me. Where I thought there was a possibility of such mischiefs, I would grant power with a niggardly hand; and here there is a strong probability that these oppressions shall actually happen. I may be told, that it is safe to err on that side; because such regulations *may* be made by congress, as shall restrain these officers, and because laws are made by our representatives, and judged by righteous judges: but, sir, as these regulations may be made, so they may not; and many reasons there are to induce a belief that they will not: I shall therefore be an infidel on that point till the day of my death.

This constitution is said to have beautiful features; but when I come to examine these features, sir, they appear to me horribly frightful: among other deformities it has an awful squinting; it squints toward monarchy; and does not this raise indignation in the breast of every true American? Your president may easily become king: your senate is so imperfectly constructed that your dearest rights may be sacrificed by what may be a small minority; and a very small minority may continue forever unchangeably this government although horridly defective: where are your checks in this government? Your strongholds will be in the hands of your enemies; it is on a supposition that your American governors shall be honest, that all the good qualities of this government are founded: but its defective, and imperfect construction, puts it in their power to perpetrate the worst of mischiefs, should they be bad men: and, sir, would not all the world, from the eastern to the western hemisphere, blame our distracted folly in resting our rights upon the contingency of our rulers being good or bad? Show me that age and country where the rights and liberties of the people were placed on the sole chance of their rulers being good men, without a consequent loss of liberty? I say that the loss of that dearest

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CORPORATE INCOME AND THE FLAT-RATE

by
Joseph Horton

Introduction

Introduction of a flat rate tax would provide a great opportunity to increase the fairness and the efficieny of our tax system. It particularly provides an opportunity to decrease the negative impact of the tax system on the financial management of corporations and other businesses. The focus of this analysis is upon the improved financial decisions which business management can make under a flat rate tax and on the improved allocation of resources between the corporate and unincorporated sectors which will result. The relationship between the corporate and the personal income tax is an important consideration in ensuring efficiency and fairness for the tax system as a whole.

Requirements for Fairness and Efficiency

It is essential that we recognize that only people pay taxes if we are to achieve the goals of increased fairness and greater efficiency. Corporations and other businesses may pay with checks drawn on their accounts, but ultimately the taxes are paid by the individuals who are their customers, owners, creditors, and workers. This is true whether the tax is the current complex, more or less graduated income tax or a flat rate tax. Fairness requires that the tax burden be allocated in a manner which is neither arbitrary nor a matter of chance, as tends to be the case with the present excessively complex system.

It would be unfair to use the change to a flat rate tax as merely another way to increase taxes. A flat rate combined with a suitable level of exempt income is both fairer and more efficient than our present tax system (or non-system) for any given amount of revenue. It does not follow that it is fairer or more efficient if the result is to collect more revenue. The greater the percentage of people's income which they must pay in taxes, the greater are the harmful effects of the tax on efficiency for any given tax system. The change to a flat rate tax would have the greatest beneficial effects if it were a part of a tax reduction program, not merely a replacement for the current income tax. Certainly it should not be adopted as part of a tax increase scheme.

Use Same for All Income

We fine people for speeding. The greater the speed in excess of 55 miles per hour, the higher the fine. This discourages speeding. People earn incomes in our free enterprise economy by producing the goods and services people want. The more successful a person is at producing the goods and services people want, the higher his income is. Our present progressive tax system fines him for his success. The more he satisfies other people's wants, the higher his tax rate. The effect of the progressive income tax on work, saving, and investment is the same as the effect of the progressive speeding fine on speeding. Higher fines reduce speeding, and higher tax rates reduce work, saving, investment and production.

Lower marginal tax rates will increase people's incentive to save, work, invest, and produce the goods and services we all want. Moreover, lower rates, especially for people in high tax rate brackets, will reduce the incentive to avoid taxes. Tax avoidance, both by individual tax payers and by corporations, introduces inefficiences and distortions into our economic system. People make investments, which they otherwise would not have made, and they avoid investments which would yeild a greater pay-off to society because of the high progressive tax rates and the exemptions and credits built into the present tax law. A change to a flat rate tax gives us the opportunity to remove the incentive to pick less productive investments and to waste the talents of highly skilled specialists in tax avoidance.

Under a flat rate tax income should be taxed at the same rate (or small number of rates) regardless of its source. Whether income is desired from investment in a corporation or in an unincorporated business should not affect the amount of tax paid. Failure to follow this principle results in a misallocation of resources and reduced output of the goods and services we all want.

If income from investments in corporations is taxed at a higher rate than income from investments in unincorporated businesses, there will be an incentive for people to refrain from incorporating even though in the absence of the tax differential it would be advantageous for them to do so. Too much production will be in the unincorporated sector of the economy and too little in the corporate sector. Too few people will be availing themselves of the advantages of the corporate form of organization. Both efficieny and fairness, therefore, suggest that income from investment in corporations and in unincorporated businesses should be taxed at the same rate.

Income should be taxed at the same rate regardless of whether it is income from equity investment or from investment in the debt of a firm. It is inequitable to tax someone at a higher rate merely because he receives income (dividends) from equity investment rather than from interest on a loan to a firm. Both should be taxed equally for fairness to be achieved.

Interests and Dividends

A lower tax rate for interest income causes corporation as a group to use more debt and less equity. Since interest is currently tax deductible and dividends are not, corporate managers have an incentive to use an excessive amount of debt. In effect, debt is taxed less heavily than equity. The greater the proportion of its capital which is raised through debt, the riskier a given corporation is. Smaller fluctuations in its sales and operating income lead to greater changes in its profits and losses. It is less able to withstand declines in sales. As a result of the differential treatment of dividends and interest, more corporations go bankrupt in periods of recession. More workers lose their jobs and recessions are more severe than they would be if corporations did not have this tax incentive to use excessive debt. Equal taxation of income from interest and dividends can be achieved by making dividends as well as interest payments tax deductible for corporations. This would reduce the severity of economic fluctuations and enhance the stability of our economy while protecting the jobs of workers and the investments of both stockholders and bondholders.

The equal taxation of income from equity and debt requires that dividends be a deductible business expense just as interest is. Income from equity and from debt would then be taxed at the same flat rate when received by individuals as interest and dividends. Corporate managers would no longer have to consider the tax status of potential investors relative to corporate tax rates in deciding on a debt issue or an equity issue.

Retained Earnings and the Level of Exempt Earnings

The part of each year's corporate income which is kept as retained earnings rather than paid out as dividends should be taxed. Retained earnings are part of the equity income of stockholders. They should, therefore, be taxed at the same flat rate as other income. If there is only one tax rate, this is easily accomplished. The corporation pays this rate on all of its retained earnings. Under the present system with its multiplicity of rates, the retained earnings would have to be allocated to each stockholder and each stockholder's share of the retained earnings would have to be taxed at his marginal tax rate for full fairness and efficiency to be achieved. A flat rate tax eliminates this difficulty since the marginal tax rate would be the same for virtually all stockholders.

Even a system with only a few rather than the current multiplicity of rates would be an improvement over the present system. Relatively little distortion would occur by taxing retained earnings at the smaller of the two or three individual rates. Using the lower rate in such a system would tend to offset the fact that individuals would have some level of income which is exempt from tax whereas fairness consideration do not require that any amount of corporate retained earnings be tax exempt. The exemption of the first several thousand dollars of income should, therefore, be available to individuals, but not to corporations.

The level of income which is exempt from taxes should be proportional to the size of the family. It should be recognized that a family is an equal partnership of all of its members who combine their incomes for tax purposes and who, therefore, should combine their levels of tax exempt income. If the level of tax exempt income were set at $3,000 for an individual, a family of three would have a tax exempt level of income of $9,000. It should be required to pay the flat rate tax only on income above that level. Since most owners of corporate stock have incomes above the exempt level, they would not be affected by applying the flat rate tax to retained earnings without allowing a tax exempt level of income for corporations.

The level of tax exempt income for individuals should be adjusted for inflation to prevent the equivalent of bracket creep. If this is not done, the real value of the exempt level of income will decline, and lower income individuals will rapidly approach the full flat rate of taxation.

Capital Gains

The current differential taxation of capital gains forces the management of corporations to consider the tax induced preferences of stockholders for dividends verus capital gains. Just as dividends should not be taxed twice, neither should increases in the value of a firm be taxed twice. Increases in the value of a firm result primarily from investments including those undertaken with retained earnings. If retained earnings are taxed as proposed above, then increases in the value of the firm attributable to them should not be taxed a second time as capital gains. This is true of both unincorporated businesses and of corporations. Likewise, if expansion is financed through new stock issues or new debt issues, income from the expansion will be taxed as interest or dividends. It should not be taxed a second time as capital gains.

An alternative approach would be to tax capital gains at the full flat rate but to exempt retained earnings from taxation. This has the appeal of apparent simplicity. It would, however, be difficult if not impossible to tax-capital gains as they occur rather then when they are realized. The value of securities fluctates constantly, and one would be faced with a continuous series of gains and losses. If taxed when realized, capital gains taxation would tend to occur in surges. The government would tend to collect large revenues when the stock market and business in general are booming and very little when the prices of stock and other assets are depressed. Individuals might also prefer not to suffer large tax burdens at the infrequent intervals at which they realize capital gains. This suggests the alternative of taxing retained earnings but making capital gains tax exempt, that is, not subject to double taxation.

If capital gains are subject to the flat rate tax, retained earnings should not be. Moreover, only increases in real value should be taxed. Taxation of increases in the value of an asset when the increase is merely the result of inflation is really a tax on the original value, not just on its increase in value. Suppose that a share of stock is purchased for $50 and is later sold for $100. Under a flat rate tax of 20%, the tax would be $10. The person who sold the stock would have $90 after taxes. This $90 would, however, buy what $45 would have bought when he purchased the stock if the price level has doubled. He has been taxed on his original investment, not on any increase in its real value. Only increases in value above the inflation adjusted value of an asset should be subject to capital gains tax.

Conclusion

The introduction of a flat rate tax applicable to income regardless of source and with double taxation of none will allow corporate managers to make more socially responsible decisions. Our economy will be less subject to unemployment and business failure during recessions because the current tax incentive to go into debt will be removed. Resources will be used more efficiently ~~to~~ produce the goods and services we all desire. The individual who pays the tax under the law will more closely correspond to the one who actually bears the burden of the tax. The impact of the tax will, therefore, be less arbitrary and less a matter of chance than is currently the case. These improvements in fairness, efficiency, and economic stability depend upon the flat rate tax not being used as a means to raise taxes. It would be far better if it were a reduction in taxes as well as a reform of how they are imposed.

It is respectfully requested that the following be entered into the records as regards SB 2206 (The Flat Rate Tax).

Submitted by Mrs. Barbara P. Hutchinson, tax law researcher

4416 Alamo Drive

San Diego Ca 92115

(714) 583-1138

I have been self-employed as a tax preparer and tax law researcher for 34 years and have watched the tax statutes grow from a volume I could easily hold to a tome containing almost 10000 statute, with thousands of sub-sections that would give one a double hernia to lift. Title 26 (the tax laws) is out of control and must be simplified. The 16th amendment to the Constitution gave this responsibility to the Congress. I offer the attached statement and copy of the first form 1040 for the record.

With respect,

Barbara P. Hutchinson

TAXATION WITHOUT REPRESENTATION
by BARBARA P. HUTCHINSON

OVER Two hundred years ago a few thousand people representing a population divided by those who felt ready for self-government reached the conclusion that taxation without representation was reprehensible. They said their choice was between freedom as citizens or enslavement by a distant monarch. That they chose freedom is a matter of history. That they avoided oppressive taxation by having representation is a matter of regret. Never have so many paid so much for so little return as do the American people under the burdensome yoke of legislated taxation.

Never has so many different arms of government spent so much time and so little talent in their search for economic supports for their invaluable services. Never have so many branches of society looked for so many avenues that lead to the public trough.

Never has so much pressure been placed on our political representatives to find ways to advantage the special interest that fund campaigns.

It's time for a clean sweep of our tax laws and a new beginning. Time for a total revolution of our bureaucracy and while we recognize the time and the need, no one has the way. We can't rely on elected representatives because they are wedded to their prime supporters and not to ideals.

If we could somehow place them in padded cells and guarantee them immunity and re-election, we might get an honest attempt at tax reform. If we could gag special interest, we could close down pork barrel activites, streamline government and eliminate the suet of bureaucrap!

It stands to reason that if the Federal income tax laws were abolished as of 12-31-82 and a flat 10% percent gross were established, we could eliminate 90 per cent of the Internal Revenue's payroll, close all loopholes and quit using tax regulations to reward, penalize, or manipulate the citizens.

Without all the complicated formulas for deductions we would be free to devote our time and concern to real values and not hire CPA's, attorneys, etc., to help us do our fair and just share of avoiding taxes.

To adopt such a simple reform would not be worthy of the intellectual giants we have elected to public office, but it might bring us back to sanity and government by law before we find ourselves once more rebelling over the same cause as created these United States two hundred years ago.

At the time of ratification of the I6th Amendment (I9II-I2) a simple tax form was presented to the people along with the "hoopla" that it would SOAK THE RICH. The first form I040 in I9I3 exempted the first $4000 of income to a married taxpayer and gave $I000 for each dependent. It had EIGHT lines to be filled out. The percentage tax began at I% on amounts over $20,000 and not exceeding $50,000,2% over $50,000 up to $75,000, 3% over $75,000 up to $I00,000, 4% over $I00,000 up to $250,000, 5% over $250,000 up to $500,000, 6% over $500,000. Today,some 70 years after the dreaded name "IRS" became part of our language and the economic life that revolves around it,we REWARD those with a child,who earned less than $I0,000 in the year (tax credit of up to $500),REWARD those who hire the armies of tax shelter artist called Financial Planners,and punish the poor dumb slob in between who knows what poverty is if he works for less than $20,000 a year.

Is it asking too much just to tie the consumer price index to the I9I3 form I040? Or is simplicity too complicated for the congressional brain?

TO BE FILLED IN BY COLLECTOR	Form 1040	TO BE FILLED IN BY INTERNAL REVENUE BUREAU
List No. ______	INCOME TAX	File No. ______
______ District of ______	THE PENALTY FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS \$20 to \$1,000. (See Instructions on Page 4)	Assessment List ______
Date received ______		Page ______ Line ______

UNITED STATES INTERNAL REVENUE

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS

(As provided by Act of Congress, approved October 3, 1913)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 1913
(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) JOHN A. SMITH of 124 SPRUCE St.
(Full name of individual.) (Street and No.)

In the City, Town, or Post Office of LOS ANGELES State of CALIFORNIA

(Fill in pages 2 and 3 before making entries below.)

1. Gross Income (see page 2, line 12)			\$ 12,628.00
2. General Deductions (see page 3, line 7)			\$ 291.00
3. Net Income			\$ 12,337.00
Deductions and exemptions allowed in computing income subject to the normal tax of 1%.			
4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See pg. 2, line 11)	\$ NONE		
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See pg. 2, line 9, column A)	5,178.00		
6. Specific exemption of \$3,000 or \$4,000, as the case may be. (See Instructions 3 and 19	3,000.00		
Total deductions and exemptions. (Items 4, 5, and 6)			\$ 8,178.00
7. Taxable Income on which the normal tax of 1% is to be calculated. (See Instruction 3)			\$ 4,159.00

8. When the net income shown above on line 3 exceeds \$20,000, the additional tax thereon must be calculated as per schedule below.

	INCOME	TAX
1% on amount over \$20,000 and not exceeding \$50,000	\$ 4,159.00	\$ 41.59
2% " over 50,000 and not exceeding 75,000		
3% " over 75,000 and not exceeding 100,000		
4% " 100,000 and not exceeding 250,000		
5% " over 250,000 and not exceeding 500,000		
6% " over 500,000		
Total additional or super tax		\$ —
Total normal tax (1% of amount entered on line 7)		\$ 41.59
Total tax liability		\$ 41.59

EMILE R. JARDINE
CERTIFIED PUBLIC ACCOUNTANT
648 WEST MONTEREY AVENUE
STOCKTON, CALIFORNIA 95204

September 23 1982

Hon. Robert Dole,
Chairman of the
Senate Finance Committee,
U.S. Senate Office Building
Washington, D.C. 20515

Dear Senator Dole: In re: Flat Tax proposals.

The Congress should be aware of the concerned reaction of many investors to the Flat Tax proposals, that would classify 100% of their capital gains as ordinary income, without indexing the cost basis to the inflation of the dollar from the date of purchase to the date of sale of the related capital asset.

For example:

1,000 shares of ABC Corporation - 1982 sale	$60,000
1,000 shares of ABC Corporation - 1950 cost	10,000
Apparent capital gain	$50,000
Inflation of the dollar: 1950 (71.4) vs 1982 (290.1)	
306% x $10,000 cost	30,600
Capital gain, adjusted for the inflation of the dollar	$19,400

If the Congress proposes to subject the entire $50,000 capital gain to the full flat rate, the investor will be paying tax on the fictitious increment (not a profit at all) of $30,600, which, in effect, represents a part of the recovery of his cost, adjusted to date from his 1950 position.

Consider for a moment the effect on our nation's economy, when investors will refuse to risk their savings in productive enterprise and new business in the face of such an unfavorable consequence.

Your kindness will be much appreciated in referring my letter for entry in the printed record of proceedings of the Senate Finance Committee, when the Flat Tax proposals are scheduled for hearing.

Respectfully,

Emile R. Jardine

Emile R. Jardine C.P.A.

ERJ:e

League of United Latin American Citizens

Office of National President
TONY BONILLA

PRESS RELEASE

CONTACTS: SEPTEMBER 28, 1982

Tony Bonilla, National President
(512) 882-8284
Robert Gnaizda, Tax Counsel
(415) 431-7430
Arnold Torres, Executive Director
(202) 628-0717

HISPANICS OPPOSE FLAT TAX: SUPPORT SIMPLE TAX THAT CONSIDERS SOCIAL SECURITY

The League of United Latin American Citizens (the nation's largest Hispanic membership organization with 100,000 members in 45 states) was not allowed to testify at these U.S. Senate Finance hearings. As a result, the views of twenty million Hispanics and other minorities could be overlooked.

The attached prepared testimony (by LULAC's tax counsel who is a former IRS attorney) sets forth:

1. The opposition of the Hispanic community to the Hoover Institution's pro-millionaire flat tax. This tax is regressive since it fails to consider the highly regressive social security tax. (The typical working person pays 6.7% in social security taxes and the typical corporate chief executive pays less than 1%.)

2. The support of the Hispanic community for a SIMPLE TAX. The Simple Tax would exclude from taxation the first $15,000 for a

married couple and provides $200 tax credits per dependent. No other deductions or exceptions would be permitted. The tax rate would be 18% up to $50,000 and 25% on income above $50,000.

3. Under the Simple Tax, a typical family of four (median income of $22,000) would pay less than one thousand dollars ($860) in federal taxes. Under the Hoover Institution's straight 18% flat tax, the sum would be four times as great ($3,960).

4. Under the Simple Tax, a person earning a million dollars a year would pay $243,400 in federal income taxes. Under a straight flat tax, a millionaire would pay $63,000 less, or only $180,000.

5. No honest analysis of the impact of the flat tax can be made without considering the highly regressive nature of social security taxes. The Simple Tax addresses this by a combination of a substantial exclusion and a two-tiered rate. When combined with social security taxes, it produces a Flat Rate.

6. Deductions don't necessarily help working people. For example, prices for first-time homebuyers would be reduced and equality would be established between renters and homeowners if the mortgage interest deduction was eliminated.

7. All corporate tax preferences, artificial depreciation and credits should be eliminated. In return, the maximum corporate tax rate could be reduced from 46% to 25%, yet still yield a greater dollar contribution to tax revenues ($100 billion versus $47 billion under the present system).

8. All Americans, including the poor and the middle class, would benefit from the Simple Tax which could be completed on a postcard.

Tony Bonilla, the National President of LULAC said:

> "The Hispanic community is disappointed that we were excluded from orally testifying.
>
> The American people need a Simple Tax, not a pro-millionaire flat tax. Reagan's millionaire flat tax is a regressive tax since working people pay almost 7% in social security taxes while typical corporate chief executives pay only 1% of their earnings in social security taxes.
>
> Tax reform can't be left just to economists and tax lawyers. Since tax reform affects the public's ability to participate in and understand our "Alice-in-Wonderland" tax system, twenty million Hispanics insist on playing a major role."

TESTIMONY

OF

THE LEAGUE OF UNITED LATIN AMERICAN CITIZENS

THE HISPANIC COMMUNITY SEEKS A SIMPLE TAX,

NOT A REGRESSIVE FLAT TAX*

Hoover Institution's Anti-Working Person Regressive Tax:

The League of United Latin American Citizens (LULAC) is the largest Hispanic membership organization in America. It has 100,000 members in 45 states.

This testimony is submitted on behalf of 20 million Hispanics and the almost one hundred million Americans subject to the 6.7% social security tax.

LULAC opposes the Hoover Institution's flat tax. In reality, the Hoover Institution is supporting an anti-working person regressive tax. For example, its proposal ignores the impact of the highly regressive social security tax.

A person earning $30,000 pays 6.7% in social security taxes. A person earning a quarter of a million dollars (the average salary of senior tax partners in Washington, D.C. law firms) pays less than one percent in social security taxes.

Thus, under the Hoover Institution's regressive flat tax proposal, individuals earning $30,000 would pay an effective rate (assuming an 18% flat rate) of almost 25% while wealthy corporate lawyers would pay only 19%.

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* This testimony is presented by the League of United Latin American Citizens' Tax Counsel, Robert Gnaizda of Public Advocates, Inc., a San Francisco, public interest law firm (415) 431-7430, 1535 Mission Street, SF, CA 94103. Mr. Gnaizda is a former tax attorney with the Chief Counsel's Office of the I.R.S. and is a 1960 graduate of Yale Law School.

Simple Tax -- Less Than $1,000 For Median American Family:

The real issue is whether the current tax system (which does not have the confidence of the public, is an open invitation to fraud, and is understood by only a handful of tax attorneys), should be simplified. LULAC believes that the system should be radically simplified and consider the impact of social security taxes.

In order to deal with the inequities of the highly regressive seven percent (6.7%) social security tax, LULAC believes that there should be at least two tax rates, 18% for income under $50,000 and 25% for income above $50,000.*

The other provisions urged by LULAC, in what is hereinafter referred to as the Simple Tax, are as follows:

1. An exclusion from tax of the first $7,500 of income per individual and $15,000 for a married couple.

2. A $200 tax credit per dependent (equivalent of $1,100 tax deduction at 18% rate).

3. No other exclusions, exemptions or preferences of any kind, no matter how meritorious.

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* The data set forth herein is based on U.S. Internal Revenue Service Statistics of Income Bulletin, Winter 1981-82, Washington, DC 1982, and data from "Tax Notes", June 21, 1982. Including capital gains, the Simple Tax will generate as much revenue as the present system. Assuming changes in corporate tax (see next section) and/or partial reporting by the underground economy, the revenue generated by the Simple Tax could be far greater, thereby reducing the pressure for "meat axe" cuts in essential government programs such as Social Security.

4. All income, from whatever source, should be taxed. For example, all capital gains should be fully included.

Two Rates, When Combined with Social Security, Produce a Flat Rate:

The two-tiered Simple Tax is actually the only true flat tax. Specifically, virtually all wages and salaries, up to $32,400, are subject to the almost seven percent (6.7%) social security tax. Thus, only by permitting a seven percent lower rate (18%) for the first $50,000 can all incomes be taxed at the same rate.*

Sample Impact of Simple Tax

The median income of an American family is $22,000. Assuming a family of four, its tax, not including social security, would be $860 under the simple tax. Thus, the overall tax rate for a typical family would be just 4%, plus social security. Under the Hoover Institution's flat tax, the tax would be over four times as much ($3,960).**

Under the Simple Tax a family of four earning $50,000 would pay $5,900. Under the Hoover Institution's proposal it would pay 50 percent more ($9,000).

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* Fifty thousand dollars, rather than the $32,400 subject to social security, is the correct figure since under the Simple Tax all families of four, without regard to wealth, have the first $17,200 ($15,000 plus credit value of two dependents) excluded from any tax ($17,200 + $32,400 = $49,600).

** Assumes no exclusions or exemptions.

Under the Simple Tax a wealthy family of four earning $250,000 would pay $55,900. Under the Hoover Institution's proposal, it would pay ten thousand dollars less ($45,000).

For a millionaire, the Simple Tax, compared to the Hoover Flat Tax, would mean $63,400 more per year or $634,000 more over the next decade ($243,400 versus $180,000 per year under Hoover).

COMPARISON

	Income for a Family of Four	Simple Tax	Hoover Tax
1.	$22,000 (Median family income)	$860	$3,960
2.	50,000	5,900	9,000
3	250,000	55,900	45,000
4.	Millionaire ($1 Million per year)	243,400	180,000

Corporate Tax of 25%:

The League of United Latin American Citizens also favors the lowering of the present 46% corporate tax to a maximum of 25%. However, all tax preferences and special credits should be eliminated. The only exception would be the exclusion of the first $50,000 in income from all but a nominal 10% corporate tax.

In 1982, corporations will pay taxes of only $47 billion. It is estimated that true corporate income, after climiration of all special preferences and credits is probably between $400 and $500 billion. A 25% tax on $400 billion would produce revenue of

$100 billion, or twice the present amount achieved from the nominal 46% tax rate that, for example, permits banks to, on the average, pay no corporate income tax.*

Eliminating Influence of 14,000 Lobbyists:

There are an estimated 14,000 special-interest lobbyists in Washington, D.C. Virtually none of them are employed by the 95% of Americans who earn under $50,000 a year and pay over 90% of all federal taxes. As a result, the tax system has increasingly become a refuge for wealthy special interests and a disincentive for economic growth.

The Simple Tax will minimize, if not eliminate, the influence of lobbyists since any changes will be clearly understood by the press and the public.

It is possible that the Simple Tax may not produce an ediate reduction in taxes. However, its advantages are long-range and more fundamental to a participatory, self-sufficient democracy. For example:

-- the debate about who pays how much to support their government should be right out in front of the people, not hidden behind an incomprehensible labyrinth of code clauses.

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* It should be noted that in 1950 corporations and individuals each contributed an identical amount to the federal treasury ($17 billion). In 1982, despite the enormous growth of corporations, their tax contribution was only one-sixth that of individuals. (In 1982, an estimated $47 billion will be paid by corporations versus $299 billion by individuals.)

-- The majority of Americans would no longer be dependent on outside assistance to understand and complete their most important annual document. (Last year 52% sought such assistance for their Form 1040s.)

-- Those who can purchase Washington DC's 14,000 lobbyists to manipulate our system, without scruples or public scrutiny, would no longer have an advantage over the 95 percent of Americans who can't so do.

Impossibility of Understanding the Present Tax System:

The Internal Revenue Code consists of 1,764 pages and has 110 major categories of tax exemptions. In addition, there are at least 44 separate forms that can be filed regarding individual taxes.

As a result of such complexity, billionaire Bunker Hunt, according to Fortune Magazine, paid less than ten dollars ($9.65) in federal taxes during the years 1975-1977. Similarly, President Reagan paid no federal tax in 1970 and his Attorney General recently secured tax shelter deductions three times the value of his actual investment.

Reversal of Historic Role Between Social Security and Corporate Taxes:

The present, complicated tax preference system has obscured the fundamental change in the financial contributions of social security, corporate and individual federal taxes.

Specifically, thirty years ago (1950) social security taxes contributed only $3 billion to the federal Treasury while corporate and individual taxes each contributed $17 billion.

Today, this relationship has been totally reversed, despite an absence of any public discussion. Social security's highly regressive taxes will contribute almost four times as much as corporations ($186 billion versus $47 billion). And individuals will pay in nearly $300 billion, six times the corporate share.

Comparison of Contributions to Federal Treasury

Year	Social Security Tax	Individual Tax	Corporate Tax
1950	$ 3 billion	$ 17 billion	$ 17 billion
1982	$ 186 billion	$ 299 billion	47 billion

Senator Bradley's Proposal: An Open Invitation to Lobbyists:

Senator Bradley's objectives in allowing some deductions may be laudable. However, the allowance of even a few deductions could open the door to other equally "laudable" and "necessary" exemptions. Within a few years, the tax code will be as complicated as ever.

In addition, it is unclear how beneficial the mortgage interest and charitable deductions are.

Firstly, the group that will suffer the most, should charitable deductions be denied, will be art collectors and art museums. According to the I.R.S., it recently investigated $72.8 million in art deductions and allowed less than 2% ($1.3 million).

In addition, it is highly unlikely that most persons, as opposed to the wealthy, determine their church givings based on their tax deductions.

In any event, the value of charitable deductions is substantially eliminated by any lowering of the tax rate under any flat tax system.

Thus, if those who favor the continuance of the charitable deduction are correct, we should raise the single tax to the previous 91% rate. That is, the higher the rate the greater the amount of charitable giving, according to this theory.

Secondly, the mortgage interest deduction loses most of its value when the rates are lowered under any flat tax proposal. (A flat tax of 18% as opposed to a 50% rate reduces by more than 60% the value of the interest deduction.)

In addition, the present mortgage interest deduction causes the following distortions:

1. Preference to homeowners over renters.

2. Encourages urban sprawl as opposed to revitalization of inner cities. (Most inner city housing are rental units.)

3. Encourages condominiums at the expense of rental units.

4. Harms first-time homebuyers since the price of housing is artificially raised by the value of the housing interest deduction. Specifically, $150,000 houses are likely to sell for under [illegible] if there are no tax advantages involved in home ownership.

A New Type of I.R.S. Agent and Taxing the $600 Billion Dollar Underground Economy:

The complexity of the present tax system makes it impossible for the Internal Revenue Service to effectively collect its taxes. No matter how many agents it hires, it will never be enough. Only two percent of returns are audited and as much as $600 billion (20% of gross national product) goes unreported.

The Simple Tax will eliminate the need for a significant number of Internal Revenue agents, thereby fulfilling President Reagan's commitment to reduce the government's civilian workforce.

Most important, the Simple Tax will allow the government to hire a different type of revenue agent, one with investigative skills rather than bureaucratic skills, since the only issue will be reporting of income.

In addition, under the Simple Tax, the vast majority of Americans will support tough and effective tax enforcement. Therefore, tough jail sentences will be handed out by jurors. And within a short period of time, the $600 billion underground economy, fearing a combination of effective I.R.S. investigators and tough juries, will begin to surface and be subject to tax.

Six hundred billion dollars taxed at 18% would produce $108 billion in additional tax revenue.

Conclusion:

Most Americans hunger to have faith in and strongly desire to deal honestly with their government. The Simple Tax system in which all pay an understood and agreed on fair share and no one is able to carve out special, inequitable preferences may be a first step in restoring this faith and integrity.

Shakespeare's popular remedy for the ills of society, as expressed by Henry VI was, "The first thing we do, let's kill all the lawyers." The Simple Tax could go well beyond this by knocking off a few thousand accountants as well.

JOHN D. MARKS
BOX 18514 • SALT LAKE CITY, UTAH 84118

October 4, 1982

The Honorable Robert Dole
2213 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Dole:

I understand you, as Chairman of the Senate Finance Committee, will be holding hearings on establishing a flat income tax rate.

I respectfully request that you make this letter public at that time and make it an exhibit of those hearings.

1. I enclose a copy of an article entitled "A Proposal to Simplify Our Tax System" (Wall Str. Jr., Dec. 10, 1981). It is self-explanatory. I request this proposal be established as the basis for a flat tax system.

2. There are many so called special interest groups who will oppose a flat income tax. May I suggest that the largest single "special Interest" group is those of us who as individuals pay our income taxes.

3. One of the reasons given against a flat income tax will be that deductions are the way charitable, religious, and certain business groups (e.g. real estate) are supported. This should not be treated as a viable reason by congress, since congress itself has already provided the means to provide for the legitimate needs of such organizations. I speak of the tax credit. The tax credit is direct and up-front; not the surreptitious, difficult to understand deductions that have made tax liars and cheats of many otherwise upstanding citizens.

Tax credits can be issued at any level that congress desires to incentivise . However, may I suggest that the upper limit of the sum of all such credits be no more than one-third of the total tax due.

In 1776 Mr. Thomas Paine wrote a series of articles entitled, "Common Sense" an address to Inhabitants of America. May I quote and paraphrase.

"I draw my idea of the form of (taxation) from a principal in nature which no art can overturn, viz. that the more simple anything is, the less liable it is to be disordered and the easier repair when disordered; and with this maxim in view I offer a few remarks on the so much boasted (present income tax of the United States). That it was noble for the dark and slavish times in which it was erected is granted

.... But that it is imperfect, subject to convulsions, and incapable of producing what it seems to promise is easily demonstrated."

It is now time for a flat tax!

Please call on me if you believe there is a way I may assist you in implementing a fair, limited, flat income tax.

Cordially yours,

John D. Marks
(801) 278-1092

jdm:jwm

P.S. It was a personal pleasure to hear you when you visited Utah this summer.

THE WALL STREET JOURNAL, THURSDAY, DECEMBER 10, 1981

A Proposal to Simplify Our Tax System

By ROBERT E. HALL and ALVIN RABUSHKA

Despite recent progress in lowering rates, the tax system remains a disgrace. It is in dire need of simplification and reform. The tax system is inordinately big, filling volumes of codes, complicated by hundreds of credits, exemptions and special provisions. Many taxpayers need expensive professional help to fill out their returns. Each act of the Congress complicates the system further. Widespread evasion is apparent on interest, dividend and other forms of household or professional income. Tax shelters are commonplace. Estimates of the size of the underground economy range from tens of billions of dollars to several hundred billion. In short, we have a system that fosters contempt for the law, and simultaneously discourages productive economic activity.

We have recently worked out the details of a simple income tax, imposed at a low uniform rate on a comprehensive measure of income. The tax would be founded on the following principles:

1. All income should be taxed only once, as close as possible to its source.

2. All types of income should be taxed at the same rate.

3. The poorest households should pay no income tax.

4. Tax returns for both households and businesses should be simple enough to fit on a postcard or on a single page.

A major problem with the current system is its helter-skelter taxation of business income. Corporate income is taxed first under the corporate tax and again under the personal tax on dividends. Income from proprietorships and partnerships often evades tax, or is taxed lightly. We propose a single business tax on all types of income other than wages.

The Current Range of Rates

A uniform rate of 19% would replace the current range of rates. The current rates now stretch from actual subsidy of highly leveraged tax shelters with large interest deductions to rates as high as 80% that are imposed on income earned by stockholders.

The proposed new 19% business tax applies equally to all forms of business – corporate, partnership, professional, farm and rentals and royalties. The base for the tax is gross revenue less purchases of goods and services and compensation paid to employees. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions are permitted for depreciation, interest or payments to owners in any form.

Even for a multibillion-dollar corporation, the business tax return would fit easily on a single page. It would look like this:

1 Gross revenue from sales

Costs

2 Purchases of goods and materials
3 Compensation paid to employees
4 Other direct costs
5 Total costs (lines 2, 3 and 4)
6 Net Revenue (line 1 less line 5)
7 Purchases of capital equipment and structures
8 Taxable income (line 6 less line 7)
9 Tax (19% of line 8)
10 Tax carry forward from losses in previous years
11 Net tax (line 9 less line 10)
12 Tax payment (amount on line 11 if positive)
13 Carry forward to next year (amount on line 11 if negative)

1000A **Individual Compensation Tax** **1981**

1 Compensation (including fringe benefits as reported by employer) | 1
2 Other wage income, including pensions paid directly by employer | 2
3 Total compensation (line 1 plus line 2) | 3
4 Personal allowance
(a) ☐ $5,000 for married filing jointly | 4(a)
(b) ☐ $3,000 for single | 4(b)
(c) ☐ $4,500 for single head of household | 4(c)
5 Number of dependents, not including spouse | 5
6 Personal allowances for dependents (line 5 multiplied by $600) | 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

Individual tax returns would fit on a postcard

In place of the hodge-podge of investment incentives in the tax system now, we propose the use of straightforward first-year write-off of all business investment. First-year capital recovery is a great simplification over the complicated depreciation deductions and investment credits in present law.

The net revenue of U.S. business in 1980 was $803 billion. Under the new business tax we are proposing, capital recovery allowances would have been $317 billion, leaving net taxable business income at $486 billion. A tax rate of 19% would have yielded $92 billion, that would be about half again the revenue from the actual corporate income tax in 1980 of $64 billion. Despite a much lower tax rate, the extra revenue comes from the much wider tax base, including unincorporated business, and from taxing business income at the source.

Under the simple tax system, all business income would be taxed only once at its source. Household receipts of interest, dividends and capital gains would be after-tax income. Though wealthy households might receive large amounts of these types of income, it is important to understand that the taxes on such income have already been paid. Taxing business income at its source has the important practical benefit of taxing the large amounts of interest and dividend income that escape taxation under the current system.

With comprehensive taxation of business income, taxation of capital gains should be eliminated at the level of the individual. The value of a share of stock or other interest in a business is the capitalized value of its after-tax income, and so already embodies the appropriate tax when business income is taxed at the source.

Our simplified tax system also includes a comprehensive tax on the earnings of individuals.

Most income in the U.S. is compensation for work. In the proposed tax, compensation is broadly defined as anything of value received by workers from employers, including cash wages and salaries, the market value of fringe benefits and contributions to public and private pension plans.

A Set of Personal Allowances

To limit the tax burden of poor families, we propose a set of personal allowances. Taxes would be 19% of compensation in excess of the following allowances:

Married Couple	$5,000
Single	3,000
Single head of household	4,500
Each dependent	600

Except for the personal allowances, no deductions of any kind would be permitted, including interest deductions.

The individual tax return for the compensation tax would look very much like the illustration accompanying this article. It would fit on a postcard.

In 1980, total compensation in the U.S. – including fringes and pension contributions – was $1,596 billion. We estimate that personal allowances in 1980 would have been $420 billion, leaving taxable compensation of $1,176 billion. At a rate of 19%, tax revenues would have been $223 billion. By comparison, the personal income tax in 1980 yielded about $255 billion.

At the outset, the simple income tax, with common flat rates of 19% on business income and compensation, would raise revenue equal to about 12% of GNP, the same as the current combination of corporate and personal income taxes. Though our system would stabilize revenue as a fraction of GNP, it would probably produce more revenue than the government needs to maintain existing programs.

Low marginal tax rates would draw economic activities from the underground economy into the formal market, where they are recorded as part of GNP. Businesses and individuals would spend less time worrying about the tax consequences of their actions and concentrate instead on earning higher incomes. On these grounds, we believe that the revenue needs of the federal government could be met with tax rates as low as 16% or 17%, rather than the 19% needed to reproduce current revenue at current levels of GNP.

The benefits of tax reform are not merely economic. The complexities of the federal tax system now foster contempt for government and make petty criminals out of a large fraction of the population. A simplified tax with low marginal rates would help restore confidence in government and would support the basic honesty of the American people.

Messrs. Hall and Rabushka are senior fellows of the Hoover Institution, Stanford University. Mr. Hall is also professor of economics at Stanford.

MILLIKIN UNIVERSITY
DECATUR, ILLINOIS
62522

OFFICE OF
THE PRESIDENT

September 15, 1982

WRITTEN STATEMENT FOR INCLUSION IN PRINTED RECORD OF SENATE FINANCE COMMITTEE HEARINGS ON FLAT-RATE TAX PROPOSALS (September 27-29, 1982).

Millikin University, Decatur, Illinois, has enhanced its position in the field of private higher education as a result of the philanthropy of alumni and friends. We strongly urge that incentives for charitable giving be preserved in any future changes of the tax law.

We do not oppose current proposals for a flat-rate tax or simplified tax system as long as those proposals allow a credit for charitable gifts. The tax savings -- and hence the tax incentives -- would not be dependent on a taxpayer's bracket, as is the case for the current charitable deduction.

Millikin University favors a credit of 50% of the amount of charitable gifts. If this is not possible, a progressive credit could be allowed based on a taxpayer's adjusted gross income.

To assure that donors do not entirely avoid paying taxes by making charitable gifts, a ceiling could be placed on the credit (similar to the current percentage of adjusted gross income ceiling for the charitable deduction).

We also favor continuation of the five-year carryover rule under the charitable credit system.

J. Roger Miller

J. Roger Miller
President

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOMEBUILDERS

Before The

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

FLAT RATE TAX PROPOSALS

SEPTEMBER 28, 29 AND 30, 1982

Chairman Dole and Members of the Committee:

The National Association of Home Builders (NAHB) is a trade association representing the nation's more than 108,000 members. NAHB is pleased to present its views on proposals to revise the individual income tax laws.

The popular perception of these changes it that they involve the development of a single "flat rate tax." However, there are many different proposals. Some often involve more than a single tax rate and move toward a series of lower tax rates along with elimination of certain deductions and tax credits and a broadening of the tax base. And, as Senator Dole noted in the press release announcing the hearings, the purpose of the hearings goes beyond a review of the flat rate tax and is an attempt to look closely at ways to simplify the tax system as well as provide for greater tax equity.

NAHB favors a tax code which is simple, which promotes economic efficiency, and which is fair. NAHB is concerned about the implications of comprehensive changes in the current tax law being recommended in flat rate tax proposals. If sufficient time, study and analysis is not given to proposed changes, the end result could be a tax system which fails to be simpler, more efficient, or fairer, than the present law."

NAHB's position comes from a realistic assessment of the current state of the housing industry and the prospects for its future recovery. Housing is in a serious depression. The past several years have been the worst years for housing production since World War II. Housing starts and new home sales have been at rock bottom levels. Our membership, which represents the broad spectrum of the housing industry, has declined by over 15,000 members since November of 1981, less than a year ago.

The implications of this situation for the economy as a whole are far-reaching. Housing creates jobs and economic growth. More than 3,000 items are built into one house. Steel, textiles, and lumber are all highly sensitive to the state of the housing industry. An upswing in housing has a positive ripple effect throughout the economy. Conversely, a downturn extends negatively throughout the rest of the economy.

It is, therefore, important, from a general economic point of view, that present tax incentives for housing be maintained and, perhaps, even expanded. Major changes in the tax code which would eliminate or curtail current incentives for homeownership would contribute to a decline in housing . The changes would create market uncertainties and could drastically depress real estate values, thereby adversely affecting investment decisions made many years in the past in reliance upon tax incentives deeply embedded in the tax code.

The social importance, as well as the economic importance of housing, must be considered. Housing is more than a commodity. It is part of the social fabric of our nation. It contributes positively to family life and community involvement. It is a force for political stability. A basic aspiration of most Americans is to own a home and be adequately housed. Elimination or diminution of tax incentives directed toward this American goal would have adverse social and political consequences.

NAHB is, therefore, opposed to measures which would eliminate, or reduce current incentives for homeownership, rental housing, and real estate investment. NAHB would favor tax revisions to simplify the tax code and provide more incentives for savings and investment. It urges Congress to move slowly and study carefully proposals to establish a flat rate tax or similar type of tax.

I. GENERAL DISCUSSION

Analysis of flat rate tax proposals should be approached from the perspective of the extent to which the proposals would simplify the tax law, provide for greater economic efficiency, and create a fair tax code.

Simplification

The proponents of the flat rate tax argue that it would be a much simpler tax system. They point to pages of tax returns which taxpayers must file as well as the elaborate enforcement and administrative mechanism of the IRS as evidence of the complexity of the tax law. The Hall and Rabushka proposal has even gone so far as to provide a one-page income tax return.

The argument for the flat rate tax on grounds of simplicity should be examined in greater detail. First, it assumes that for most individual income taxpayers completing tax returns is a complicated matter. This is not the case. Many taxpayers already take the standard deduction and filing tax returns is a relatively simple matter of collecting information on wage withholding and filling out a two-page tax form. Much of the complexity in the current system is for those who itemize tax deductions and for businesses who presumably are capable of paying for the cost of tax compliance.

In addition, flat rate tax proposals as well as measures which involve a significant broadening of the tax base create complexities of their own. Under current law, income subject to taxation is derived in three separate steps, involving three sections of the Internal Revenue Code.

First, there is "gross income," which is defined in terms of 15 separate items of income such as compensation for services, interest, rents, dividends, and so forth, with the additional proviso that "income" includes "income from whatever source derived." Internal Revenue Code, Section 61. The second measure of income is "adjusted gross income." Internal Revenue Code, Section 62. Adjusted gross income (AGI) is gross income less certain deductions, generally associated with the conduct of a trade or business. Important deductions associated with housing which take place in arriving at AGI include depreciation on structures and the capital gains tax deduction. A final measure of income is taxable income. Internal Revenue Code, Section 63. This takes into account itemized deductions such as those for home mortgage interest and real estate taxes. This is the final sum against which tax rates are applied to compute tax liabilities.

Because the tax rates will be dramatically reduced under most flat rate tax proposals, the current method of defining income will almost certainly have to be revised to broaden the definition of income. This base-broadening process will definitely lead to complications, particularly in the valuation of items considered to be income. Fringe benefits, for example, would probably be considered as part of an enlarged tax base. However, how does one value such fringe benefits such as employer parking, free air travel for airline employees, and other fringe benefits? Are fringe benefits to be valued at employer cost or fair market value? The difficulties in valuation, as well as the political unpopularity of taxing many normally excepted fringe benefits has led to a continuing moratorium on IRS fringe benefit regulations. This moratorium, which the Congress first enacted in 1978, was extended in 1979, and in 1981 and is scheduled to continue through December 31, 1983.

In addition, an item often viewed as income in a comprehensive income tax base is so-called imputed income. This would be income not received but imputed because of its economic consequences. For example, imputed income would include the value of rental income, which a homeowner would receive if he were to pay himself rent for the use of his home. This is an established economic concept, yet its practical application is mind boggling. Can you imagine every homeowner having to arrive at the rental value annually of his home. This clearly would add greater complexity to the tax code. And, it certainly would not be a popular item with most taxpayers.

Closely associated with the complexities of defining income, is the uncertainty associated with the transition from one set of definitions to a new set of definitions. Current rules have been in existence since 1954 and the concepts are familiar to many in the tax community, as well as the public at large. Transitional problems are bound to arise if a new comprehensive tax is created. Uncertainties would need to be resolved both administratively and ultimately in the courts. These uncertainties would continue to perpetuate complications and tax gamesmanship.

Another important point to remember is that many of the flat rate tax proposals merely deal with individual income tax rates. Yet, individual income taxes are closely interwined with business taxes. Most businesses are not incorporated. Income from a sole proprietorship is reflected in the individual income tax return. And, the items of partnership income and loss are flowed-through to individual partners. Unless flat rate tax proposals deal with both business and individual activities, the potential for endless conflicts between whether or not the deduction could be taken as a business deduction rather than an individual one will develop. This again leads to more complications which would need to be resolved.

Another element often associated with tax simplification is its thrust toward elimination of many of the currently allowed tax deductions. Yet, these deductions have been put in place for a purpose. The mortgage interest deduction both rewards socially desirable behavior -- i.e. homeownership -- and allow a deduction against income for interest which consumers must pay. The medical deduction provides a safety net for persons who incur large medical expenses through no fault of their own. While Congress would, in enacting a flat rate tax, reduce or eliminate many tax deductions and credits, the potential for additional complications during the congressional process is ever present. While Congress may be taking away some tax deductions, it may be adding others, thereby leaving the final product not much different in terms of complexity than the current code.

Economic Efficiency

The proponents of the flat rate tax criticize the current tax law as being economically inefficient. The theoretical foundation for this view is a free-market system without economic distortions of any kind. In this environment, investment decisions would be made without concern for their tax consequences. Under this view, high marginal tax rates cause economic distortions by interfering with incentives for savings and investment and by diverting resources into tax motivated transactions.

In response to this view, it should be noted that any system of taxation will interfere with an ideal model of economic efficiency. Taxes, whether they are a flat tax on income or a direct tax on consumption, will be factored in economic decision-making.

In addition, the view that the present tax system discourages savings and investment needs to be examined closely. A major thrust of the Economic Recovery Tax Act of 1981 was to encourage savings and investment. Marginal tax rates were reduced. Major changes in depreciation were developed. Incentives to encourage individual savings were provided. These incentives, along with other incentives in the tax law, are designed to reward risks and encourage desirable economic activity.

The average taxpayer is concerned with the amount of tax paid, not the method of arriving at that determination. The rate at which he is taxed, while perhaps the most visible evidence of the incidence of tax, is only one factor in determining the total liability. Twenty percent of $100,000 is still more than 40% of $10,000. If base-broadening increases the total amount of tax owed, then the benefit to that discrete taxpayer of rate reductions is hard to discern. If the base-broadening also necessitates elimination of incentives to invest in socially desirable goals, the benefit to the [illegible] sus-pect.

The limited partnership is one of the most important real estate financing vehicles in the United States today. It is one of the few investment vehicles that allows the small investor the ability to participate in the investment incentives that exist in the tax code. The depreciation changes in the 1981 Act are highly significant for real estate development and housing. Without these depreciation provisions and the ability of individuals to utilize these benefits as investors in limited partnerships, the typical real estate project will not be financed. Absent the ability for individual taxpayers to utilize tax write-offs as investors in limited partnerships, the cost of the typical real estate project, either commercial or residential would increase substantially.

The need to broaden the tax base to accommodate the rate reductions associated with flat rate tax and other tax rate deduction proposals could have a negative effect on other types of savings. For example, one of the greatest sources of capital accumulation in our nation is pension funds, which are tax-exempt. This tax advantage is a powerful incentive for savings. If the tax base were broadened to tax current income from pension investments, a significant source of capital would be eroded.

Finally, the practical economic difficulties associated with a major change in the tax law should be carefully weighed against any theoretical advantage which may accrue.

A flat rate tax would cause a readjustment of investment decisions. Prior investment decisions, based upon an earlier set of tax incentives would no longer be valid. Taxpayers have made investments which utilize tax incentives in anticipation of the continuation of the current rules. Millions of middle-income families have brought homes and factored the mortgage interest deduction and the other tax benefits of homeownership into their family budget. Repeal or modification of these deductions could squeeze family budgets to the breaking point. Homeowners with long-term mortgage contracts could not respond to a sudden broadening of the tax base. Real estate values could diminish, causing serious economic dislocations and market adjustments.

Equity

One of the most vocal arguments advanced for the flat rate tax is that the current tax system is not fair. Many middle income taxpayers perceive the flat rate tax as an opportunity to "soak the rich" who presumably have the advantage of sophisticated tax advice thereby reducing taxes substantially.

The assumption beneath this view is that the current tax system is not, in reality, progressive and that the rich escape paying their fair share of taxes. As the Joint Committee on Taxation indicated in its analysis for these hearings, the average tax rate increases progressively as expanded income increases.

Studies by the NAHB Economics Division confirm this result. Table I demonstrates 1982 effective income tax rates for various income levels as projected for 1982.

TABLE 1

FLAT RATE TAX VS. CURRENT TAX LAW - 1982 PROJECTIONS

Individual Income Levels	Income Within Level *	Tax Liability of Level*	Effective Tax Rate**	Flat Rate Liability Of Level*	Flat Rate Tax
Below $5,000	$ 17.5	$ -.2	-0-%	$ 2.5	14.2%
$5-$10,000	98.7	5.5	5.6	13.9	14.2
$10-$15,000	162.8	14.5	8.9	23.0	14.2
$15-$20,000	188.2	20.4	10.8	26.6	14.2
$20-$30,000	416.7	52.1	12.5	59.0	14.2
$30-$50,000	509.7	75.4	14.8	72.2	14.2
$50-$100,000	230.7	45.4	19.7	32.7	14.2
$100-$200,000	83.9	21.2	25.3	11.9	14.2
$200,000+	67.5	17.1	25.4	9.6	14.2
Total	$1,775.7	$251.4	14.2%	$251.4	14.2%

*($ BILLIONS)

** Current System

The data shows an increase in effective tax rates for each higher level of income. The average tax rate for all taxpayers was 14.2%. The data also shows that the primary beneficiaries of a flat rate tax would not be low or middle income taxpayers, but the rich. To achieve a 14.2% flat tax rate, the tax burden would shift substantially to low and middle income taxpayers, and if exemptions were not provided for low income taxpayers, they would experience substantial tax increases.

The flat rate tax eliminates one important element of tax equity, that is tax progressivity. Ability to pay would no longer be a criterion for taxation. Instead, a higher proportion of disposable income would be taken from low and middle income taxpayers under a flat rate tax. This shift in tax burden would be on top of an already flat payroll tax which accounts for almost 30% of the federal government receipts in 1981. Individual income taxes accounted for over 45% of government receipts during the same period.

II. SPECIFIC CONCERNS

This testimony does not attempt to catalogue all of the incentives for housing now in the tax code. Obviously, the most popular incentive is the mortgage interest deduction. But others include the rollover of gain on the sale of a residence, the exclusion from capital gains tax of $125,000 on the sale of a residence for those homeowners over 55 years of age, the deduction for real estate taxes, and the capital gains tax provisions. In addition, tax incentives for housing extend beyond those which encourage homeownership. Affordable rental housing depends upon investment incentives, particularly depreciation. Each of these incentives would be directly affected by flat rate tax proposals.

The specific flat rate tax legislation which has received the most attention is the Gephardt and Bradley bills. These proposals are not actually a flat tax but several simplified progressive tax rate brackets which could reach 28 percent. Certain tax exemptions, deductions and credits, such as capital gains, percentage depletion and the investment tax credit would be eliminated. Deductions would be permitted for home mortgage interest, charitable contributions, state and local income taxes, and real property taxes.

NAHB commends Senator Bradley and Congressman Gephardt for recognizing in their proposal the social and economic desireability of preserving key tax provisions for home ownership, the deduction for mortgage interest and real estate taxes. NAHB, however, has reservations about these bills. The proposals could have a highly negative effect upon housing, both homeownership and rental housing. For example, the elimination of the capital gains tax deduction would have an adverse effect on investment and would involve the double taxation of the same income -- once, when the income is for compensation and second, when the income comes from capital savings and investment.

In addition, while the mortgage interest deduction would be retained, its value would be substantially diminished. At most, the highest marginal rate would be 28 percent, making the deduction worth 28 cents for every dollar of interest spent. The effect on homeownership of such a change is difficult to quantify, but obviously a home purchase would be a less attractive investment because of the lower potential tax savings. NAHB, therefore, does not support the Gephardt/Bradley proposals.

III. CONCLUSION.

In conclusion, at a time when there is a need to encourage increased housing production, ~~Congress~~ should be looking at specific proposals to encourage housing development -- single family and multifamily. A flat rate tax, in eliminating current incentives, could only adversely affect the housing industry. NAHB would strongly oppose any change in these incentives pursuant to enactment of a flat rate tax.

NAHB shares the concern of this Committee for tax simplification, efficiency and equity. Rather than a comprehensive change in the tax system as envisioned by most flat rate tax proposals, NAHB would urge the Committee to look at incremental changes which would improve the operation of the tax system. Some of these changes could have a positive effect upon housing rather than the potentially disastrous effects of the flat rate tax. NAHB would be pleased to have the opportunity to work with this Committee to achieve a simple, efficient, and equitable tax system.

NATIONAL TAX EQUALITY ASSOCIATION

000 CONNECTICUT AVENUE BUILDING WASHINGTON D C 20036 TELEPHONE 202 296 5424

CHAIRMAN	PRESIDENT	VICE PRESIDENT	SECRETARY TREASURER
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STONY BROOK NEW YORK			STONY BROOK NEW YORK

October 8, 1982

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lighthizer: Re: Major Tax Reform Proposals

The National Tax Equality Association (NTEA) appreciates this opportunity to comment on the important examination of alternatives and proposed improvements to our system of income taxation being conducted by the Senate Committee on Finance.

This association was organized in 1943 by businessmen who sought an effective means of expressing their concern about the tax-favored position of cooperatives with which their investor-owned businesses were competing. Firms in the grain, lumber, coal, feed, fertilizer, cotton and seed industries are among those represented by NTEA. Additionally, approximately 1200 commercial banks subscribe to the association's tax equality programs.

In the press release announcing this hearing, Chairman Dole indicated the Committee's preference for comment concerning the merits of the various flat-rate tax proposals as well as the important question of whether all income should be taxed without regard to the form of business organization.

As this committee is well aware, the flat-rate tax concept is not new. However, the sudden, recent surge in flat-rate fascination is unparalleled on the tax policy scene. To determine the impetus for this surge one needs only open the Internal Revenue Code and attempt to logically move through the labyrinth of complex, seemingly endless pages of rules, exceptions, credits, deductions and preferences.

The greatly simplified approach to taxation engendered in a flat-rate tax system is, for many, the map out of the tax maze.

While this association does not, at this time, specifically endorse <u>any</u> of the various flat-rate tax proposals, we do encourage the dialogue accompanying these proposals and have for some time supported many of the goals pursued by the flat-rate enthusiasts. These serious discussions are long overdue, and we feel that the goals sought can be achieved without a <u>radical</u> shift away from the current progressive income tax system.

The taxation goals which the National Tax Equality Association endorses, and which we would be happy to work with this Committee in developing, include:

<u>INCOME TAX NEUTRALITY</u>--Our Income Tax Code has developed into a hodgepodge of different rules and regulations which act to differentiate the burden of taxation according to various taxpayer characteristics. This differentiated tax burden is inherently economically inefficient.

For example, the degree of taxation often is determined by particular taxpayer activity or industry. New activities and industries are regularly approached because of their relative tax advantage, not because of any contribution to overall economic efficiency or market considerations.

Of even greater concern to competing businessmen is the favored tax treatment accorded some forms of business organization vis-a-vis alternative forms of business organization. Common examples include corporate taxation vs. sole proprietorships vs. subchapter S corporations vs. partnerships. One area of differing corporate taxation with which NTEA is particularly concerned involves the area of cooperative taxation.

Cooperative corporations today bear little resemblance to their predecessors of 50 years ago. No longer do they consist primarily of small groups of farmers operating at the local level. Cooperative corporations today are involved in what is casually termed "big business." Nine cooperatives are listed among the current 500 largest industrial corporations in America. Three of these corporations hold assets in excess of $1 billion.

Yet cooperative taxation rules continue to bestow what amounts to virtual tax exemption on the cooperative entities. The Joint Committee on Taxation estimates that the tax expenditure for the agricultural cooperatives alone will exceed $1 billion by 1985.

The co-op tax scheme is only one example of distorted tax policy. Legislation (H.R.6378) has been introduced into the 97th Congress which would remove the special tax status from cooperatives. The point being that piecemeal legislation designed to achieve tax neutrality is difficult to enact. This Committee, and the Congress, needs to recognize that tax neutrality, regardless of the form of business organization, must be the primary goal underlying reform of our tax system.

SINGLE TAXATION OF INCOME, AS CLOSE AS POSSIBLE TO ITS SOURCE--The Economic Recovery Tax Act of 1981 did much to ease the existing bias in the federal income tax laws against savings and towards increased capital investment.

The next significant step Congress can take to encourage increased investment involves the repeal of the current system of double taxation of corpor. e earnings. Our present system of taxation results in a tax at the corporate level when income is earned and another tax on the same earnings when they are distributed to corporate owners as dividends or interest on corporate debt. This double taxation acts to reduce the individual's return on investment and therefore is a disincentive to corporate capital investment.

Business income should be taxed once--at the corporate level. Individual receipt of interest, dividends and capital gains should be tax free at the individual level since the earning activity (business operations) has already been taxed.

Although most flat-rate tax proposals advocate single-source taxation, NTEA believes the same can be achieved within the present progressive system. The revenue loss which the Treasury would experience from repealing the double taxation provisions would be compensated for by way of increased savings, investment and reduced present consumption.

CLOSING TAX LOOPHOLES--As the Chairman of the Senate Committee on Finance has suggested, all income-producing entities should equitably share in this nation's taxation burden.

Because of the years of tinkering with the revenue code to achieve perceived desired social goals or redistributive ideals, many potential taxpayers avoid a significant share of this tax burden.

We urge Congress to reexamine the entire area of tax expenditures with an eye towards eliminating many of the tax credits, exclusions and deductions currently allowed. We recognize that there are a few tax incentives which may be necessary to alleviate genuine economic hardship. These few incentives should be preserved.

However, elimination of the majority of the estimated $250 billion of tax expenditures could pave the way towards improving the basic progressive income tax system. Since many taxpayers have already taken the continuation of these tax subsidies into long-range planning, a phaseout period will certainly be necessary. NTEA will be happy to assist in developing the proper time schedule.

Our tax system needs to be revamped, fairly and equitably. If the goals mentioned above are reached, and they can be, then overall tax rates could be further cut while the tax base would expand, creating increased tax revenues.

This association therefore urges Congress to first work within the progressive tax system to improve it--close the unwarranted tax loopholes, work towards true tax neutrality, achieve a single source income tax--instead of working outside the present system to change it.

Thank you.

Sincerely,

Ray M Stroupe

Ray M. Stroupe

NATIONAL TAXPAYERS UNION

FOR IMMEDIATE RELEASE

FOR FURTHER INFORMATION CONTACT
Katherine Kiggins (202)543-1300

NTU COMMISSIONED POLL REVEALS MAJORITY OF AMERICANS SUPPORT

FLAT RATE INCOME TAX PLAN

(Washington, D.C., September 28, 1982) -- The results of a nationwide survey conducted for the National Taxpayers Union by Market Opinion Research revealed that a 54-32 percent majority of Americans favor a simplified flat rate income tax with no deductions over the current graduated income tax. James Dale Davidson, Chairman of the National Taxpayers Union (NTU), announcing the results today said "Our poll clearly shows that the American public sees the flat rate income tax as a fair and equitable alternative to the current system."

Strong support was [illegible] ~~for the flat rate tax system~~ when respondents were questioned on personal financial benefit of the plan. A plurality of 40-29 percent felt that it would be easier for them "to become financially successful under a flat rate tax system than under the current system."

A resounding 60-30 percent majority agreed with the statement that the current income tax system is "unfair [illegible] [illegible] of money to make money." [illegible] of the sample with particularly strong [illegible] (under $15,000 -- 65 percent agree, [illegible]) and Democrats ([illegible] percent, [illegible] percent).

"What this poll also points out is that the people [illegible] of a flat rate tax actually [illegible] ~~[illegible] and the middle~~ class realize, even if some politicians don't, that [illegible] will benefit them. The American people see the current system [illegible] their own economic advancement."

The National Taxpayers Union [illegible] representing 450,000 family members [illegible].

TABLES

Between September 10th and 14th, Market Opinion Research [illegible] a cross section of 1200 adults nationwide by telephone:

Question (1) Some people have proposed a simplified flat rate tax system to replace the current graduated tax system with its many deductions and credits. This tax would be based on the following principles: 1) All types of income should be taxed at the same rate, no deductions or credits would be allowed; 2) The lowest income households should pay no income tax, and 3) Tax returns for [illegible] households and businesses should be simple enough to fit on a post card or on a single page. Do you favor or oppose [illegible]

REPLACE GRADUATED INCOME TAX WITH FLAT RATE TAX?

	% Favor	% Oppose	% Don't Know/No Answer/ Neither
Total	54	32	14
Republican	55	30	15
Independent	58	30	12
Democrat	49	35	16
Under $15,000	53	29	18
$15,000 - $30,000	54	36	10
Over $30,000	56	31	13

Question #2) Critics of the current tax system charge that it is unfair because it makes it more difficult for people who do not have a lot of money to make money. Do you agree or disagree with this?

CURRENT TAX SYSTEM UNFAIR?

	% Favor	% Oppose	% Don't Know/No Answer/ Neither
Total	60	30	10
Republican	44	43	17
Independent	62	30	8
Democrat	69	20	11
Under $15,000	65	24	11
$15,000 - $30,000	61	30	9
Over $30,000	54	38	8

Question #3) Do you think it would or would not be easier for you to become financially successful if you paid taxes under a flat rate system, somewhere between 12 and 19 percent, than under the current income taxes?

EASIER TO BECOME FINANCIALLY SUCCESSFUL UNDER FLAT RATE TAX?

	% Favor	% Oppose	% Don't Know/No Answer/ Neither
Total	50	28	22
Republicans	50	28	22
Independent	51	27	23
Democrat	48	29	23
Under $15,000	42	30	28
$15,000 - $30,000	53	29	19
Over $30,000	59	27	15

Methodology

This Market Opinion Research Survey was conducted by telephone with a representative nationwide cross section of adults 18 and over at 1,200 different sampling points within the United States between September 10th and 14th. Figures for age, sex and race were weighted where necessary to bring them into line with their actual proportions in the population.

In a sample of this size, one can say with 95% certainty that the results are within plus or minus 3 percentage points of what they would be if the entire adult population had been polled.

This statement conforms to the principles of disclosure of the National Council on Public Polls.

STATEMENT OF

Sergeant Major C.A. (MACK) McKinney USMC Retired
Executive Director for Government Affairs
Non Commissioned Officers Association of the USA (NCOA)

MR. CHAIRMAN. The Non Commissioned Officers Association of the USA (NCOA) represents the largest, single group of active duty, reserve, and guard noncommissioned and petty officers in the United States Armed Forces. The Association welcomes the opportunity to comment on the proposal to establish a single tax rate, and - hopefully- to persuade this distinguished committee that such legislation would not be in the best interests of the Nation, its national defense, or the men and women who serve in its uniformed services.

Regular Military Compensation

The current compensation system employed by the federal government to pay members of the uniformed services is a unique one. In addition to a basic pay structure for grades and times-in-service (TIS), Regular Military Compensation (RMC) involves the use of quarters (BAQ) and subsistence (BAS) allowances, plus a tax advantage resulting from the receipt of these allowances. However, all service members do not receive BAQ and/or BAS and, therefore, do not have the tax advantage enjoyed by their comrades-in-arms.

Additionally, the Uniformed Services use a number of financial incentives to reward or compensate their members. These include but are not limited to; special pays, hostile fire pay, hazardous duty pay, flight pay, proficiency pay, bonuses, and foreign duty pay.

Also available for the use of service members are commissary and exchange store privileges; morale, welfare, and recreation (MWR) facilities; medical and dental care; low-cost insurance programs; and other considerations that may have a monetary value for those who participate.

Finally, there are allowances provided members for purchases and maintenance of uniforms, family separation, accrued leave, travel and transportation, temporary duty, and certain inconveniences and high costs involved with assignments in the United States and overseas.

Such a system of remuneration probably is the best method to employ when compensating individuals living in an almost complete society of socialism. Uniformed services personnel are the most socialized of all U.S. citizens. They are on duty 24 hours a day and have little movement that is not controlled or semi-controlled by the federal government. There should be no question as to why the government continues to use the system it employs to pay its service personnel.

Despite the basic socialism in the uniformed services, individual compensation is regulated by many independent or correlated factors, such as occupational specialty, assignment (duty and location), marital status, proficiency on the job, responsibility, and specialized skills. Most are used as a management tool to keep the services at congressionally-mandated strength levels with the best qualified personnel at the least cost to the taxpayer.

The net result is that two servicemembers of equal grade and TIS may be drawing different pay checks. For example, if one is not married, resides and eats on a military installation, he or she receives a lesser amount in his or her pay check than one who is married and lives in family housing on the installation. The same applies to the one who is married and resides in the civilian community. His or her pay check is greater than either the single member's or the one who is married and lives on the installation.

Tax Bases

The current federal income tax method provides that cash allowances given to servicemembers to augment costs of housing and food are tax-free. The system assures an equitable application of taxation since it provides that personnel of equal grade and TIS will be taxed only for their basic pay, plus any special pays, bonuses, and allowances that are earned, but also available to all under similar circumstances.

Prior to July 1982, a single servicemember earning and entitled only to a basic pay of $1,000 monthly was taxed $149.60 per month. A married servicemember with one dependent, also earning and entitled to the same basic pay, but also entitled to BAQ and BAS, had a withholding tax of $95.80 computed on receipt of basic pay only. If a flat 10 percent single tax rate is applied only on the basic pay or each, both would pay $100 monthly in withholding tax. On the other hand, should the married servicemember have to pay the single rate on basic pay, plus BAQ and BAS, his or her withholding tax increases significantly.

For example, an E-5 (pay grade) servicemember with 10 years TIS earned a monthly basic pay of $1004.40 (prior to Oct. 1, 1982). If married, he or she also received a BAQ of $267.90 and a BAS of $135.00, for a total monthly income of $1,407.30. A single tax rate of 10 percent would cost the married E-5 $140.73 each month-$40.73 more than the single E-5 must pay.

Such a plan is counter productive. The services have had to provide extra allowances in order for its married personnel to pay the higher costs for housing in the civilian community. To now tax these allowances through the individuals who are in receipt of same, will force the uniformed services to seek greater increases in BAQ, BAS, and Variable Housing Allowances (VHA) to offset the loss in taxes.

Chart No. 1 depicts the disparities and inequities that a single tax rate of 10 percent will cause within a single pay grade (E-5) under the circumstances noted.

CHART 1
PAY GRADE E-5
(To nearest $1.00)

MARITAL STATUS/ EXEMPTIONS	ANNUAL BASIC PAY 1/	JAN. 1982 TAX 2/	10% TAX RATE	W/ANNUAL BAQ & BAS	10% TAX 1 RATE	W/ $1,000 EXEMPTION 4/	10% TAX RATE
Single/1	$12053	$1795	$1205	$ 0	$1205	$1,000	$1105
Married/2	$12053	$1150	$1205	$4835	$1689	$2,000	$1489
Married/4	$12053	$ 829	$1205	$4835	$1689	$4,000	$1289
Married/4	$12053	$ 829	$1205	$51[illegible] 3/	$1721	$4,000	$1321

1/ - Effective Oct 1, 1981

2/ - Federal Income Tax Monthly Withholding Table (Wage-Bracket Method)-(Pertaining to Income Earned prior to July 1982)-(Courtesy of 1982 Uniformed Services Almanac)

3/ - Also include VHA for Fort Leavenworth, KS- $26.79 monthly-effective Oct. 1, 1981.-(Courtesy of 1982 Uniformed Services Almanac)

4/ - If allowed under single tax rate legislation

What occurs with a single tax rate is a reversal in the current system. Married servicemembers will either pay as much or more than the single taxpayer. Even if the proposal should provide for a monetary value to be applied to the "in-kind" quarters and subsistence given the single E-5, there would be little, if any, equity in the application. The federal government pays much less to house and feed single servicemembers. It would be unfair and indiscriminate to place a value on "in-kind" allowances for single members at the same rate as given in cash to married servicemembers.

Another Reversal

The single tax rate proposal also has another inequitable ingredient for servicemembers. Junior personnel who are married will pay a higher proportion in taxes while senior personnel will pay less - with or without cash or "in-kind" allowances credited to taxable income (see Chart 2 below).

CHART 2

(To nearest $1.00)

PAY GRADE/ TIS	ANNUAL BASIC PAY	W/DEPENDENT ALLOWANCES (BAQ/BAS) 1/	JAN 82 TAX BASE 2/	10% TAX RATE 3/	10% TAX RATE 4/
E-5/10 yrs	$12053	$4835	$1150	$1205	$1689
E-8/26 yrs	$22828	$5706	$3505	$2283	$2853

1/ - Married W/ 1 dependent

2/ - Federal Income Tax Monthly Withholding Table (prior to Jul. 1982)

3/ - Without dependents allowances

4/ - With dependents allowances

Equitable Solution

To be as fair as possible, the uniformed services would have to change their current compensation system to a salary base where everyone in the same grade and TIS, married or single, receives the same wages (i.e. - a program similar to that employed in the civil service system). However, it is estimated that a conversion to a salary plan would cost taxpayers an estimated $4 billion the first year.

Since it will be fiscally irresponsible to adopt a salary system for the uniformed services, the Non Commissioned Officers Association must go on record in opposition to a single tax rate proposal. Under the current system employed by the uniformed services there is no fair or equitable method to determine the monetary value of each servicemember's total compensation package. Therefore, a single tax rate would be equally as difficult to apply to a servicemember's total "income" for the purpose of taxation.

Over the past few years there has been a struggle in Congress to recognize the pay congression suffered by uniformed services personnel in the 1970s. Comparability with the civilian sector has been the goal. Surely, the very same Congress that gave servicemembers that comparability is not ready to jeopardize its positive action by endorsing a negative proposal such as the single tax rate.

NCOA predicts that the adoption of such a proposal will adversely affect recruitment and retention of qualified and skilled personnel for the uniformed services. It, therefore, urges Congress to reject a single tax rate for the uniformed services.

Testimony of Brian O'Connell

President

INDEPENDENT SECTOR

Summary of Testimony

INDEPENDENT SECTOR does not take a position on the tax structure itself or the restructuring of it, but we do argue that any revisions must not eliminate the charitable contributions deduction.

Historic recognition of the importance of voluntary associations and private charitable activity through special tax treatment, has deep roots. Over the last 200 years, government at all levels in the United States has used tax legislation as a means of encouraging the activities of voluntary associations.

In addition to providing basic services, voluntary associations serve the fundamental principles of a democratic society. The pluralistic character of American voluntary associations exemplifies the spirit of free participation and constitutes an essential manifestation of the democratic process.

There is mounting evidence from research that the amount of an individual's gift to charity is influenced by the tax deductibility of that gift.

Research by Feldstein and Taylor indicates that eliminating the charitable deduction would have reduced total giving in 1970 from $17.3 billion to $12.8 billion, a decrease of 26%.

Based on this and other studies, it is likely that elimination of the contributions deduction would reduce individual giving by at least 20% or a loss of more than $8 billion a year.

My name is Brian O'Connell. I am President of INDEPENDENT SECTOR, a membership organization of 425 national voluntary organizations, foundations, and corporations which have banded together to strengthen our national tradition of giving, volunteering and not-for-profit initiative.

Our Voting Members are organizations with national interest and impact in philanthropy, voluntary action and other activity related to the independent pursuit of the educational, scientific, health, welfare, cultural and religious lives of the nation. The range of members include the American Heart Association, United Negro College Fund, National Council of Churches, Council on Foundations, American Association of Museums and General Motors. The common denominator among this diverse mix of organizations is their shared determination that the voluntary impulse shall remain a vibrant part of America.

The INDEPENDENT SECTOR does not take a position on the tax structure itself or the restructuring of it, but we do argue that any revisions must not eliminate the charitable contributions deduction.

To remove that deduction would significantly undercut a part of our society that public policy, including tax policy, has sought in every conceivable way to encourage.

From the earliest beginnings of our country, a deliberate effort has been made to encourage private initiative for the public good and to promote and sustain the voluntary institutions through which the nation does so much of its public business. Those conscious efforts included the property tax exemption and, when the modern day Federal income tax was adopted, the charitable contributions deduction. To reverse that direction now -- for whatever intended good purpose -- would dangerously overlook the larger value to this society of our unique degree of voluntary participation.

None of this is to suggest that tax incentives are the major factor in this country's impressive record of volunteering and giving. However, because we have so cherished those traditions and those forms of civic behavior, we have constructed even our tax system to enhance them. A flat tax or a value added tax or any other kind of tax will not destroy the willingness of Americans to give of themselves for the larger good. But, any tax restructuring that eliminates the charitable deduction will suddenly remove one of the ways this country has found to enhance giving. The resulting decrease in giving will move us away from the very kind of society we've determined that we want.

Historic recognition of the importance of voluntary associations in private charitable activity through special tax treatment has deep roots. The famous Statute of Charitable Uses was enacted in England during the reign of Elizabeth I and early American Colonists brought the tradition of tax support with them and incorporated it into our laws. Custom and common understanding supported the practice of not taxing income given to charity even where no specific legislation existed. Over the last 200 years, government at all levels in the United States has used tax legislation as a means of providing support to the activities of not-for-profit voluntary associations.

The base upon which government support for voluntary associations rests is very strong. Both historically and in the current period, not-for-profit endeavors have provided critical services to our society both as organizations addressing essential human needs and as associations furthering the basic principles of democracy. From early community and church efforts to relieve the suffering of the poor and the sick to today's partnership efforts in which the Federal Government and private voluntary agencies jointly provide essential human services, charitable contributions from individuals have provided an essential form of support. Such contributions constitute a resource freely given to sustain activities which are ~~the responsibility~~ of government. Private philanthropy in support of parks, education, and essential human services relieves government of significant expenditures in these areas of public responsibility. Gifts of this kind clearly constitute activity in the public interest and in support of public policy.

In addition to providing basic services, voluntary associations serve the basic principles of a democratic society. The pluralistic character of American voluntary associations exemplifies the spirit of free participation and constitutes an essential manifestation of the democratic process. Citizen participation as volunteers or donors constitutes a constructive act of citizenship and is an important form of individual expression. Voluntary associations provide opportunities for individuals to take active responsibility for the quality of life in their communities and their nation. Finally, voluntary associations play an important role in seeing that government lives up to its responsibilities. Through monitoring, advocacy, and careful stewardship of our constitutional freedoms, voluntary organizations serve all Americans.

The value of voluntary association activities to our society has long been recognized by the granting of tax exemptions in one form or another. By 1894, the practice of granting tax exemptions in favor of religious, educational and charitable institutions was virtually universal among the American states. The charitable contributions deduction for individual gifts was first enacted by Congress in 1917. This action provided a clear indication of the value placed on voluntary not-for-profit organizations and institutions in our society.

Tax exemption as a means of support has much precedent behind it. Significant arguments in favor of this form of government participation can be made in terms of cost effectiveness and incentives for significant discretionary giving. An argument could be made that in cases where individual charitable contributions are made in support of activities which government would otherwise have to provide, a tax on such gifts would constitute a penalty on those who elect to subsidize government. Rather than viewing a charitable tax deduction as revenue foregone, we suggest it should be viewed as a voluntary extra payment in support of the social good.

If charitable contributions are viewed as discretionary expenditures in support of the social good, incentives to give, especially in significant amounts, are clearly desirable. While altruism is the most important basis for almost all charitable giving, there is little doubt that the tax incentive plays a significant role in determining how much money people can give and do give.

Previous surveys commissioned by INDEPENDENT SECTOR and undertaken by the Gallup Organization made clear that the availability of the tax deduction does not influence the number of gifts an individual makes. However, it does influence the size of those gifts particularly for individuals who use the charitable deduction. Those studies show that in every income bracket, itemizers gave significantly more than nonitemizers. On the average, itemizers gave 2 1/2 to 3 times the nonitemizers' amount.

Dr. Martin Feldstein, Harvard economist and President of the National Bureau of Economic Research, stated in 1980 testimony before the Senate Finance Committee that his research clearly demonstrates, "the deduction of charitable contributions in the calculations of taxable income lowers the 'price' of giving and stimulates increased amounts of giving." He went on to point out that there would be a substantial drop in charitable contributions if they were not tax deductible.

In an article "Income Tax and Charitable Contributions" (Econometrica, Vol. 44, No. 6 - November, 1976) Feldstein and Taylor stated "Consider first the implications of completely eliminating the deduction without substituting any other provision that encourages charitable giving. The simulation indicates that this would reduce total giving in 1970 from $17.3 billion to $12.8 billion, a decrease of 26 per cent. Eliminating the deduction also increases total tax revenue by $3.5 billion. This implies that the current deductibility induces $1.29 of additional charitable giving per dollar of revenue lost."

INDEPENDENT SECTOR has commissioned an immediate analysis of the impact on giving of the various "flat rate tax" proposals now before Congress and we will submit the results to this Committee just as soon as they are available.

Based on previous studies including Feldstein and Taylor, it is likely that elimination of the contributions deduction would reduce individual giving by at least 20% or a loss of more than $8 billion a year.

Beyond the dollars, there is a vast multiplier effect in terms of what the sums do to further enable and involve volunteers. Thus the loss of $8 billion would have ramifications and reduce service and voluntary activity into the scores of billions of dollars.

Voluntary organizations supported by charitable contributions are indispensable to our way of life.

--They provide many services at little or no cost to their constituents which would otherwise have to be provided by government at full cost to taxpayers.

--They can and do espouse unpopular causes, minority viewpoints, and are free to fight inequity and injustice.

--They engage in activities which, under our way of life, neither the profit sector nor government should get into.

--They promote "watchdog" functions such as monitoring business and government, which can be performed best by nonprofit groups.

--They are free to explore, to experiment, to innovate, to try - and to fail. Many of today's essential government functions are yesterday's volunteer innovations. Public schools, for one example.

--They have been responsible for virtually every significant social change in the past century. They include the abolitionists, the populists, the suffragettes, those who sought legislation against child labor, the civil rights movement, the environmentalists, consumer groups - all these and many more.

The action of Congress in 1917 to provide for the charitable contributions deduction was a clear indication of our determination as a society that we wanted to find every conceivable way to encourage pluralism and maximum possible involvement of citizens in addressing their own problems and aspirations. Passage of the Charitable Contributions amendment just a little more than a year ago, which again allows all taxpayers, even those who use the standard deduction or short form, to deduct their contributions, was a recent and further indication of how essential it is that Americans be encouraged to support the causes of their choice.

We are keenly aware that authors of some flat rate tax proposals believe that it is a contradiction to their aims to make any exception. As I indicated in the beginning, we do not pretend to be experts on the tax structure itself, but we do know what the availability of the tax deduction has meant to the kind of society we have fortunately become. Thus to the extent that any such tax restructuring is given serious consideration we argue for an exception for the charitable contributions deduction. This deduction is totally unlike all the other deductions which primarily benefit the individual. The contributions deduction benefits society.

Therefore, we commend the proposal of Senator William Bradley (D-NJ) and Congressman Richard A. Gephardt (D-MO) in S2817 that would retain the charitable deduction. We're also encouraged that legislation introduced by Senator George Mitchell (D-ME), S2887, would also retain the charitable deduction. Even these proposals however could result in a great loss to charity. Any flat tax that reduces the average tax rates now in use will have that effect.

If we really believe that pluralism is important in our society, then it is exceedingly important that we be searching every possible way to encourage just such behavior and certainly should not inadvertently adopt measures that would shrink this increasingly important part of our national life. We therefore urge Congress to exclude the charitable contributions deduction from any consideration of tax restructuring.

STATEMENT FOR SENATE COMMITTEE ON FINANCE

by

Fred W. Peel, Visiting Professor,
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The purpose of this statement is to comment on proposals for a flat-rate income tax and for conversion of the income tax to a consumption base tax, and to suggest an alternative program for improvement and simplification of our present Federal income tax.

The Flat-rate Tax

Adoption of a flat rate for the income tax could achieve simplification in some areas. The flat rate would eliminate the complexities, and the accompanying discriminations, caused by the present system's different treatment based on marital status. Under a flat rate the singles no longer would be discriminated against as compared to married couples of whom only one spouse has substantial income, and married couples both of whom have substantial incomes no longer would be discriminated against as compared to single taxpayers. The deduction for two earner married couples no longer would be necessary.

A flat rate also could eliminate the complications now caused by different treatment of capital gains and losses. It would be surprising, however, if all the proponents of the flat rate really intend that long term capital gains be taxed at that rate.

A flat rate tax could not eliminate literally all deductions, though that claim has been made for it. For example, if deductions were to be denied for wages and salaries paid in the service industries, rent paid on business premises, and advertising expenses the tax, even at a relatively modest rate, would be in excess of 100 percent of profits for many businesses. And deductions must be allowed for depreciation, or some capital cost recovery alternative, to permit taxpayers to recover their investments in machinery and equipment. With these and other business-related deductions remaining in the tax system, many of the hopes for simplification through a flat rate evaporate. And some of the projections of large revenues from a low flat rate also disappear.

Realistically, enactment of a flat rate tax could be accompanied by elimination of the deductions allowed by present law that are not related to the measurement of profit, or net income. The principal examples are charitable and religious contributions, medical expenses, and casualty losses. The Tax Equity and Fiscal Responsibility Act of 1982 already has reduced substantially the revenue cost of the medical expense and casualty loss deductions.

The interest deduction, insofar as it involves interest on loans to finance personal consumption outlays, frequently is targeted as a personal deduction that should be eliminated. Some interest expense, however, arises from business loans and loans to finance income-producing investments. If a person has debts and has made expenditures for personal consumption assets and for income-producing assets it is not logical to attempt to trace to determine if the motive for incurring the debts was personal consumption or income production.

Even if it were possible to isolate part of interest expense as personal expense, denial of deduction for this interest would discriminate against these taxpayers as compared with persons who can afford to use their own funds for personal consumption outlays and thus achieve tax-free imputed income from use of the personal items they have bought. In the context of home loans, the chief component of personal interest deductions, the effect of denying the interest deduction would be to shift the present point where discrimination occurs (home owners over renters) to discrimination against persons who owe money on their homes as contrasted with person who own their homes outright.

The best chance for a flat-rate tax to recoup revenue lost through substitution of a lower rate would be through reaching income now exempt or deferred indefinitely. Municipal bond interest is an obvious example. Probably a much bigger potential for revenue would be by reaching the income that escapes current taxation through contributions to pension and profit-sharing plans and through the exemption of the investment earnings from the funds that have been contributed to the plans. This potential revenue source includes pension plans for the self-employed and IRA's as well as employee benefit plans.

Shifting from progressive tax rate schedules to a flat tax rate might provide an excuse to make drastic changes in the tax system--changes affecting personal deductions (and perhaps some business deductions) and income that is not presently taxed. If these changes are desirable they can be made without adopting a flat-rate tax. A flat-rate tax is intrinsically unfair because taxpayers with higher incomes can afford to, and should, pay higher tax rates.

The Consumption Tax

A consumption tax as a substitute for the present income tax could take either of two forms: an excise tax burdening retail sales (either directly or step by step through the stages of production under the Value Added Tax variant), or a tax based on reported income, with deductions for investments that are considered savings so as to arrive at a consumption base. The consumption tax in either mode is regressive. The smaller a taxpayer's income, the smaller the share of that income he can afford to save, so a tax based on consumption will take a bigger share of his income than it will of larger incomes.

Furthermore, the approach of converting a tax that starts with reported income into a consumption tax by deducting savings has the additional disadvantage that taxpayers with sufficient previously accumulated wealth can qualify for the deduction for "savings" while still maintaining consumption levels equal to their incomes. They can accomplish this by switching their prior investments into deductible savings items. Alternatively, they can save part of their current incomes and compensate by simultaneously cashing in their prior investments to maintain personal consumption levels equivalent to their current incomes.

By a curious circular logic, conversion of our income tax into a consumption tax often is justified on the grounds that the income tax already has become, in large measure, a consumption tax. And it is true that savings, or at least shifts into deductible or excludible investments, already do reduce our income tax base drastically. The most spectacular examples are the deductions or exclusions for contributions to pension and profit-sharing plans, both for employees and for the self-employed. The same result of shielding saved (and invested) amounts from tax is achieved by the excess of the ACR deductions for newly-acquired depreciable assets over any reasonable estimates of actual depreciation.

The fact that the income tax is being converted gradually into a tax only on persons who cannot afford to save or who have no investments to switch to deductible savings is not, however, a good reason why the process should be endorsed and accelerated. On the contrary, the process should be reversed. The tax base should be restored so that it measures income fairly for all instead of penalizing those who have no choice but to consume current income.

Senator William Borah, speaking in the Senate 70 years ago, said, "No man should escape entirely his contribution to the Government. It is not only a duty, but it makes him a more vigilant, thoughtful, interested citizen. On the other hand, it is manifestly inequitable and unjust that consumption should bear all the taxes, for this is to compel the man of small means to pay almost, and sometimes quite, as much to the Government as the man of great income." Those principles still are valid today.

An Alternative Program

If greater equity in our income tax system, and a significant reduction in its complexity, are desired, these goals can be achieved. And they can be achieved without resorting to either a flat-rate tax or a consumption base tax. Our income tax has been moving away from equity and simplicity, however, and it will take a radical program of revision to reverse the current trend. My purpose here is to suggest such a program.

The following proposals will not make the Federal income tax simple. In our complex economy the tax could not be made simple without sacrificing basic principles of fairness. The proposals made here would, however, eliminate unnecessary complexities and, in the process, make the tax fairer than it is now. Also, taxpayers should be able to anticipate the impact of the tax more accurately and, if the taxpayers are economic beings, that should lead to a more efficient allocation of resources. The suggested alternative program is as follows:

1. Revise the individual tax rate schedule by dropping the present system of narrow rate brackets and substituting three broad rate brackets—low, medium, and high.

As an example, the tax rates might be 15% on the first $15,000, 30% on the next $25,000, and 50% on the excess over $40,000. The rates mentioned are only for illustration. Actual rates would be set consistent with revenue needs. The only constraint is that subsequent proposals require that the tax rate on the income of corporations, trusts, and some estates be equal to the highest rate imposed on individuals. The present top rate for individuals of 50% would be feasible in this context.

Given the lack of precision in measuring taxable income and the numerous exceptions in the tax law, the present narrow rate brackets give a false illusion of precision. Rates that vary by only a few percentage points from bracket to bracket do not reflect with such precision the marginal tax rates on economic income for most taxpayers. For example, even a low-income taxpayer who owns his own home is taxed on a significantly lower marginal rate on real income than is a renter with the same salary.

With only three tax brackets, most individuals would know what their marginal tax rates would be for the year and could make informed economic decisions accordingly.

2. Apply the same tax rate schedule to each individual's income, regardless of marital or head of household status.

This proposal would solve the problems of tax rate discrimination against unmarried individuals and also against married couples when both husband and wife have substantial incomes. Earned income would be taxed to the spouse who earns it in community property states as well as in common law states (as is done already in applying the tax on self-employment income). The spouse who owns an investment would be taxed on the investment income. Married couples in community property states might be considered as having some advantage over those in common law states under such a system because of the splitting of investment income from community property, but couples in common law states could redress the balance by equalizing their ownership of investment assets by interspousal gifts. Joint returns still would be permitted as a convenience to married couples, but they would be practical only in cases where the resulting combination of incomes would not result in a higher marginal tax rate.

The need to get away from the present system of taxing family units is becoming urgent because of two trends. First, more wives are working and, with lessening pay discrimination against them, situations are becoming increasingly frequent in which the incomes of wives approximate those of their husbands. The second trend is a social change: there is increasing willingness to forego the formality of marriage, so a perceived tax discrimination against married couples if each has income may significantly reduce the number of marriages.

The deduction for two-earner married couples, enacted in 1981, is a crude attempt to equate the treatment of couples having two income with their single counterparts, but it is not a satisfactory solution because it exempts some income from tax entirely.

3. Eliminate the zero bracket amount and reinstate the optional standard deduction as a percentage of adjusted gross income.

The zero bracket amount attempts to accomplish two things. First, it sets a floor on taxed income for low-income taxpayers and, second, it provides a substitute for itemized personal deductions from adjusted gross income. The considerations that dictate the size of a low-income floor on taxable income are not the same as the considerations for an optional deduction in lieu of itemized personal deductions. The optional standard deduction was designed to relieve taxpayers and the Revenue Service from the complexities of calculating, substantiating, and auditing small personal deduction items such as charitable contributions and non-business interest deductions. If the amount of the optional standard deduction is held down to an amount considered appropriate for outright exemption of low-income persons, it will not simplify the returns of middle-income taxpayers. Rather than dispensing with the optional standard deduction as a percentage of adjusted gross income, it would be advisable to set a high ceiling on the deduction—still limited, of course, to a fixed percentage of adjusted gross income.

4. Eliminate the different tax treatment now provided for capital gains and losses.

It is proposed that gains from sale or exchange of capital assets and section 1231 assets be treated as ordinary income, and that losses from sale or exchange of capital assets and section 1231 assets be treated as ordinary losses, eligible to offset ordinary income dollar for dollar.

Adoption of this proposal would permit sweeping simplification of the tax law. Professor Boris Bittker has called the differential treatment of capital gains and losses "perhaps the single most complicating aspect of existing law." If capital gains and losses are treated like other gains and losses, separate capital loss carryover rules would no longer be necessary; separate computations for section 1231 assets would be dispensed with; section 1245 and section 1250 depreciation recapture could be eliminated; the problems in defining capital assets would become immaterial; and capital gains need not be treated as tax preference items for the minimum tax. In the area of corporate-shareholder relations, the collapsible corporation provision could be repealed. Furthermore, the taxpayer-Revenue Service struggle over tax-avoidance efforts to transmute ordinary income into capital gains would be over.

5. Repeal the tax credits designed as business incentives and replace them with direct transfer payments outside the tax system.

Neither the investment nor the various other incentive credits is relevant to the measurement of taxable income or the determination of tax liability. Proposals that the investment credit be made "refundable" recognize that the credit has no necessary connection with income tax liability. A refundable credit would be remitted to an eligible investor as a direct payment when the credit exceeds current income tax liability.

The refundable credit is logical. There is no more reason to reward a business for investment in depreciable personal property if the business has taxable income than to reward a business that makes an identical investment but has a net operating loss.

Also, the present investment credit is a clumsy tool because it has only one rate for rewarding all assets with useful lives of seven years or more. Thus, a taxpayer investing in assets with seven-year lives is rewarded with the investment credit three times as often as a taxpayer with assets that are replaced after 21 years. And, because the credit is not limited to incremental investment, the reward has to be paid for investments that needed no incentive and would have been made to replace old assets in any event.

6. Impose a flat-rate corporate income tax at the maximum individual income tax rate.

This proposal has become a realistic possibility now that the maximum individual income tax rate has been reduced to 50%. Using a single corporate tax rate and linking it to the maximum individual rate would permit elimination of double taxation of corporate income by using the method described under Proposal 7.

Elimination of graduated corporate tax rates for the first $100,000 of income is proposed for three reasons. First, a graduated rate schedule for corporations is an illogical application of the ability-to-pay principle. Second, taxing all corporate income at the full corporate rate permits an assumption that the income has been fully taxed and need not be taxed again at the shareholder level. Third, the present provisions against abuse of the graduated rates by multiple corporations with the same owners is complex.

The size of a corporation or the amount of its income bears no necessary relation to the ability of its shareholders to pay. If the corporate tax rate is lower than an individual shareholder's marginal tax rate, the shareholder has been given an opportunity to split income and save tax that is not available to other persons.

7. Integrate corporate and individual income taxes by excluding dividends paid by domestic corporations from the gross income of the recipients.

This proposal is based on the premise that corporations should properly be treated as taxable entities. If a corporation generates net income it is logical to tax that income regardless of the status of the stockholders. (As indicated in Proposal 8, an exception is valid for closely-held corporations whose owners are willing to come under the rules for the taxation of partnerships.) A business corporation operates in the market place as a business entity competing with other businesses and taking advantage of a corporation's continuity of existence and facility in assembling capital and managing its operations. As such, when it earns income it is a logical and viable taxpayer in its own right. Thus, if relief from double taxation is to be provided, it should be provided by relieving shareholders from the second tax when dividends are received.

The proposed dividend exclusion would be limited to dividends paid from corporate income earned after the effective date of the change. Allowing the exclusion to apply to distributions of earnings and profits accumulated earlier would produce an unjustified windfall because business decisions of corporations, their shareholders, and their former shareholders during the period the earnings were accumulated were based on the assumption that the dividends would be taxed. Also, it would be unfair to distribute previously accumulated corporate earnings and profits on the assumption that they had been fully taxed at the corporate level when, in fact, they may have been only partially taxed (because of the graduated corporate tax rates or the earlier surtax exemption) or untaxed (because of inclusion of various untaxed items—such as accelerated depreciation—in accumulated earnings and profits accounts).

The present presumption in section 316(a) as to the sequence in which earnings and profits are presumed to be distributed would be reversed under the proposal. Each dividend distribution would be presumed to be from the earliest post-March 1, 1913 earnings remaining in the corporation's accumulated earnings and profits account. Dividends would be considered to be paid from current earnings and profits only after earlier accumulations had been exhausted.

The corporate tax would not be considered an advance payment of shareholder's tax that had been withheld at the corporate level. Therefore, there would be no refunds of the corporate tax to dividend recipients--either untaxed individuals or exempt organizations. In this respect the proposal is consistent with the principle of taxing active business income of exempt organizations and taxing feeder corporations owned by exempt organizations.

The definition of earnings and profits earned in years after the effective date of the change would have to be modified to match the definition of taxable income, with the following exceptions:

(a) Earnings and profits would be reduced, as at present, by the income tax paid by the corporation.

(b) Earnings and profits would include intercorporate dividends received if paid out of earnings after the effective date of the new system. (Such dividends would be excluded from taxable income of corporate shareholders, just as they would be excluded from the taxable income of individual shareholders.) Intercorporate dividends paid out of earnings and profits of the payor corporation accumulated prior to the effective date of the new system would, however, be treated by the recipient corporation as though they were earnings and profits accumulated by it before the effective date.

(c) Tax exempt interest would not be included in current earnings and profits, but would be added to the account for earnings and profits accumulated before the effective date.

Corporations no longer would be allowed to carry back net operating losses, capital losses, or unused foreign tax credits because such carrybacks might invalidate the basis for tax-free dividends previously paid.

The proposal would not affect the treatment of distributions that are not out of earnings and profits. Such distributions would continue to be applied against the basis of the stock and distributions in excess of the basis of the stock would be treated as gain to the shareholders. Gain on redemptions or on complete or partial liquidations would be recognized as at present.

This proposal in combination with Proposal 6 would eliminate any further need for the tax on unreasonable accumulations and the personal holding company tax.

8. Repeal Subchapter S and, instead, give all business corporations with 25 or fewer shareholders an election to be treated as partnerships.

Since it is proposed that corporations be taxed at the highest tax rate applied to individuals, it is appropriate to permit closely-held organizations that can operate like traditional general partnerships to sidestep the corporate tax entirely. The proposal is that they be permitted to elect to be treated as partnerships. The election would be exercisable one time only by a corporation.

Election of partnership treatment by an existing corporation would be on condition that it first make an actual or constructive distribution of its accumulated earnings and profits. No earnings and profits account would be maintained by a corporation during the period of its election to be taxed as a partnership.

The complexities of Subchapter S appear, in large part, to result from permitting corporations to come in and out of Subchapter S without changing their essential nature as corporations. Consequently, it has been necessary to maintain earnings and profits accounts for Subchapter S corporations and to tax the shareholders, not on their shares of distributive income, but on constructive dividends out of current earnings and profits. If a corporation could elect only after clearing out its earnings and profits account, it would be feasible to treat it exactly like a partnership and to treat its stockholders as partners while the election is in effect.

A corporation that elected partnership treatment would be free to terminate the election at any time. The consequences of termination would be the same as a section 351 transaction in which partners contribute partnership assets to a new corporation.

The tax treatment of partnership is not simple. Its rudiments are generally understood, however, and the tax law would be simplified by removing the complex in-between status of Subchapter S corporations.

9. Tax the undistributed income of trusts (and of estates that have not been distributed within a specified period) at the same rate as the corporate tax rate.

A decedent's estate may be viewed, for a time, as a quasi-extension of the deceased individual. On that theory it is reasonable to tax the estate as an individual. The same logic is not applicable to a trust, and it is not applicable to an estate that continues so long without winding up as, in effect, to be administered as a continuing trust.

A trust is not an individual. Trustees need not be individuals and, even when they are, the tax on the trust's income is not imposed on them in their capacity as individual taxpayers. A trust is a separate legal entity, an artificial creation of the law, more akin to a corporation than to an individual taxpayer. Taxing undistributed trust income at the corporate tax rate with the corporate rate equal to the top individual rate as proposed earlier, would eliminate a whole area of complexities engendered by individuals attempting to split investment income to avoid progressive tax rates.

The proposal would not change the essential principle of the taxation of trust and estate income. These entities would continue to occupy a status between corporations and partnerships. Like corporations, they would be taxable entities, but only for income accumulated. Like partnerships, they would be conduits, but only for income currently distributed to beneficiaries.

Taxing trusts on accumulated income at the corporate tax rate would remove the need for complex throwback rules for income earned after the effective date of the change. Income earned by a trust and taxed to the trust because it is not distributed currently would be excluded from income by the beneficiaries when distributed to them in a later year.

10. Review each of the tax preference items in the minimum tax base, make any reductions considered appropriate in those benefits, and repeal both the add-on minimum tax on corporations and the alternative minimum tax on individuals.

The minimum taxes add an additional layer of complexity to the income tax. This complexity is unnecessary, because the tax preference items on which the taxes are based reflect situations where Congress is dissatisfied with its own generosity in providing tax benefits. It would be much simpler, and fully as effective, to cut back on the benefits from the tax preference provisions Congress considers overly generous, rather than continuing the complex minimum taxes.

11. Repeal deductions that are designed to relieve taxpayers personally and are not related to the measurement of income.

Several categories of deductions are not necessary to determine profits, or net income. Some are deductions for expenditures that are direct benefits to the taxpayers, and their only relation to the income tax is that they reflect expenditures or losses that may have impaired taxpaying capacity to some degree. It is proposed that the following deductions be eliminated:

(a) Property taxes on the taxpayer's personal residence and vacation home;

(b) Medical expenses; and

(c) Personal casualty losses.

12. Repeal exclusions from gross income that make the tax system more complex.

The major statutory exclusions from gross income, in all likelihood, made the income tax system simpler. These are exclusions of gifts and inheritances, life insurance proceeds, interest on state and local securities, and damages received on account of personal injuries or sickness. Other exclusions add to the complexity of the tax system, however, and it is proposed that at least the following ones be repealed:

(a) Gain on sale of residences by persons 55 or older;

(b) $5,000 of employee death benefits;

(c) $1,000 of income received annually by a surviving spouse from investment of insurance proceeds left with the insurer;

(d) Disability pensions paid to persons with less than $15,000 of taxable income per year;

(e) The rental value of parsonages and rental allowance paid to ministers; and

(f) Scholarship and fellowship grants.

13. Exclude foreign source earned income of citizens living abroad.

This proposal essentially would restore the earned income exclusion for bona fide foreign residents that was contained in the law prior to 1951. It reflects a principle applied almost universally by other countries. It would replace the present complex housing cost exclusion for persons working abroad, reduce a difficult compliance burden on the Revenue Service, and reduce the complexity of the foreign tax credit. It still would be desirable, however, to complicate the foreign tax credit to the extent of denying credit against

United States tax for foreign income tax attributable to the excluded income.

14. Repeal the exemption of private foundations and deny deductions for contributions to them.

Outright repeal of the exemption for private foundations would be much simpler than the intricate system of penalty excise taxes enacted in 1969. The present system appears to be an attempt to harass the private foundations out of existence by financial threats to their trustees and officers and by a suffocating web of compliance detail.

If this proposal is adopted, the definition of private foundations would need to be sharpened. The objective should be to draw a line to separate organizations controlled by their donors and associates from organizations under independent, broad-based, or community control. It is reasonable to limit exemption and the benefit of deductible contributions to the latter type of organizations because the Government is entitled to be assured that deductible contributions and exempt income are put to public uses that justify favored tax treatment.

15. Limit employee exlusion of vesting pension and profit-sharing plan benefits to the minimum level of contributions by the employer for the lowest-paid workers, and postpone employer deduction of contributions until rights in them vest.

With the difficulties we face in financing the Social Security system, it is ironic that we have in effect a system of income tax exclusions and deductions that allows huge amounts of income to go untaxed currently because it is going to finance pension benefits for high-income individuals who need no special tax breaks to finance their retirement plans. Maximum contributions to qualified plans were cut back sharply in the Tax Equity and Fiscal Responsibility Act of 1982, but the current tax benefits still are far higher than can be justified in a period of budget tightening and need for additional revenue.

Without disturbing the present definition of qualified plans, covered employees could be required to take into income the value of their benefits as they vest, minus some modest amount that can be jusitifed from a public policy standpoint as a supplement to Social Security. For employers with large numbers of employees unrelated to the owners a satisfactory limit on the exclusion probably could be achieved merely by limiting the exclusion to an amount equal to the benefits vesting in the lowest-paid workers. Consistent limits would be necessary on pension plan deductions taken by the self-employed, and contributions to IRA accounts would be applied against the maximum annual exclusion.

16. Concentrate litigation of civil tax disputes in a single court system.

It is inconceivable that anyone starting from scratch would have designed the present system for adjudication of tax disputes. Taxpayers may choose between the District Court and the Claims Court for refund suits, with the option of a jury trial in one forum but not in the other. The Tax Court is forbidden to handle refund suits, though it can determine that a refund is due once it has established jurisdiction. The Tax Court's decisions can be appealed to all the circuits, resulting in the peculiar situation that the Tax Court decides issues differently depending on the position previously taken by the circuit to which appeal lies.

Instead of the present hodgepodge, it is proposed that:

(a) The Federal District Courts and the Claims Court be relieved of jurisdiction over tax refund cases;

(b) The Tax Court be given exclusive jurisdiction of refund cases as well as the review of proposed deficiencies;

(c) The Tax Court be reorganized on a regional basis;

(d) Regional Tax Court decisions be appealed to a National Tax Court of Appeals (relieving the Circuit Courts of appeals jurisdiction); and

(e) The Supreme Court provide final review on certiorari.

Statement of

JOHN H. PERRY, JR.

Chairman, Perry Oceanographics, Inc.

Perry Cable TV, Inc.

I thank the Chairman and the Committee for this opportunity to express my views in your consideration of alternative means of restoring our nation to a sound economic footing. These views are solely my own and are submitted in my dual role of a gravely concerned citizen and businessman. It has been my good fortune to know personally most of the members of this Committee prior to now so I see no need to go into detail on my personal and business background at this time.

Our major problem today is a stagnant economy. For more than three years there has been virtually no growth in economic activity in the United States. As long as that condition exists, it can only mean more unemployment, more inflation, more high interest rates and more declines in profits.

Without profits there can be no prosperity, no full employment, no advances in technology, no improvement in our competitive world trade position and no real, earned money to support government. Without a restructuring of the federal government's financial obligations, we cannot restore confidence in Wall Street or in the consumer, and, therefore, we cannot recover.

How did we get into this critical situation? Plainly stated, by using a philosophy of stimulating the economy through demand-side economics, we took on more federal programs than we could afford. Let me make it clear that I intend no criticism of the motives or goals of those who promoted and implemented these programs. The motives and the goals were sincere and were well-intentioned. But the fact is that even the best programs may have features built into them that create destructive side effects over a long period. One of those side effects was rampant inflation, and we turned from demand-side to supply-side economics to reduce and bring it under control. But when we reduced inflation, we also reduced personal income tax bracket creep, and that choked off federal revenues, aggravating already serious budget deficits. In addition increases in military spending, and indexing of welfare and Social Security sent the budget even further out of control. And this has paved the way for more debt and deficits which will send inflation soaring again because there is an absolute and undeniable connection between the amount of our federal debt and the consumer price index as shown by the attached chart.

We need a politically feasible way to curb the forces which cause the federal budget to remain in deficit.

We must separate the debt from the dole.

We must have both supply-side and demand-side economics.

Legislation designed to meet these needs has been introduced with bipartisan sponsorship in the House of Representatives. It is H.R. 5085 and is known as the National Dividend Act.

I believe the National Dividend Act is a major step in the direction of a sound national economic footing. I also believe that the members of this Committee will concur when they learn of its provisions and potentialities.

The National Dividend Act provides a new way of conducting United States fiscal policy. It creates incentives for politicians to respond to the public and to conduct the budgetary policy of the nation on a sounder basis. It also creates incentives for cooperation between business and the taxpayer, because under this legislation the more profitable business becomes, the greater the benefits received by the public. The public's primary benefits are job security and enhancement of society's real wealth.

There are other direct, individual benefits, too. However, before getting into them, we should examine the basic framework of the legislation.

There are five basic tenets of H.R. 5085:

1. A National Dividend Trust Fund would be set up. All federal corporate income tax collections would be placed in this trust fund. These funds would be held in trust for all legally registered United States voters and would be distributed as dividends on a quarterly basis to those voters. These dividends would be exempt from federal taxes.

2. To ensure that there would be no further federal deficits, the registered voter would in effect be paying for any deficit because he or she would not get the full national pro rata dividend unless the government first earned a surplus. In Treasury jargon this is called "statutory ratcheting." This feature of the proposed legislation was conceived and worked out by a former Treasury official Ernest Christian, Jr., assistant deputy Secretary of the Treasury several years ago.

3. Double taxation on corporate dividends would be eliminated. Dividends paid by corporations to stockholders would not be taxed as personal income. Thus, dividends received through the National Dividend Act and through stock ownership would be exempt from any federal tax. This provision greatly simplifies the tax code and eliminates approximately fifty provisions of it.

4. Maximum corporate tax rates would be frozen at the current 46 percent rate. This is designed to enable members of the Congress to resist any possible political pressure to increase the corporate tax rate for larger dividends which in turn would result in going beyond the point of diminishing return. Such tax rate increases would destroy all incentives to business and would drain the vitality from the producers.

5. A five-year moratorium would be imposed on federal budget increases. The Act would prohibit the Congress for the first five years of the dividend from considering any budget resolution that would increase total budget outlays beyond the level of fiscal year 1981. During this initial five-year period, corporate tax revenues would be paid into the trust fund in increments of 20 percent per year since the problem of paying for current deficits still exists. The five-year moratorium on federal budget increases and the five-year incremental funding of the trust fund are designed to allow revenues to catch up with expenditures as the economy grows over that period.

The administration of the Trust Fund would take place through the banking system. Payment to the banks for servicing the trust fund would be implicit. By allowing the banks to maintain the deposits until payment, this would give them interest free money for about 90 days and should give them incentive for taking on the deposits and administering the fund.

The National Dividend Act's use of the nation's registered voters on a per capita basis as a distribution system for the dividend payments is based on this reasoning:

First, voting records already are maintained in every community throughout the country. This eliminates any need for setting up a huge, costly agency to do the job. Second, the voting system assures equality of treatment for all without regard to sex, race, creed or national origin. It removes political pressures and bureaucratic manipulation as factors in the distribution process. Third, by checking voter registration signatures in poll books with voter endorsements of national dividend checks, election officials will be able to eliminate fraudulent voting practices where suspicions are strong enough to commit the resources needed to cross check. And, fourth, since each registered voter will receive the same amount, there would be no necessity to involve the costly overhead of the federal government in the distribution of the dividend.

The National Dividend Act provides an alternative to current fiscal operations that contains a different set of incentives than the present system. The current fiscal operation, although developed along desirable social guidelines, has presented an incentive system to the public and to the government itself, that has been detrimental to the economy over the long term. The National Dividend Act seeks to correct this incentive system while implementing a program where private enterprise is encouraged and the needy are not forgotten.

The National Dividend Act's provisions do not depend upon the particular form of the tax system. The present progressive tax system with a multitude of exemptions is compatible as is the new idea of the proportional income tax system with very few exemptions The precise income tax system is not the crucial thing. If a proportional income tax system were introduced without the National Dividend Act, it would still contain all the incentive problems of the current system and the present environment would still exist.

A proportional tax is aimed at simplifying the reporting system and reducing the tax load on larger incomes so the incentive to use tax shelters or not report income is lessened. The National Dividend Act is designed to make all of the people feel that they benefit from the economic system, from business and not necessarily from government. It has to do with corporate taxes, not personal income taxes.

The source of the money and the success of the program embraced in the National Dividend Act are dependent on the same force, the productive abilities of American business. As business grows and profits, the consumer benefits because he or she will receive larger dividend payments.

Politicians will not profit from government programs that expand the deficit and reduce dividend payments. Deficits will take money out of the pockets of the general public and concentrate it in specific sectors. On the other hand surpluses from which the National Dividend can be paid will enable us to reduce inflation and create a resistance to vote-buying demagoguery.

The public will begin to conduct its affairs on a more prudent basis as it perceives that the government is conducting its affairs more soundly. A significant change in the operation of the government can result in a significant change in the behavior of the public as well. Less prudent fiscal behavior on the part of the government has led to less prudent fiscal behavior on the part of the American public.

There are other potential benefits in the program offered by the National Dividend Act. Reduced inflation rates should result in lower inflationary expectations. And that, in turn, should bring lower interest rates and more efforts to expand production activities, because the potential for economic gain in speculation will drop relative to that which can be earned from production.

Labor-business problems should be eased because with a lessening of inflationary pressures, the antagonistic relationship between labor and business should be reduced. In addition, labor benefits from the National Dividend Act's program so it is in the interest of labor for business to be successful.

There are two points of major importance about the National Dividend Act's provisions which should be emphasized. They are:

1. No funds would be distributed to the registered voters that had not been earned; as long as we have profitable productivity and a federal government operating without deficits, we will have national dividend payments.

2. The National Dividend Act in no way disturbs the property rights of corporation owners, the shareholders. It simply calls for a different, more direct, more efficient way of distributing tax funds that already are being collected---and have been collected for years.

In my remarks today I have drawn heavily on material from a newly-published booklet by Dr. John M. Mason and the Sindlinger Company, entitled, "Post-World War II Fiscal Incentives and the National Dividend Plan." A copy of the publication is being made a part of the record of this hearing.

Dr. Mason describes the program for a national dividend as a plan that "attempts to get people, consumers and politicians, to act positively and not in a direction that has some self-destructive properties."

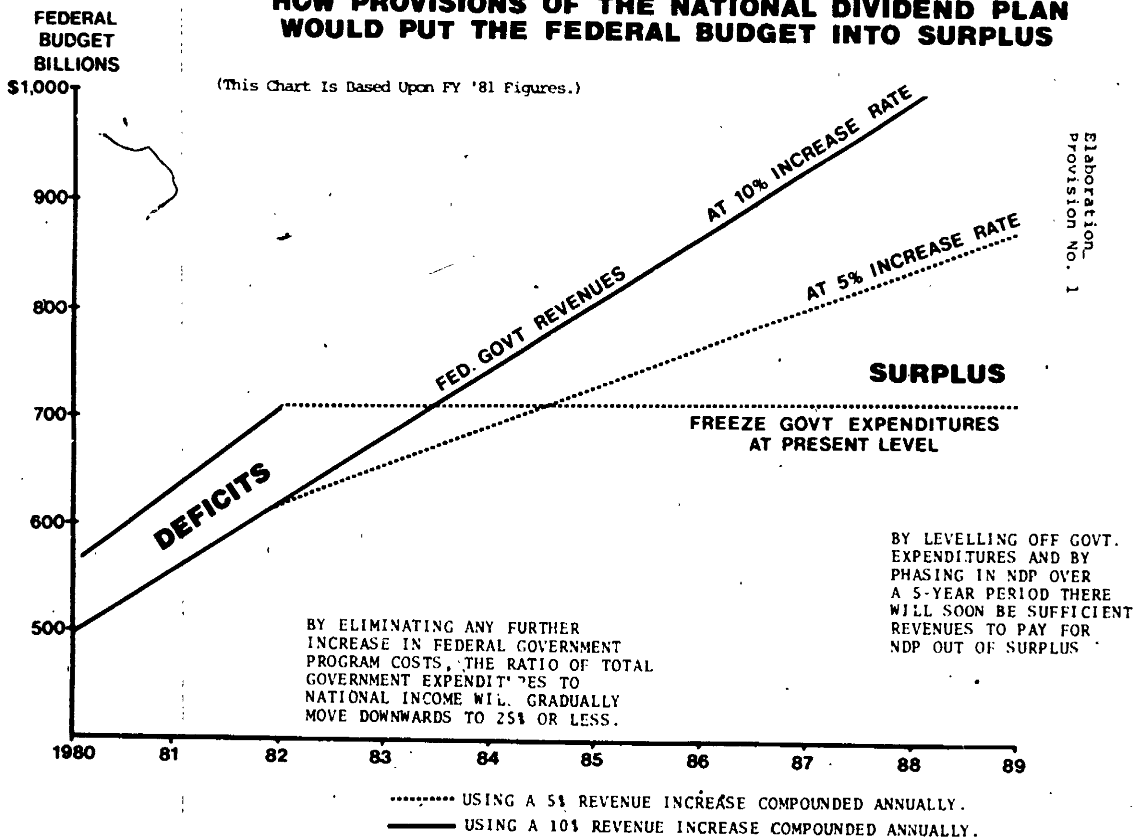
One thing is certain. More of the same programs followed in the last 30 years will just exacerbate the difficulties now being experienced and put the American economic and social system under pressures that will be hard to bear. Both politicial parties are coming up with extensions of existing philosophy. But what is really needed is a new philosophy. This the National Dividend Act provides.

Until H.R. 5085 is enacted into law, I do not believe it will be possible to get transfer payments under control because there will not be a sufficient political constituency to curb their indexing to the inevitable inflation that is bound to occur as a result of the coming escalating budget deficits and ensuing staggering public debt. Gentlemen, it becomes obvious that we must separate management of the debt from that of the dole.

H.R. 5085 can achieve that necessary goal in a politically feasible manner because the electorate will back it up. With current warnings by the Congressional Budget Office that predict budget deficits will soon be in the neighborhood of $200 Billion, I respectfully suggest that this august body should introduce in the Senate a counterpart to H.R. 5085 so that before it is too late we can get the federal budget back under control.

Thank you

HOW PROVISIONS OF THE NATIONAL DIVIDEND PLAN WOULD PUT THE FEDERAL BUDGET INTO SURPLUS



Elaboration_
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September 29, 1982

United States Senate
Washington, D.C.

Attn: Senator Robert Dole

Dear Senator Dole:

Please have the enclosed article read into the record of your Senate Finance Committee hearings on the Flat Tax. The article, entitles "Flat Tax Adoption Would Benefit Wealthy," is out of the Middletown, New York Times Herald Record for September 11, 1982, page 21.

As my article explains, I am opposed to the flat tax. However, I see nothing wrong with getting rid of the confusing part of our tax system. There is absolutely no connection between the percentage of income which is the tax rate, and the complex collection of calculations by which one finds taxable income, to which the tax rate is applied.

I say, get rid of deductions, exemptions, and credits; but keep the progressive tax rates we have now. This simplified progressive system would be no more complex than the flat tax you are considering. Under the flat tax, a taxpayer would have to figure out, say, 19 percent of his (taxable) income. Under the simplified progressive tax, the taxpayer would look up his tax on a chart. I think it would be even easier to use a chart than to figure an odd percentage.

Yours truly,

Arthur Shipman

Arthur Shipman

AS/ed

Flat tax adoption would benefit wealthy

"my view..." Arthur Shipman

In regard to your recent editorial supporting the flat tax, I have a question:

Are you trying to fool your readers, or has the tax system fooled you?

Who would deny that our tax forms are too complex? Who would deny the appeal of a simpler system? Who needs the deductions, exemptions and credits? You stated that our present system of deductions, exemptions and credits is complex and unnecessary. Fine! Let's get rid of them! That will make it easier for me to figure my taxes.

But that has nothing at all to do with the flat tax! The tax system is confusing enough without any help from your editorials. The "flat tax" proposal is an attempt to change things so that rich and poor pay the same percentage of their income in taxes: a "flat rate of taxation." This is a concept completely apart from the confused arithmetic of deductions, exemptions and credits. The flat tax is a bad deal.

The flat tax, where everyone pays the same 15 percent or whatever, is an alternate to the progressive tax we have. I think everyone is familiar with the progressive tax: many people have said it doesn't pay them to work overtime because "it all goes to taxes." And many people have seen a new raise evaporate into higher taxes.

Arthur Shipman lives in Westbrookville.

Under the progressive tax we have, a higher income means not only higher taxes, but a higher rate of taxations. The bad features of this sytem are widely known. In an inflationary economy like ours, the bad features stand out. But the system was set up for a noble purpose: the more you have, the more you can afford to contribute to the common good. (If the "common good" itself has lately come to be questioned, that is another matter.) This noble purpose will be defeated if we drop the progressive tax and set up a flat tax.

According to a recent article in Fortune (July 26, pages 34 and 35), the flat tax "punishes the poor"... It "is likely to foist a greater share of the tax burden upon lower-income groups"... It "generally implies a tax increase for those below certain income level, roughly $30,000, and a tax cut for those above that point."

What is worse, a flat rate of taxation could still be complicated by deductions, exemptions and credits. Deductions, exemptions and credits are rules that develop to protect the income of those with enough political pull to get them into the tax code. The result of all the deductions, exemptions, and credits is that the rich cut down on the taxes they owe. If we could eliminate all the deductions, exemptions and credits, according to the Fortune article, "no longer would the truly wealthy be able to get a free ride."

But changing the tax system will not change human nature. Those with the power to do so will attempt to protect their income. A whole new jungle of deductions, exemptions, and credits will grow up around any new system. In fact, the flat tax itself is an attempt to protect the income of the wealthy. According to the Fortune article, the flat tax "would enable us to bring down the top (tax) rates."

Some people might still support the flat tax because they're fed up with the present system. Even if the deductions, exemptions and credits begin to develop again, at least we would get relief for a while. But the flat tax won't be a relief.

I favor getting rid of the maze of deductions, exemptions and credits, but I'd keep the progressive tax so that those who can best afford it must pay the largest share. In other words, I'd simply remove all the loopholes from the present system. If you agree with me, please write to Sen. Robert Dole and let him know. He will be holding hearings on the flat tax this Fall.

WRITTEN STATEMENT OF

E.T. COLLINSWORTH, JR.
CHAIRMAN OF THE BOARD
AXIA INCORPORATED

ON BEHALF OF THE

COMMITTEE TO REFORM DOUBLE TAXATION
OF INVESTMENT

The Committee to Reform Double Taxation of Investment was formed in September 1976 with the objective of obtaining the elimination of the double tax on corporate dividends. The Committee now consists of over 600 corporate members. A list of the Committee's corporate members is found on the reverse side of the title page of this Statement. Millions of individual shareholders are represented by the corporate membership of the Committee.

Our Committee was formed because of the growing interest in corporate dividends integration in both public and private sectors. The membership has reached the conclusion, shared by numerous economists and tax experts, that the elimination of the double tax on corporate dividends is both equitable and an essential step toward increasing the nation's productivity, standard of living, and achieving a full employment economy.

We wish to thank Chairman Dole and the other members of the Committee on Finance for including corporate dividend integration as a topic in these hearings.

I. NEED FOR IMMEDIATE ACTION

It is time we take action of a permanent nature to provide the savings and capital investment required for the future. The elimination of the double tax on corporate dividends would be the most effective way of achieving that goal.

The effectiveness of this measure is demonstrated by a Data Resources, Inc. study analyzing the economic effect of eliminating the double tax. Although the study was prepared in 1978, the conclusions remain instructive. That study indicates that even a phased-in elimination of the double tax by providing a shareholder credit for corporate taxes would significantly increase domestic investment, savings, capital formation and jobs. Further, the positive impact of eliminating the double tax would be greater than other tax incentives, including a four percent reduction in the corporate tax rate. A summary of the Data Resources study is available from this Committee.

II. DESCRIPTION OF DOUBLE TAX

Our present tax system provides for a dual tax on corporate income. A tax is imposed at both the corporate and individual shareholder levels. The dual system may be illustrated as follows: assuming the maximum corporate rate, for each $100 of corporate income, $46 of corporate tax is paid and $54 remains available for distribution. Assuming the $54 is distributed to a 50 percent bracket individual taxpayer, an additional tax equal to $27.00 is paid. Thus, the effect of the dual or double tax results in a $73.00 Federal Income tax burden on $100 of income.

The following table illustrates the effect of the double tax on various tax bracket individuals:

Additional Burden on Dividends of the Corporation Income Tax on $100 of Corporation Income[a]

Marginal individual income tax rate (percent) (1)	Corporate income before tax (2)	Corporation tax at 46 percent (3)	Dividends received by stockholders (4)	Stockholder's individual income tax (5)	Total tax burden[b] (6)	Additional burden of the corporation tax (7)
0	100	46	54	0	46.00	46.00
10	100	46	54	5.40	51.40	41.40
20	100	46	54	10.80	56.80	36.80
30	100	46	54	16.20	62.20	32.20
40	100	46	54	21.60	67.60	27.60
50	100	46	54	27.00	73.00	23.00

Column 3 = .46 x column 2.
Column 4 = column 2 - column 3.
Column 5 = column 4 x column 1.
Column 6 = column 3 + column 5.
Column 7 = column 6 - column 1 x column 2.
a. Assumes that corporation income after tax is devoted entirely to the payment of dividends.
b. Does not take into account the effect of the exclusion of the first $100 of dividends from the individual income tax base.

Adapted from: Pechman, Federal Tax Policy (Third Edition, Washington D.C.: Brookings, 1977).

It is also noteworthy that the additional burden from the corporate tax falls as individual income rises. To illustrate: a taxpayer in a 20 percent bracket would pay a $20 tax on $100 of income. However, the above table demonstrates that the additional burden of the 46 percent corporate tax increases the tax on dividend income to $56.80. Thus, the tax on dividend income is $36.80 higher than the tax on other sources of income ($56.80 - $20.00). The tax on $100 of dividend income in the case of a 50 percent bracket taxpayer is only increased by $23.00 over other sources of income ($73.00 - $50.00). The regressivity of the double tax is illustrated by the last column of the above table.

It is clear from the above analysis that the double tax is inequitable because it places a heavier tax burden on corporate income than on other sources of income. In addition, it operates regressively impacting dividend income of low income taxpayers far greater than high income taxpayers. The regressive nature of the double tax operates to inhibit investments in corporations by low income individuals. At the same time the high rate paid by persons in the 50 percent bracket discourages them from investing.

III. CORPORATE DIVIDEND INTEGRATION PROPOSALS

Before proceeding to the proposal of this Committee, it is helpful to briefly look at the evolution of our tax system and those of other nations along with recent integration proposals.

A. U.S. Tax System

Corporate integration has been contained in the U.S. tax system since the initial income tax was enacted during the Civil War. The Civil War Income Tax Act of 1864 treated most corporations the same as partnerships taxing corporate income to shareholders whether or not distributed (the partnership approach). The 1865 Act taxed certain corporations but allowed the shareholders to credit the corporate tax against their individual tax.

Since the individual income tax was reinstituted in 1913, there have been various forms of integration. Initially, dividends were only taxed to individuals if their income exceeded $20,000. In 1936, President Roosevelt proposed a corporate deduction for dividends (corporate deduction approach) but Congress enacted a split-rate corporate tax, which was in effect from 1936-1938—taxing retained earnings greater than distributed earnings (split-rate approach). After considerable debate on the double tax system, the Internal Revenue Code of 1954 adopted a $50 dividend exclusion (dividend exclusion approach) and a four percent dividend credit (shareholder credit approach).

Additionally, certain small corporations may elect to be taxed under subchapter S of the Internal Revenue Code, enacted in 1958. Under subchapter S, shareholders are directly taxed on corporate earnings. The subchapter S provisions have been liberalized in recent years and, as members of the Committee on Finance are well aware, further liberalizations were made by this Congress. The subchapter S provisions accomplish an integration of the Corporate and shareholder income tax. This Committee fully supports broadening the scope of the subchapter S provisions; however, even after the action by this Congress, these provisions do not benefit shareholders of publicly held corporations.

Thus, most types of corporate integration have been contained in the U.S. tax system during one period or another. Unfortunately, since 1964 when the four percent dividend credit was repealed, the only remaining relief from the double tax for individuals, other than subchapter S, is the limited dividend exclusion under section 116 of the present Tax Code.

B. Foreign Tax System

1. Current

Most of the major industrial nations of the world have adopted a system for eliminating or diminishing the double tax on corporate earnings. The U.S., as one of the few remaining countries using the double tax system, is placed at a competitive disadvantage. That the disparity of corporation tax systems is increasing rapidly is illustrated by the liberalization of the German system and the adoption of a system for eliminating the double tax in Italy, both in 1977.

Foreign nations have primarily adopted four approaches for eliminating or reducing the double tax:

(1) The split-rate system—reduces the double tax by taxing distributed corporate income at a lower rate than undistributed income.

(2) The corporate dividend deduction system—a special case of the split-rate system where the lower rate on dividends amounts to no tax because of a deduction for dividends paid—reduces the double tax by allowing the corporation to deduct dividend distributions from its taxable income.

(3) The shareholder credit system—reduces the double tax by grossing-up dividends by the amount of an allowed credit and allows that credit against the tax otherwise payable by the shareholder.

(4) The combination of systems—reduces the double tax through a combination of the split-rate, corporate deduction, or shareholder credit systems.

The following table lists the countries using the various systems:

FOREIGN SYSTEMS ELIMINATING THE DOUBLE TAX

Split-Rate or Corporate Dividend Deduction	Shareholder Credit (Withholding or Imputation)	Combination
Austria	Belgium	Germany
Finland	Canada	Greece 1/
Japan 1/	France	
Norway	Ireland 1/	
	Italy	
	Turkey	
	United Kingdom	

2. Recommended

The Commission of the European Communities issued a draft Council directive in August 1975 proposing the harmonization of the tax systems of the member states. The proposal provides for the elimination of the double tax using the withholding approach.

C. Recent Proposals to Eliminate the Double Tax

The elimination of the double tax is a non-partisan issue. It has been recommended by Democratic Presidents, such as Franklin Roosevelt and Jimmy Carter. In addition, President Ford recommended the elimination of the double tax during his Administration. A brief summary of the various recent proposals is helpful.

1. Treasury Proposal (July 31, 1975)

Then Secretary of the Treasury William Simon testified before the Committee on Ways and Means on July 31, 1975, on a Tax Program for Increased National Savings. The elimination of the double tax was a cornerstone of the Treasury proposal.

1/ These are special cases.

The Treasury statement compared two mechanisms for corporate integration—a shareholder dividend credit for corporate taxes (withholding approach) and a corporate deduction for dividend payments (corporate dividend deduction approach). The Treasury recommended the elimination of the double tax in six phases beginning January 1, 1977, by a combination of the corporate dividend deduction and withholding approaches. When fully phased-in corporations would be allowed a dividend deduction for approximately 50 percent of dividend distributions and shareholders would gross-up their dividends by 50 percent and receive a 50 percent credit.

The Treasury urged the enactment of this proposal in order to:

(a) increase national savings;

(b) eliminate an unfair tax;

(c) eliminate the tax discrimination for debt over equity (interest payments are deductible but dividends are not);

(d) make U.S. business more competitive abroad (most industrial nations have eliminated all or a part of the double tax as indicated above);

(e) increase the efficiency of capital and produce a 0.5 percent increase in national income;

(f) make capital markets more competitive by eliminating tax discrimination against corporate investment;

(g) assist equity financings;

(h) assist utilities and other industries where investors rely on steady income;

(i) reduce the tension and distortions from the large differential between capital gain and other tax rates;

(j) reduce the added price consumers pay for corporate goods and investments; and

(k) reduce the systematic bias against lower bracket taxpayers owning corporate stocks.

2. Blueprints for Basic Tax Reform (January 17, 1977)

One of the final acts of the Ford Administration was the issuance by the Treasury of Blueprints for Basic Tax Reform on January 17, 1977. That study expresses similar concerns to those of the Treasury in 1975 and emphasizes the present bias against corporate investments and the flow of savings to corporations. Further, it concludes that the Code encourages debt financing, the accumulation of earnings, and inhibits investment by low income taxpayers. Blueprints contains a model integration plan adopting the partnership approach, namely, "the corporate income tax would be eliminated, and the effect of subchapter S corporation treatment would be extended to all corporations."

3. Joint Committee on Taxation Study (April 4, 1977

On April 4, 1977, the Staff of the Joint Committee on Taxation presented a report entitled Tax Policy and Capital Formation to the Task Force on Capital Formation of the House Committee on Ways and Means (the "Report"). The Report reaches the conclusion that it is mandatory for the nation to increase investment and capital accumulation in order to sustain our standard of living, maintain the real growth rate of wages and jobs, and depress the rise of inflation. Moreover, a significant effort will be required to reverse the last decade's decrease in the rate of growth of both plant and equipment. One way of achieving this goal is the adoption of corporate dividend integration. The Report contains three approaches: integration of dividends through shareholder credit; integration of dividends and retained earnings through shareholder credit (complete integration using the withholding approach); and corporate dividend deduction.

4. Tax Proposals Prepared for President Carter (September 23, 1977)

The Treasury, Council of Economic Advisors, and other administrative agencies prepared a package of tax reform proposals, or options, dated September 23, 1977, for President Carter's consideration. Those papers, among other things, dealt with the need to generate additional business investment and capital formation.

The Treasury suggested the adoption of the shareholder credit approach. The shareholder would include the amount of corporate tax for which a credit is allowed in income. The maximum credit would begin at 20 percent and rise to 25 percent after two years and to 28 percent after two additional years.

The credit would be computed on the basis of actual corporate tax paid. A corporation paying low taxes could elect a lower withholding tax rate than the maximum allowed or pay a withholding tax in addition to the normal corporate tax in order to permit a full credit to its shareholders. The investment tax credit benefit would be treated as a tax paid by the corporation and therefore the benefit would pass to the shareholders. During a transition period, a portion of the foreign tax credit would also be treated as corporate tax.

The reasons supporting the elimination of the double tax were:

(a) it decreases the bias for debt over equity financing;

(b) by adding the withholding credit to dividend income, low bracket tax-payers benefit more than high bracket taxpayers from the credit;

(c) it eliminates the discrimination against doing business in corporate form;

(d) it should encourage saving and investment by increasing after-tax return on capital;

(e) it will offset the effect of eliminating capital gains preference (also proposed); and

(f) it will not increase dividend payments because after-tax return will increase on present levels.

Unfortunately the elimination of the double tax was not contained in President Carter's Tax Program when it was announced on January 21, 1978. According to then Secretary Blumenthal, the double tax proposal was not contained in the Program due to timing problems and because a recommendation to eliminate all capital gains benefits was dropped as well.

5. The Ullman Proposal (February 2, 1978)

Al Ullman, former Chairman of the House Ways and Means Committee, announced his proposal on partial integration in remarks on the House Floor on February 2, 1978. Subsequently, the Committee on Ways and Means announced that the proposal would be considered by the Committee during its deliberations of President Carter's tax package. Then Chairman Ullman expressed his view that the current system of double taxation reduces business investment and causes distortions in the capital markets which creates a dangerous bias toward debt financing. The proposal was intended as a beginning toward eliminating the double taxation of corporate dividends by providing a shareholder credit initially equal to 10 percent of dividend income but increasing over a six-year period to 20 percent (the credit would be 10 percent for 1979 and 1980 and increase by two percent per year until it reaches 20 percent in 1985).

The Chairman stated that his proposal, if enacted, would: increase capital formation; reduce the bias toward debt financing; reduce the bias toward retained earnings; make the tax system more equitable; and discourage corporations from using tax preferences.

The specific operation of his proposal is as follows:

a. The credit would operate on a "gross-up" concept, i.e., a shareholder must include in his income the amount of the dividend plus the amount of credit against taxes allocated to him. For example, assuming a dividend payment to a shareholder of $100 and a $10 credit, the shareholder would be taxed on $110 (the $100 dividend received plus the $10 amount of the credit).

b. The proposal requires the creation of a special corporate "shareholder credit account" in order for the amount of the credit to be ascertained. This account limits the shareholder credit to the amount of taxes, or a set percentage of such taxes, actually paid by the corporation.

If the taxes paid by the corporation are insufficient to cover the allowed 10 percent shareholder credit, the corporation may inform the shareholders that their credit is less than 10 percent or "voluntarily" pay the Treasury additional taxes sufficient to increase the shareholder credit account to the allowed shareholder credit. Dividend distributions reduce the shareholder credit account by the amount of the credit allowed shareholders.

c. There are other specific requirements connected with the credit. The amount of corporate tax applied to the credit account is after so-called corporate preferences, such as the foreign tax credit and investment tax credit. However, there may be a period of adjustment before corporate preferences are disregarded. In the case of the foreign tax credit, the Treasury may (by treaty) provide that foreign tax credits can be added to the shareholder credit account. The corporation is required to elect the rate of credit applicable to dividends during the taxable year prior to the first dividend distribution in that year.

d. The credit is not available for tax-exempt shareholders (charitable organizations, qualified pension and profit-sharing plans, etc.) and foreign shareholders.

e. In the case of dividends to corporate shareholders, the 85 percent and 100 percent exclusions currently available would remain. However, the credit would not be available to corporate shareholders. Instead, the amount of the credit would be added to the receiving corporation's credit account.

f. The credit can only be applied against a taxable dividend under the Internal Revenue Code. Accordingly, redemptions, constructive dividends, and other types of nontaxable dividends would not be eligible for credit. Special rules would be developed for corporate liquidations, reorganizations, and other types of corporate transactions.

g. Where a shareholder credit has been taken during a profitable year and in a later year the company suffers a net operating loss which wipes out the credit account by the net operating loss carryback, the corporation would have to pay an additional (withholding) tax to make up the amount of credit in the earlier year. The same would be true in cases where the tax in the credit account is reduced due to audit adjustments or amended returns.

h. The corporation would be required to report to shareholders the amount of credit allowable on dividends by the end of February following the calendar year in which the dividends were paid.

6. <u>American Law Institute-Reporter's Study</u>

A study of the treatment of corporate distributions was undertaken by The American Law Institute through its Federal Income Tax Project - Subchapter C. The study was exploratory in nature. The Institute did not vote on the proposals developed as a result of the study. The results were therefore published as a Reporter's Study.

The study presents a series of proposals which generally retain the classical system of double taxation. A corporate dividends-paid deduction is provided for dividends paid on newly contributed equity capital. Dividends on existing equity would not give rise to a deduction at the corporate level. Modifications to current law are also proposed for non-dividend distributions.

IV. PROPOSAL OF THE COMMITTEE TO REFORM DOUBLE TAXATION OF INVESTMENT

A. In General

The Ullman Proposal was a step in the right direction. However, the proposal failed to gather the broad support necessary for passage by Congress. Perhaps the major reason for this lack of support was its failure to grant the benefits of corporate tax incentives to shareholders.

Since the Ullman proposal substantial work has been devoted to the double tax issue. Leading commentators have explored alternatives available for double tax relief.[2/] Further, the American Bar Association Section of Taxation has recently formed a special committee to explore the double tax problem. The Technical Advisory Committee of this Committee is in the process of refining a proposal for a shareholder credit method of integration.

B. Overview

The underlying philosophy of the proposal is that the tax consequences to the shareholder should be the same as if he, rather than the corporation, had earned the income. Although work on the proposal is ongoing, its major features may be set forth.

C. The Mechanism

A shareholder receiving a dividend, as defined under current law, is allowed a refundable credit for tax actually paid at the corporate level and further receives the effect of designated corporate tax benefits. A dividend received by

2/ See, C. McClure, Must Corporate Income Be Taxed Twice? (Brookings, 1979); and A. Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 720 (1981).

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the shareholder is grossed up (increased) by the amount of U.S. taxes paid by the corporation (on ordinary income and capital gain) and by the amount of creditable foreign taxes paid. No gross-up is made with respect to investment tax credit and tax-exempt income.

An example of the operation of the proposal, in its present form, is attached as Appendix B.

D. Treatment of Corporate Level Tax Benefits

1. Investment Tax Credit

The investment tax credit is treated as a tax paid for purposes of computing the shareholder credit. However, because the investment tax credit does not reflect a cash outlay by the corporation (as distinguished from U.S. taxes paid and foreign taxes paid), the actual dividend received by the shareholder should not be grossed up by the amount of the investment tax credit. That portion of the shareholder credit that is attributable to the investment tax credit is treated as investment tax credit in the hands of the shareholder, subject to the general limitations on utilization of such credits at the shareholder level.

2. Foreign Tax Credit

Foreign taxes eligible for the foreign tax credit are treated in the same manner as taxes paid to the United States. Thus, the amount of the dividend distributed to the shareholder would be grossed up by the amount of such foreign taxes paid. That portion of the shareholder credit that is attributable to the foreign tax credit is treated as foreign tax credit in the hands of the shareholder, subject to the general limitations on utilization of such credits.

The foreign tax credit presents issues which are under study by our Technical Advisory Committee at this time. Due to the complexities involved at the shareholder level, alternatives to the above treatment of the foreign tax credit are being prepared which sould simplify the handling of this credit.

3. Tax-Exempt Income

Tax-exempt income earned by the corporation is passed through to the shareholder as a tax free distribution. The pass through of tax-exempt income requires neither gross-up of the shareholder dividend nor allowance of a credit to the shareholder.

4. Long-Term Capital Gain

Long-term capital (and section 1231 of the Code) gain distributed to the shareholder is to be separately stated and treated as such in the hands of the shareholder. The amount of the dividend is grossed up by the amount of corporate capital gain tax paid.

5. Certain Accelerated Deductions

The most prominent accelerated deduction is the Accelerated Cost Recovery System (ACRS) allowance. Under the proposal accelerated deductions, such as ACRS, are treated as benefits subject to the pass through. In each case, the acceleration element is treated as tax free income.3/

For example, in the case of ACRS, the excess of the allowance over the amount allowable under the straight-line method is treated as the acceleration element. The straight-line amount is computed using the rules set forth in section 312(k) of the Code for computation of earnings and profits.

3/ The appropriate treatment of other accelerated deductions should be considered, for example: mining exploration and development expenditures, intangible drilling costs, and research and experimental expenditures.

E. Operating Rules

1. Ordering of Income Available for Distribution

As several categories of income receive special treatment, rules are necessary to establish the source of the dividend distribution. Distributions are made from the cumulative accounts maintained by the corporation.

Distributions are deemed made in the following order: ordinary income, long-term capital gain, tax-exempt income, and, finally, the account created by certain accelerated deductions.

Distributions are considered made from the cumulative account balances as of the most recent taxable year for which a tax return has been filed. This is necessary as current information will not be available when the distribution is made. The shareholder receiving the dividend includes it in income at the appropriate time under the shareholder's accounting method.

The shareholder will receive an information return which includes all relevant tax information necessary for the shareholder's tax return. This treatment should simplify the procedure at the shareholder level. Appendix C to this statement illustrates one form in which shareholder information could be presented.

2. Effects on Basis of Stock

The basis of stock is not affected by distributions from taxable income included in the gross-up and credit. Basis is not reduced for distributions which are treated as tax free. However, distributions in excess of the above amounts are treated as under current law, i.e., they first reduce basis and, after basis is exhausted, result in gain.

3. Audit Adjustments

Audit adjustments are reflected in the corporation's cumulative accounts and thus affect future rather than earlier distributions. A penalty mechanism is under study to preclude unjustified characterizations that are later reversed on audit. This penalty mechanism will lessen any potential for manipulation in using account balances as of the most recently filed federal income tax return.

F. Retain $100 Dividend Exclusion as Alternative to Credit

The existing provision which permits stockholders to exclude up to $100 of their dividends (section 116 of the Internal Revenue Code) should remain in the law as an alternative to the credit. The primary beneficiaries of this rule would be small investors whose annual dividends are $100 or less.

G. Summary

The unfairness of the double tax and the substantial benefits from its elimination are clear. Relief from the double tax should occur as quickly as possible. Accordingly, we urge that a shareholder credit mechanism be adopted which grants shareholders the effect of tax benefits earned by the corporation.

The shareholder credit should not be limited by corporate taxes paid. If adopted, the shareholder credit accounts should reflect all taxes paid plus tax incentives now in the law. This would also prevent discrimination among corporations on the basis of tax incentives which could otherwise cause a shift of capital among corporations. In particular, corporations relying on tax incentives to offset major investment programs and which have the greatest need for capital should not be penalized by the new system which is intended to enhance capital formation.

V. ECONOMIC JUSTIFICATION

A. In General

The economic distortions caused by the double tax have been described many times. Perhaps the best summary is contained in the April 4, 1977, report by the staff of the Joint Committee on Taxation. The report states:

> The double tax on dividends significantly increases the cost of funds for corporate investment financed by new issues of stock. As a result, the before-tax rate of return on such investment projects must be higher for them to be profitable, and corporations, therefore, undertake fewer investments than they otherwise would.
>
> * * * * * * * * * * * *
>
> Because the double taxation of dividends raises the cost of funds to corporate business relative to non-corporate business, it leads to inefficient allocation of capital. Corporate investments need to be more profitable than non-corporate investments if they are to yield a sufficiently large after-tax return to make it worthwhile for a business to undertake them. From the standpoint of economic efficiency, there is too little capital in the corporate sector.
>
> * * * * * * * * * * * *
>
> Current law also encourages the use of debt finance relative to new stock issues, since interest payments are deductible and dividends are not. More debt increases the risk associated with corporate financial structures because firms must meet higher fixed charges for interest and face greater risks of bankruptcy. This causes corporations to undertake too few risky investment projects.

Similar conclusions were reached by the Task Force on Capital Formation of the Ways and Means Committee in the report on its meeting ot February 24, 1977:

> There is a good reason to believe that integration will make corporations more eager to invest. The reduced tax burden on corporate-source income will make more potential investment projects profitable, so that corporations should be more willing to invest in them. Therefore, at times of excess capacity in the economy, integration will increase the amount of capital formation. In doing so, it will stimulate the economy and reduce unemployment.

The many other reasons for eliminating the double tax in terms of tax equity and economic benefits are set forth in the various recent proposals for its elimination discussed under Corporate Integration Proposals above. In addition, there have been a number of economic studies which analyze the benefits from the elimination of the double tax.[4/]

VI. CONCLUSION

There is ample justification for the elimination of the unfair double tax now. The inequity of taxing corporate distributions twice is clear. The economic benefits of its elimination are documented and represent a realistic approach to generating the business expansion and jobs required if we are to meet our present and long-term economic goals. Finally, the U.S. is lagging behind other industrial nations which have incorporated the elimination of the double tax into their tax systems, placing U.S. corporations at a competitive disadvantage in international commerce.

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4 See, for example, Harberger, "The Incidence of the Corporation Income Tax," The Journal of Political Economy, LXX, No. 3; Rosenberg, "Taxation of Income from Capital by Industry Group," (Harberger and Bailey, editors), The Taxation of Income From Capital, (Brookings, 1969); and McLure, "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals," 88 Harvard L. Rev. 532 (1975).

APPENDIX A

COMMITTEE TO REFORM DOUBLE TAXATION OF INVESTMENT

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APPENDIX B

Schedule 1

Example of Shareholder Credit Operation

Assumed Corporate Accounts
Prior to Distribution

1.	Ordinary income		$100.00
	- Foreign source	$25	
	- U.S. source	75	
2.	Pre-credit tax attributable to ordinary income		46.00
3.	Tax credits allocated to ordinary income:		
	a. Investment Tax Credit (ITC)		12.40
	b. Foreign Tax Credit (FTC)		10.00
4.	Net ordinary U. S. tax paid		23.60
5.	Ordinary income available for distribution (1-2+3a)		66.40
6.	Long-term capital gain		100.00
7.	Pre-credit tax attributable to long-term capital gain		28.00
8.	Less:		
	ITC allocated to long-term capital gain		7.60
9.	Net capital gain tax paid		20.40
10.	Long-term capital gain available for distribution (6-9)		79.60
11.	Excess accelerated deductions		50.00
12.	Tax exempt income		100.00
13.	Foreign tax credit (assume all allocated to ordinary income)		10.00
14.	Investment tax credit		20.00
15.	Net available for distribution (5 +10 +11 +12)		296.00

Schedule 2

EXAMPLE 1

Tax Treatment of Shareholders

Full Distribution of All Amounts
Available for Distribution

16.	Ordinary income distribution		$ 66.40
17.	Gross-up for ordinary U.S. income tax paid		23.60
18.	Gross-up for foreign tax paid		10.00
19.	Grossed-up ordinary income distribution		100.00
20.	Long-term capital gain distribution		79.60
21.	Gross-up for captial gain tax paid		20.40
22.	Grossed-up long-term capital gain distribution		100.00
23.	Shareholder credit*		
	- U.S. tax paid -	$44.00 (4 + 9)	
	- Foreign tax paid -	10.00	
	- Investment tax credit -	20.00	74.00
24.	Tax free distribution(11 + 12)		150.00

		30% Shareholder	50% Shareholder
25.	Taxable income (grossed up):		
	Ordinary income	$100.00	$100.00
	Capital gain (100 less the capital gain deduction of 60)	40.00	40.00
		$140.00	$140.00
26.	Shareholder tax (tax rate x $140)	42.00	70.00
27.	Shareholder credit	(74.00)	(74.00)
28.	Tax due (refund)	(32.00)	(4.00)

* The Technical Advisory Committee is considering appropriate limitation for the foreign tax credit and the investment tax credit.

Note: 1. Examples 1 and 2 reflect only the treatment of the distributed amounts.
2. After the full distribution in Example 1 all corporate accounts listed in Schedule 1 would be depleted and have a zero balance.

Schedule 3

EXAMPLE 2

Tax Treatment of Shareholders

$50 CASH DISTRIBUTION TO SHAREHOLDERS
(Assume Corporate Accounts as in Schedule 1)

29.	Ordinary income distribution	$ 50.00
30.	Gross-up for U.S. and foreign tax paid (50.00/66.40 x 33.60)* - U. S. Tax - $15.30 - Foreign Tax - 10.00	25.30
31.	Grossed-up ordinary income distribution	75.30
32.	Long-term capital gain distribution (See ordering rules at page 16)	0
33.	Gross-up for capital gain tax paid	0
34.	Grossed-up long-term capital gain distribution	0
35.	Shareholder credit - Actual U.S. tax paid - $15.30 - Foreign tax paid - 10.00** - Investment tax credit - 9.34***	34.64
36.	Tax free distribution (See ordering rules at page 16)	0

		30% Shareholder	50% Shareholder
37.	Ordinary income (grossed up)	$ 75.30	$ 75.30
38.	Shareholder tax (tax rate x $75.30)	22.59	37.65
39.	Shareholder tax credit	(34.64)	(34.64)
40.	Tax due (refund)	(12.05)	3.01

* Derived as follows: (actual distribution / ordinary income available for distribution) x total taxes paid.

** Assumes distribution deemed to be made first from foreign source income. This is being reviewed by our Technical Advisory Comittee.

*** Investment tax credit allocation derived as follows:
50.00/66.40 x 12.40 = 9.34

Schedule 4

CORPORATE CUMULATIVE ACCOUNTS AFTER $50 CASH DISTRIBUTION IN EXAMPLE 2

41.	Ordinary income	$ 24.70
	- Foreign source - $ 0	
	- U. S. source - 24.70	
42.	Pre-credit tax attributable to ordinary income	11.36
43.	Less:	
	a. ITC allocated to ordinary income	3.06
	b. FTC allocated to ordinary income	----
44.	Net ordinary tax paid	8.30
45.	Ordinary income available for distribution (1-4)	16.40
46.	Long-term capital gain	100.00
47.	Pre-credit tax attributable to long-term capital gain	28.00
48.	Less:	
	ITC allocated to long-term capital gain	7.60
49.	Net capital gain tax paid	20.40
50.	Long-term capital gain available for distribution (6-9)	79.60
51.	Excess accelerated deductions	50.00
52.	Tax exempt income	100.00
53.	Foreign tax credit (assume all allocated to ordinary taxable income)	-------
54.	Investment tax credit	10.66
55.	Net available for distribution (5 +10 +11 +12)	246.00

APPENDIX C

Shareholder Information Form

FORM 1099X*

1. Total Amount Paid to You.. $ 296.00

2. Information for Your Federal Income Tax Return (Form 1040):

   a. Ordinary Income.. 100.00
      (to be reported as gross income on Line __ of Form 1040)

   b. Long Term Capital Gain Income................................. 100.00
      (to be reported on Schedule __ of Form 1040)

   c. Tax Credit for U.S. Income Tax Paid by the Corporation....... 44.00
      (to be reported on Line __ of Form 1040)

   d. Tax Credit for Foreign Taxes Paid by the Corporation.......... 10.00
      (to be reported on Line __ of Form 1040)

   e. Investment Tax Credit... 20.00
      (to be reported on Line __ of Form 1040)

3. Other Federal Income Tax Information:

   a. Reduction in Basis of your Stock.............................. 0
      (the tax cost of each share of stock owned should be reduced by the amount indicated)

* This form reflects a shareholder receiving the entire cash distribution from Appendix B, Example 1.

September 14, 1982

Written Statement for Inclusion in Printed Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (Sept. 27-29, 1982)

According to President Reagan "....people were contributing to charities long before there was a system of taxation."

Even if such a time ever did exist, we can be sure that those stone-age philanthropists did not give as much as they would have been able to, had their government endorsed their giving by reducing its cost to them.

Certainly the statement has little relevance to our society, since taxation not only pre-dates the existence of a United States of America, but helped to trigger its birth.

A simple Flat Rate Tax is believed by many to unfairly load the burden of taxation onto the backs of the low and middle income levels. These people have not characteristically had access to the tax incentives available to the wealthier members of our society anyway. The net result of this "simplification" appears to be a hidden but unearned tax break for those in higher brackets, while removing the tax incentives to support those institutions which help maintain the society they enjoy.

Most of the stated advantages to a Flat Rate Tax are already in place, some by way of the 1981 Tax Act, others to be phased in over the next few years.

In these times of high unemployment and intensified social stress on working class families and the poor, can we justify a new tax system which seems to tip the scales in a disadvantageous way for these people?

It seems a singularly untimely proposal.

If the Flat Rate Tax is passed into law, we urge serious consideration of tax credits as a means of encouraging philanthropy from all levels of society, rather than a system based on brackets, or worse yet, no system of incentives at all.

This Administration has espoused support for the time-honored method of private philanthropy that is truly and uniquely American. In severe economic times, there should be greater, not less attention given to the needs of organizations which face the effects of that economic stress at the most critical point.

Sincerely

Glen Braddy

Glen Braddy
Development Office
The Salvation Army/Omaha Nebraska

Summary
Testimony of
Emil M. Sunley
Deloitte Haskins & Sells
on
Flat-Rate Tax
Submitted to
Senate Committee on Finance
September 30, 1982

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1. Proposals for a broad-based low-rate tax provide a road map for how the income tax should evolve. When Congress is able to reduce taxes, priority should be given to reducing marginal tax rates. When Congress must raise revenue, priority should be given to removing tax incentives that are no longer needed.

2. The issues of broadening the individual tax base and going to a flat-rate tax involve two separable but interrelated issues. It would be possible to broaden the tax base and lower marginal rates without changing the degree of progressivity. Tax burdens, however, would be altered significantly for many taxpayers within each income class.

3. The individual income tax remains a progressive tax. The average federal income tax burden rises from 2.3 percent of expanded income in the under $5,000 income class to 24.3 percent in the $200,000 and over class.

4. Broadening the income tax base would lead to simplification to the extent that deductions, credits, and special tax computations are repealed. Not all base broadening measures result in simplification, however.

5. The impact of inflation on the income tax and the proper relationship between the corporate and individual taxes are two issues that must be faced when considering fundamental revision of the income tax.

Testimony of

Emil M. Sunley

Deloitte Haskins & Sells

on

Flat-Rate Tax

Submitted to

Senate Committee on Finance

September 30, 1982

My name is Emil M. Sunley, and I am Director of Tax Analysis in the National Affairs office of Deloitte Haskins & Sells, an international accounting firm. We welcome this opportunity to present our views on proposals for a flat-rate income tax.

The federal income tax is no longer viewed as one of the fairest taxes. In fact, according to a national public opinion survey, the federal income tax was chosen by more people for the third year in a row as the worst tax; that is, the least fair, of the nation's major taxes.[1/]

Though the local property tax was a close second in the worst tax competition, those who chose the federal income tax

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1/ Advisory Commission on Intergovernmental Relations, Changing Public Attitudes on Governments and Taxes (1981), pp.4-5.

as the worst one tended to be under the age of 44, have a high school education or better, have children in the home, and live in urban areas or the South.

There are surely many reasons why the federal income tax won the worst tax competition. First, continuing inflation has pushed taxpayers into higher and higher tax brackets. The federal income tax as a percent of personal income has risen from 9.9 percent in 1975 to 11.9 percent in 1981. Though the tax cuts provided last year will reduce the income tax to 10.3 percent of personal income in 1984, just how the income tax should handle inflation remains an unsolved problem. Second, as each new deduction, credit or exclusion is added to the tax law, the income tax becomes more complex and is viewed by many as more inequitable. Third, many taxpayers believe that they pay more taxes than those with higher incomes who take advantage of tax shelters and other tax breaks. They believe that they pay more than those with lower incomes who have generous zero bracket amounts and exemptions or who simply fail to report all their income. Contrary to these public perceptions, the income tax remains a progressive tax, but, I hasten to add, nowhere near as progressive as is suggested by the progression of the marginal tax rate schedules.

The broad popular support for a flat-rate tax reflects widespread dissatisfaction with the income tax. It also reflects a yearning for a simpler world, at least a simpler tax. Though it may not be possible to go all the way to a broad-based, low-rate tax, proposals such as Bradley-Gephardt provide a road map for how the income tax should evolve. When Congress is able to reduce taxes, priority should be given to reducing marginal tax rates instead of providing new exclusions, deductions, or credits. When Congress must raise tax revenue, priority should be given to base broadening; that is, to removing tax incentives that are no longer needed or of lower priority.

I should say at the outset, that proposals made in the name of simplification and fairness to repeal all special exclusions, deductions and credits often fail to recognize that the income tax is used to encourage and subsidize many activities. Before the various subsidies are repealed, Congress must do the hard work of evaluating them to determine which ones should be repealed, which ones modified, and which ones replaced with direct expenditures. To the extent that current tax subsidies are modified or replaced with direct expenditures, revenue is not available to meet revenue needs or to lower marginal tax rates.

Base Broadening vs. Flat-Rate

The debate over broadening the individual tax base and going to a flat-rate involves two separable but interrelated issues. The first is how broad should be the tax base be. The second is how progressive should the tax be.

Exclusions, deductions and credits shrink the size of the individual tax base. In 1978, only 43.5 percent of personal income was subject to tax at positive tax rates.[2/] In that year personal income was $1,722 billion, and the amount of income taxed at positive rates was $750 billion. (See Table 1.)

What accounts for the differences between personal income and income taxed at positive rates? Exclusions reduce the potential tax base by 18.4 percent. The largest exclusions are tax-exempt interest, transfer payments such as social security, and nontaxable labor-related income such as employer contributions for group life insurance, pension and profit sharing, and group health insurance. (It should be noted that under the conventions of national income accounting realized capital gains are not included in personal income since such gains are not income from current production.)

The adjusted gross income (AGI) of nontaxable individuals and the nonreported AGI total 9.4 percent of personal income.

2/ Although personal income as defined in the national income accounts is not the ideal tax base, it has been used as a proxy for a comprehensive base by Treasury and the Joint Committee on Taxation, especially when looking at the impact of inflation on average tax rates.

The zero bracket amount and itemized deductions total 15.8 percent of personal income. The personal exemptions for taxpayers, dependents, the aged and the blind total another 7.7 percent of personal income. Finally tax credits offset or shelter 5.2 percent of personal income from taxation.

What all this suggests is that there is considerable room for broadening the individual tax base. And it must be remembered that if the base is broadened, the same amount of revenue can be raised with lower marginal tax rates. It is the marginal tax rate--that is, the rate of tax on the next dollar of income--that determines the incentives to work, to save, and to invest. The basic efficiency argument for a broad-based tax is that if all income, or possibly all consumption, were taxed at the same rate, the allocation of scarce resources would be improved.

It would be possible to broaden the base and lower marginal rates without changing the degree of progressivity. The Treasury's Blueprints for Basic Tax Reform, released in 1977, demonstrated that if a comprehensive income tax base is used, a tax rate schedule with three marginal tax rates -- 8, 25, and 38 percent -- would maintain the revenue yield of the tax and approximate quite closely the then current degree of progressivity. Although the comprehensive or broad-based tax could maintain the degree of progressivity, tax burdens would be altered significantly for many taxpayers within each income class. Those whose income was not fully taxed under current law would pay more tax while others would benefit from the lower marginal tax rates.

Going to a flat-rate tax or a flat-rate tax with large personal exmeptions would reduce the degree of progressivity. As Joseph Minarik of the Congressional Budget Office recently has shown, a flat-rate tax will reduce the tax burden of the highest income taxpayers and increase the burden of the middle groups of taxpayers -- and even lower groups depending on whether a large personal exemption is allowed.[3/]

This result, which is surprising to many people, follows immediately from the fact that the federal income tax remains a progressive tax. Even after the 1981 Act is fully phased in, the average federal income tax burden rises from 2.3 percent of expanded income in the under $5,000 income class to 10.6 percent in the $20,000 to $30,000 class to 24.3 percent in the $200,000 and over class. (See Table 2.)

How progressive should the income tax be? There are no easy answers to this question. A recent Louis Harris poll indicates that 62 percent of the people favor a 14 percent flat tax, eliminating nearly all deductions.[4/] This would suggest strong support for reducing progressivity. The results of the poll,

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3/ Joseph J. Minarik, Testimony before Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee (July 27, 1982).

4/ Business Week (September 6, 1982), p. 15.

however, should be interpreted with caution since responses to other questions in the poll suggest that the public also opposes giving up most deductions when asked specifically about them.

Even if there is a political consensus that the income tax should be progressive, this consensus would provide little guidance as to whether progressivity should be increased or decreased. There clearly is a trade-off between increased progressivity and efficiency. The inefficiencies induced by the income tax in the work-leisure and savings-consumption choices are a function of the marginal tax rates. Increasing the progressivity of the income tax increases these inefficiencies. The costs of these inefficiencies, however, are difficult to quantify, and there is no known way to compare them with the gains in equity that might flow from a more progressive tax.

The appropriate degree of progressivity should depend in part on the progressivity of government expenditure programs. It should also be recognized that to achieve certain base-broadening measures, such as full taxation of capital gains, the top individual rate must be significantly reduced, probably to 30 percent or lower. Moreover, reducing progressivity would make it easier to achieve equity between single individuals, one-earner families, and two-earner families. Both the single and marriage penalties can be reduced.

Simplification

The wide-spread public interest in a broad-based tax is not because of its efficiency gains; rather it represents a yearning for a simpler tax. Most taxpayers do not understand the income tax. They do not or cannot prepare their own returns. Even tax professionals--accountants and lawyers--are often uncertain how the tax law will apply to a given transaction. The complexity of the income tax undermines the self-assessment system. Lower marginal rates which can be achieved by broadening the tax base are a key to simplification since lower rates will reduce the incentive value of the exclusions, deductions, and credits that remain.

Would broadening the income tax base lead to simplification? The answer is both yes and no.

Some changes would clearly lead to simplification. The first step might be to broaden the tax base by eliminating all deductions, credits, and special tax computations added to the tax laws since 1969. This is an impressive list of items with which to start. There is the deduction for contributions to individual retirement accounts, the exclusion of interest on all savers certificates, the tax credit for political contributions, the child care credit, the WIN credit, the jobs credit, the residential energy credit, and the alternative minimum tax. Over the last twelve or thirteen years, the tax law has become much more complicated as a result of adding new deductions, and particularly new tax credits.

The second step would be to prune itemized deductions. The strategy of tax reform during the 1970s was to raise the standard deduction, now known as the "zero bracket amount," so as to switch taxpayers off itemizing and onto the standard deduction. For most individual taxpayers without business income, itemizing deductions was the single major source of complexity until Congress started enacting all the tax credits.

In 1969 just under 35 million taxpayers itemized their personal deductions, and they represented 46 percent of all taxpayers. By 1980, when the standard deduction had been greatly liberalized, the number of itemizers decreased to under 29 million or only 31 percent of all taxpayers. In other words, the proportion of taxpayers itemizing fell by one-third over the period 1969 to 1980.

As you know, that led to a backlash. The charities, in particular, argue that the reduction in the number of taxpayers itemizing had an adverse impact on charitable giving. Congress in the 1981 Act did not increase the zero bracket amount. Instead, it extended the charitable deductions to nonitemizers. This new, above the line deduction will first apply in the 1982 tax year.

A third step for simplification would be to eliminate the distinction between capital gains and ordinary income. This would require the full taxation of capital gains, including those accrued at the death of the taxpayer.

The distinction between capital gains and ordinary income is a major source of complexity. Most tax planning revolves around it. It would not be simple, however, to fully eliminate the distinction between capital gains and ordinary income.

In 1973, the Commission to Revise the Tax Structure recommended annual taxation of accrued gains and losses on capital assets. Many tax experts believe accrual taxation is not practical. Without accrual taxation, the realization principle must be retained. Major simplification probably would be obtained only if there is full offset for capital losses.

Some would argue that in a world of full taxation of capital gains there still should be some limitation on the ability of taxpayers to deduct realized losses against other income. Absent some limitation, taxpayers would have an incentive to realize their losses and let their gains run. There would continue to be a significant preference for capital gains and an incentive to engage in rollover investments such as commodity straddles.

However, if there is some limitation on the deductibility of capital losses, then it would be necessary to maintain a distinction in the tax law between capital gain property and ordinary income property. This distinction is the source of the complexity surrounding the treatment of capital gains.

Not all the steps in broadening the tax base will lead to simplification. Taxing employee benefits and transfer payments will not simplify the tax law. A major issue is how should they be taxed.

Consider private pensions. Currently, employer contributions to qualified pension plans are not considered current income to the employees. Also, earnings and pension trusts are not taxed currently. Under a broad-based income tax, accrual of pension rights should be considered income. Employees each year would include in income the year-to-year increase in the expected value of the retirement benefits. To avoid taxing employees on hypothetical benefits they may never obtain, future benefits would be included in income only to the extent that the employee is fully vested. Needless to say, these rules are considerably more complex than the current rules for taxing retirement benefits when received.

Similar problems arise when considering the appropriate tax treatment of social security. The social security system involves elements of a pure insurance system and of a welfare or tax-transfer system. If one views social security primarily as a tax-transfer system, then one would tax social security benefits in full when received, and one would give no recognition to the prior employer-employee contributions. However, if one views the social security system as a type of insurance, then the appropriate treatment of social security would be very similar to the rules for the tax treatment of private pension plans and other private employee benefits.

Finally, there is the area of measuring business income. Most of the complexity in this area would remain even under a broad-based income tax. That is to say one would continue to need rules to determine what are ordinary and necessary business expenses, what is the appropriate treatment of travel and entertainment expenses, over what period and how rapidly should capital costs be recovered, what rules should apply to inventory accounting, what is reasonable compensation in the case of closely held corporations, and special rules relating to like-kind exchanges and installment sales. The complexity in this area would be limited to the small portion of taxpayers who have business income.

Corporate Income

Most of the flat-rate tax proposals have focused on the individual income tax. It would not be desirable, however, to broaden the tax base for individuals, particularly with respect to business income, without making corresponding changes in the corporate income tax. Otherwise, individuals would often incorporate businesses merely to gain the advantage of exclusions, deductions, or credits no longer available under the individual tax. If the top individual rate is reduced to the neighborhood of 30 percent, the top corporate rate should be similarly reduced.

Like the individual tax, the same amount of corporate tax could be raised by applying lower marginal rates to a much broader base. A broad-based corporate tax would have a significant effect across industries, raising the tax paid by capital intensive industries. Treasury figures indicate the wide disparity in effective tax rates across industries on the income from new depreciable capital.[5/] (See Table 3.) Even after the changes made by the Tax Equity and Fiscal Responsibility Act, the effective tax rate on new depreciable capital ranges from 9.0 percent in motor vehicles to a high of 40.0 percent in services and trade. (See Table 3.)

Effective corprate tax rates also vary widely because of incentives for specific industries such as percentage depletion for hard minerals, capital gains treatment of timber income, the bad debt reserve for financial institutions, and the DISC

5/ The effective tax rates were calculated by first determining the before-tax real rate of return required to provide a four percent after-tax real return, taking into account allowable depreciation and investment tax credits. A required before-tax rate of return of six percent would imply an effective tax rate of 33-1/3 percent.

incentive for exports. If the corporate income tax base is going to be broadened by removing these incentives, Congress must decide whether they should be replaced by direct expenditures. Special incentives may not be needed if the corporate rate is reduced significantly.

In the discussions of the appropriate treatment of corporations under a broad-based tax, consideration should be given to integrating the corporate and individual income taxes. One of the most significant trends in tax policy in recent years has been the movement in national tax structures from classical systems of separate taxation of corporations and their shareholders toward some form of integration of corporate and shareholder taxation with respect to distributed corporate profits. This trend grows out of an increasing concern over the impact of the double tax burden which the classical system places on income from capital in the corporate sector.

The double taxation of corporate profits, once at the corporate level and again at the shareholder level, creates three types of distortion which reduces the efficiency of capital markets. First, the classical system distorts the allocation of capital between the corporate and the noncorporate sector. Second, it encourages corporations to retain their earnings in order to avoid the double taxation of dividends. Third, it encourages the use of debt finance because interest payments are deductible for tax purposes and dividends are not. This

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distortion in favor of debt may increase the riskiness of a business as well as its probability of bankruptcy. Integration of individual and corporate taxes would reduce these distortions and thereby increase economic efficiency.

There are a variety of methods of integrating the corporate and individual income taxes. One could simply treat the corporation as a partnership. All of the corporation's earnings, whether distributed or not, would be imputed to the shareholders. The corporation tax could remain in place as a withholding tax which would be creditable against the shareholders' tax liability. A less complete or partial method would be to integrate corporate and individual income taxes with respect only to dividends, as is done in many foreign countries. This can be done at the corporate level by providing a tax deduction for dividends paid or a lower rate on distributed income. Alternatively, it can be done at the shareholder level by an imputation or shareholder credit system. These two basic approaches to partial integration can be made identical with respect to their impact on corporate and shareholder cash flow.

Although it is recognized that a movement toward corporate integration would improve the allocation of capital, it is not clear that it would increase the level of investment. The major concern is that corporate integration would reduce the "tax" on distributions and thereby encourage additional distributions, - reducing business savings. Unless increased savings of individuals offset the reduction in business savings, total savings would be reduced.

The benefits of partial integration are spread very unevenly across industries and across firms within an industry. Integration would provide no benefits for small, closely held companies that pay no dividends. Integration would also not benefit rapidly growing or high technology firms that pay no dividends. Large multinational companies that pay substantial foreign taxes but little U.S. taxes would benefit little from integration if the integration scheme provides a credit at the shareholder level only for corporate taxes paid to the U.S. government.

For companies that pay no U.S. tax at the corporate level, the shareholder credit system is essentially a system of withholding on dividends at the source. Countries that have adopted a shareholder credit generally require companies to prepay the credit if sufficent taxes have not been paid at the corporate level. In England, where expensing of machinery and equipment is permitted, many manufacturing companies pay no "main stream" tax. The only tax paid at the corporate level is the advanced corporate tax which is, in effect, a withholding tax at the source.

This is not the place to endorse or not endorse proposals for corporate integration. Instead we suggest that the proper treatment of corporate income has received too little attention in discussions of broad-based income taxes.

Inflation and the Income Tax

The recent interest in indexing the tax system stems from the high rate of inflation we have experienced for the last several years. If inflation were proceeding at an annual rate of only one or two percent as it did in the early 1960s, there would be much less concern with an alteration of the tax law as complex as indexing. On the other hand, if the rate of inflation were to accelerate and reach a level of 20 percent or more a year as in some other countries, almost everyone would favor indexing. Thus, one factor in deciding whether to index the tax system is the projection of likely future inflation rates. If we expect a moderate rate of inflation, say six to seven percent, we must then decide whether the complexities involved in going to an index system are worth the gains, or whether there are *ad hoc* adjustments involving much less tax complexity which could achieve the same ends as indexing.

There are two separate issues in indexing the tax system: (1) the treatment of fixed dollar amounts such as the rate bracket boundaries and (2) the proper measurement of income. Analytically they are separable. One could adjust the nominal dollar amounts of the Internal Revenue Code, as Congress did in the 1981 Act, without adjusting the measurement income, or vice versa.

In the 1981 Act, Congress provided ad hoc adjustments in the tax rates phased in over three years to offset the bracket creep from recent and anticipated inflation. The bracket widths, the zero bracket amount and personal exemptions are scheduled to be indexed beginning in 1985. Given that the inflation rate has decreased much more rapidly than was assumed during the considerdation of the 1981 Act, the ad hoc tax reductions are turning out to be larger than expected. In fact, the Congressional Budget Office estimate for the amount of increased revenue from bracket creep made in February 1982 for the period FY82-86 is $96 billion less than the estimate CBO made in March 1981. This suggests that the third year of the tax cut or the beginning of indexing might be delayed.

The second issue, the measurement of income, is the more difficult one. Ideally, the base of the income tax system should be real income--income measured in current not historic dollars--because that is the best measure of ability to pay. Moreover, the tax is paid in current dollars. With reasonable price stability, nominal income provides a satisfactory approximation of real income. But under high rates of inflation, this is no longer the case. Particularly severe problems arise in four areas: depreciation, inventory accounting, capital gains, and debt.

It may well be that making only some adjustments for inflation, say depreciation, and not others will increase the inequities and inefficiencies of the tax system. For example, if depreciable assets are financed by debt it may be inappropriate to adjust depreciation for changes in the price level while permitting a tax deduction for the inflation component of interest payments. The indexing required to measure real income would substantially increase the complexity of the income tax system and greatly increase the recordkeeping requirements of individuals and firms. Until there exists a greater consensus concerning the best means of adjusting financial and operating statements for inflation, it would be inappropriate for the Treasury Department or the Congress to attempt to impose any particular "correct" method.

Table 1

Reconcilation of Personal Income and Income Taxed at Positive Rates, 1978

	$ billions	% of Personal Income
Personal income, 1978	1,722	100.0
Less exclusions from AGI	-317	-18.4
Equals Adjusted Gross Income AGI	1,405	81.6
Less AGI of nontaxable individuals, nonreported AGI, and reconciliation	-162	-9.4
Less zero bracket amounts for nonitemizers on taxable returns	-115	-6.7
Less itemized deductions on taxable returns	-156	-9.1
Less exemptions on taxable returns	-132	-7.7
Equals taxable income on taxable returns	839	48.7
Less income offset by credits on taxable returns	-89	-5.2
Equals income taxed at positive rates, 1978	750	43.5

Source: Eugene Steuerle and Michael Hartzmark, "Individual Income Taxation, 1947-79," National Tax Journal (June 1981), pp. 145-66.

Table 2

Distribution of Expanded Income, Tax Liabilities, and Effective Tax Rates under 1984 Law at 1981 Income Levels

Expanded Income Class ($000)	Expanded Income[a] ($ millions)	Tax Liability ($ millions)	Effective Tax Rate (%)
0-5	17,502	403	2.3
5-10	98,683	5,772	5.8
10-15	162,794	12,526	7.7
15-20	188,211	17,462	9.3
20-30	416,709	44,080	10.6
30-50	509,658	63,833	12.5
50-100	230,678	38,687	16.8
100-200	83,904	18,656	22.2
200+	67,540	16,385	24.3
Total	1,775,679	217,803	12.3

a/ Expanded income is eqoal to adjusted gross income plus tax preference income excluded from AGI less investment expenses to the extent that they do not exceed investment income.

Sourece: Joint Committee on Taxation

Table 3

Effective Tax Rates on New Depreciable Assets for Selected Industries 1/

	Effective Tax Rate
Agriculture	22.5
Mining	12.6
Primary Metals	15.7
Machinery & Instruments	25.7
Motor Vehicles	9.0
Food	26.7
Pulp and Paper	11.8
Chemicals	17.7
Petroleum Refining	13.0
Transportation Services	12.2
Utilities	33.4
Communications	21.4
Services and Trade	40.0
Average for All Industries 2/	28.4

1/ Industries chosen had at least $5 billion in new investment in 1981.

2/ Average includes industries not shown in the table.

Note: Assumes a 4 percent real after-tax rate of return and 6 percent inflation.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, September 14, 1982.

SPOON RIVER
FOUNDATION

RE: Written Statement for Inclusion in Printed Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982).

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TO: Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227, Dirksen Senate Office Bldg.
Washington, D.C. 20510

FROM: David L. Deopere
Executive Vice President, Spoon River Foundation
302 East Main, Suite 530
Galesburg, IL 61401

David L. Deopere

DATE: October 8, 1982

The Spoon River Foundation, a subsidiary of the Spoon River Center for Community Mental Health, was created approximately one year ago. The mission of the Foundation is to build an endowment for the continued local support of mental health programs offered in our service area (Henderson, Henry, Knox, and Warren Counties). As you are aware, charitable donations are an integral part of the building of such an endowment. As Executive Vice President of the Spoon River Foundation, I am deeply concerned about the proposed flat-rate tax and its impact upon charitable giving to institutions such as the Spoon River Foundation.

Should the proposed flat-rate tax be implemented, all tax incentives for charitable giving would be abolished. Although most individuals donate to charitable organizations primarily as a result of their support for the organization's service to the community, charitable deductions offer incentive for individuals to make more substantial donations. Therefore, with the implementation of flat-rate tax, we can anticipate a marked reduction in the level of charitable giving and in the level of local monetary support for not-for-profit organzations.

Our Foundation is also aware of some of the merits associated with flat-rate taxing. Therefore, rather than opposing this method, we are advocating that some changes be incorporated into the proposal. These alterations are listed below:

1. Award all taxpayers a credit of fifty percent (50%) of the amount of charitable donations. This fifty percent is not dependent upon the taxpayer's bracket. This credit reduces the tax itself, not the amount of income subject to tax.

2. Alternatively, establish a progressive credit rate, based upon the taxpayer's adjusted gross income.

In both cases, we advocate that a ceiling be places on the level of credit an individual can receive; this will eliminate the individual's strategy in totally avoiding payment of taxes vis-a-vis charitable contributions.

I hope you will strongly consider these alternative proposals for flat-rate taxing. I must reiterate that implementation of the currently proposed falt-rate tax can severly threaten the continued operation of may charitable organizations. Without the essential services that these organizations offer to people-in-need, the quality of life in our communities will be greatly impaired.

Thank you for your consideration in this most important matter.

TESTIMONY OF

Scott Sklar

Political Director

Solar Lobby

Mr. Chairman, Distinguished Committee Members,

I would like to thank you for this opportunity to present our case against the extreme over-simplification of the income tax system. Although we agree that the current system is complicated, and in need of considerable reform, we feel that the enactment of extreme tax-simplification measures would be a grave error. Such action would be detrimental to the effectiveness of Congress, for it would eliminate two of the most valuable tools Congress can employ in the pursuit of National policy goals--tax deductions and credits.

The elimination of these tools leaves Congress no alternative avenue to follow toward the realization of national goals, other than the implementation of costly federally-sponsored programs. Such programs generally require cumbersome administrations and mechanisms to carry out their objectives. Tax credits, on the other hand, need no similar structures, because they have the ability to circumvent the bureaucracy, and give benefits directly to the individual.

Furthermore, tax credits are much more sensitive to market conditions than are most direct outlay programs. In a sense, tax credits do not alter the fundamental decision-making process of the marketplace; funds claimed as tax credits are simply factors--however important-- in the consumer's decision to invest. In outlay programs, however, decisions are made more unilaterally, by Congress, its staff, or program administrators. Since the current administration has put a premium upon the use of a free-market approach to business, it seems paradoxical that Congress should eliminate the use of tax credits, leaving direct outlay programs as their only method for pursuing national policy objectives.

As an example, the renewable energy tax credits have been instrumental in the shaping of a more balanced national energy plan. In 1977, energy-related issues were receiving a great deal of attention from the public. The threat of supply shortages and disruptions was great; Congress and the Administration responded by attaching top priority to the goal of energy independence. One aspect of the effort aimed at reducing our dependence upon imported oil, was the residential solar tax credit. Implemented in 1978, and enhanced in 1980, this program provides homeowners with incentives to save energy by applying renewable resource systems to their homes wherever possible. It includes a tax credit for 40 percent of the first $10,000 spent on solar, geothermal, or wind-powered equipment.

The response from the public was overwhelming. The number of returns claiming the solar credit rose from 76,555 nationwide in 1979, to 153,721 in 1980. Simultaneously, investments in solar and renewable energy equipment rose from $97 million in 1976, to $386 million in 1980--an increase of 298 percent. Not only did this give a tremendous boost to the solar industry, but the energy savings were substancial. In 1980, renewable resources generated 2.6 Quadrillion BTU's for residential purposes, a figure which translates into a savings of 452 million barrels of oil. This number is projected to climb to 553 million barrels by 1985.

The tax credits also served to pull new energy technologies into the marketplace. Manufacturers were able to sell more renewable resource equipment; increased sales are bringing the costs down, and soon, as the cost of the equipment gets lower, and the cost of conventional resources climbs, the need for federal supports will no longer be necessary.

While considering any bill that would significantly alter energy policy, we must keep in mind the fact that our energy supply situation has not substancially changed. We are still vulnerable to supply shortages and disruptions. The energy tax credits served to attach the U.S. Government's "stamp of approval" to efforts that involved renewable resources, as one aspect of a national effort to reduce our dependency and vulnerability. Removal of these credits is tantamount to sending a signal to the public that the goal of energy independence is no longer a national priority.

STATEMENT OF GLENN W. TEICHMER,
RETIRED INTERNAL REVENUE AGENT,
FOR THE SENATE FINANCE COMMITTEE
HEARING RECORD ON FLAT RATE TAX
AND MAJOR REFORM PROPOSALS.
September 28, 1982

"If the income tax is to survive it must be simplified: it must be reduced to a code and regulations that are easily understood by any educated layman; and above everything else, all, absolutely all of the special provisions, exemptions, deductions, and credits must be taken out of the Code or reduced to such a bare minimum that all taxpayers can again respect the income tax law."

That carefully reasoned opinion was explained by Malcolm Reed 20 years ago in his article, Is the Present Income Tax Law Equitable?, TAXES magazine for July, 1961. His masterful exposition of the Internal Revenue Code's inequities provides clear insight for anyone interested in equitable income taxation.

Therefore, this statement intends to identify and explain how to correct easy-to-remedy defects that make the Code's directions for computing taxable income impossible to understand: the undefined meanings of the words, "cost" and "income".

Due to the interrelationships between and among various Code provisions, the absence of a clear and precise definition of the word, "cost", makes most of the Code's directions for computing taxable income incomprehensible. As the Court stated in Lisner,73-1, USTC 9299, "It is axiomatic that a true code -- which Congress intended here to create -- is primarily different from statutes in that a comprehensive, cross-related scheme of laws is presented. No one section can be interpreted without reference to its place in the scheme of things."

Absolutely basic Code section 1012 states, "The basis of property shall be the cost of such property except as otherwise provided...."

The meaning of "cost" must be known to determine the tax basis of every property acquired for doing and/or relinquishing something, the amount of most expense, expenditure, and depreciation deductions, and the gain or loss from most dispositions of property. Nevertheless the Code nowhere defines the meaning of "cost". Furthermore, I confidently defy you to find any published definition or explanation that indicates how and why the equal-in-return-for-equal exchange concept is used to determine the cost of acquired items.

The absence of a clear and precise definition of income is another barrier to understanding of the Code's directions for computing taxable income. Basic Code section 61(a) states: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived..."

The meaning of "income" certainly must be known to determine what is and what is not "gross income", the most important component in the "taxable income" computation. Nevertheless, the Code nowhere defines the meaning of the word. I again confidently defy you to find a published definition or explanation that indicates how and why the equal-for-equal exchange concept is used to identify, measure, and name every amount of income that comes into being.

Consequently, throughout thirty years of auditing federal income tax returns, audited taxpayers often asked, "Can you tell me what income is in words I can understand?"

After 20 years of searching, the key to understanding of the exact meanings of cost, income, and every undefined accounting term in the Code was found in the Thomas Crawley Davis income tax case decided by the U.S. Supreme Court in 1962. The key is the equal-in-return-for-equal exchange concept therein used to determine income and cost.

Mr. Davis contended he derived no income from transferring shares of corporation stock to his wife during divorce preparations. His transfer of stock was made to obtain release of her marital rights. By the laws of their state, Mrs. Davis had a right to receive a share of her husband's property if they divorced.

Financial reports and income tax returns clearly show that all accounting items are measured in dollar and cent units. Mr. Davis claimed no income resulted because the money value of the received rights release was impossible to measure.

To the contrary, the Court used an established legal premise, "absent a readily ascertainable value, it is accepted practice where property is exchanged... to hold that the values of the two properties exchanged in an arm's-length transaction are either equal in fact or are presumed equal."

Applying that equal-for-equal exchange concept, the Court found the received rights release had fair money value equal to the $82,250 Mr. Davis could have obtained from sale of the stock he relinquished to get the release. Since Mr. Davis had purchased that stock for $74,775, he derived income from his disposition of it computed as follows:

A) Value of received rights release	$82,250
B) Minus cost tax basis of the stock relinquished to get the release	-74,775
C) Income from disposition of stock	7,475

Notice that no money was involved. Also notice that the Davis income computation shows the three conditions that must be satisfied before any income can come into being:

A) Money and/or something with measurable money value must be received. (why owner's use of a personal residence creates no income)

B) Something must be done and/or relinquished to get the amount received (why gifts and inheritances are not income)

C) And if any property is relinquished to get the amount received, only the amount received in excess of the remaining cost or other adjusted tax basis of the relinquished property is income. (why received loans and returns of capital are not income)

Investigating what countless taxpayers received for what they did and relinquished that could be measured in money has made it apparent that exchange -- equitable reward for what benefits others and equitable punishment for what is harmful -- is the fundamental operating principle of America's economic, legal, and social systems. America's competitive exchange economic system beneficially uses human greed to efficiently produce and equitably distribute what people most need and want. Laws that require active, fair, and open competition in professional exchanges restrain that greed by balancing the greed of each against the greeds of others.

As a result, income is a benefit (score) measured in money units which a person or business organization wins from professionally competing in America's huge exchange game. A pro competes in a game for money or profit. Therefore, professional exchanges exclusively involve money and/or things that have money values possible to measure with the equal-for-equal exchange concept of the Davis case.

Different from professional exchanges, family members, friends, lovers, etc. commonly do things for each other which they do not and would not do for a stranger solely for money. The special personal relationships required for such exchanges to occur make the money values of the exchanged things impossible to measure with the equal-for-equal exchange method. Therefore, those exchanges are personal instead of professional.

Because income is measured in money units, only professional exchanges can create income. For example, the kisses true lovers exchange create no income because those kisses are personal instead of professional exchanges.

The most quoted definitions of income by the U.S. Supreme Court repeatedly uses the words, gain, profit, and capital. Those terms have meanings as vaguely defined as the meaning of income. Consequently that definition, like the Code's directions for computing taxable income, is impossible to understand.

According to the AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, income is "Money received for labor or services, from the sale of property or from investments".

That definition erroneously indicates receipt of money is required to create income. Remember Mr. Davis received no money from his disposition of corporation stock which created income.

Additionally, that definition fails to indicate that money from a sale of property is income only to the extent that the amount received is in excess of the seller's remaining cost or other adjusted tax basis for the sold property. Saleable properties rarely have zero tax basis.

When published definitions and explanations of income are researched, you find they use terms with unknown or vague meanings that make them incomprehensible or they are incomplete or incorrect. Even basic Code section 1001 (b) specifying the received amounts to be taken into account in computing gains and losses from dispositions of property omits satisfactions of debt, personal and other services, the usage of borrowed money and property etc., which have measurable money values. The common sense Davis case income determination logically took into account the money value of a debt extinguishment which was not money or property specified in section 1001 (b).

The meaning of cost usually must be known to determine the gain or loss derived from dispositions of property. Fortunately the Davis decision makes clear how the equal-for-equal exchange concept is used to derermine the cost of acquired items.

Concerning the cost Mrs. Davis would have for computing gain or loss on subsequent disposition of the shares of corporation stocks she received from Mr. Davis, the Court said, "---- the same calculation that determines the amount received by the husband fixes the amount given up by the wife and this figure, i.e. the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received."

That statement in combination with the contents of Code section 1012 means cost is the fair money value of anything received for doing and/or relinquishing something at the instant it is received. Conditions A and B that must be satisfied for income to come into being also must be satisfied for cost to come into being.

During 1926 Congressional discussions concerning income from dispostions of property, Mr. Reed of Pennsylvania said, "---- in computing that profit, the fair value of all property that he receives in exchange is included...The critical moment is the instant when he receives it, and its value as of that time determines his taxable profit." Seidman's Legislative History of Federal Income Tax Laws, 1938-1861, page 580.

Consequently, income comes into being at the instant received in the form of money or anything that has measurable money value. However, according to Code section 451 (a), permitted accounting methods may advance or delay the accounting and taxation of some received gross income; but the total amount of every kind of received gross income eventually must be taken into account under every permitted accounting method.

The following remembered incident now will serve as the assed test of whether clear understanding of how the equal-for-equal exchange concept is used to identify, measure, and classify income has been communicated: Years ago, an internal revenue agent helped a very attractive prostitute prepare her federal income tax return. When the return was completed, she strongly insisted that Bert take $20 for his able and willing assistance. It's recalled that Bert emphatically told her again and again, "But I'm not allowed to take CASH!"

If Bert got any, what amount and kind of income did he get? Call IRS Taxpayer Information to ascertain if your answers are correct.

Seriously, every taxable income accounting item investigated and determined in the 20 years since the Davis decision indicates the equal-for-equal exchange concept can be used to clearly and precisely define the meanings of cost, income, and every accounting term used in the Internal Revenue Code. Understanding of the nature and role of that concept in accounting makes clear that most of the Code's directions for computing taxable income inequitably violate America's fundamental exchange operating principle.

Therefore, clear and precise definition of cost, income, expenditures, and expenses should be the first step toward achieving greater equity, simplicity, balance, and economic efficiency in the tax system.

Such definitions are possible. They are needed to make the Code and regulation "...easily understood by any educated layman."

The perceptive Accounting Commentary in BUSINESS WEEK for December 20,1976, pointed out that, "Somehow accountants have never sat down and defined assets, liabilities, revenue, expenses or capital. And that, probably more than any other factor, explains much of the confusion, inadequacy and abuse of present accounting."

THOMAS JEFFERSON UNIVERSITY

Philadelphia, 19107
(215) 928-7990

September 22, 1982

Written Statement for Inclusion in Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982)

Robert E. Lighthizer, Chief Counsel,
Committee on Finance, Room 2227
Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Lighthizer:

Please find enclosed my written statement for inclusion in the Printed Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982).

Thank you.

Sincerely yours,

Francis J. McGovern
Associate Director of Development/
Director of Planned Giving

FJM dmh

Enclosure

cc. The Honorable H. John Heintz
The Honorable Arlen Specter
The Honorable Thomas M. Foglietta

AN ACADEMIC HEALTH CENTER

Jefferson Medical College
Thomas Jefferson University Hospital

College of Graduate Studies
College of Allied Health Sciences

Written Statement for Inclusion in Record of Senate Finance
Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982)

A simplified tax system--with no charitable deduction--would remove all tax incentives to charitable giving. Although donors contribute to charities because they believe that the charities are worthy of support, the charitable deduction often permits them to give much more than would otherwise be possible.

While it would be inappropriate for Thomas Jefferson University to oppose a flat-rate tax or a simplified tax system, it wishes to indicate to Congress that if a flat-rate tax or a simplified tax system, or a combination of the two, is enacted, a credit should be permitted for charitable gifts. The tax savings--and hence the tax incentives--would be a direct credit which reduces the tax, itself.

A credit of 50% of the value of the charitable gift could be permitted. This would generate the same tax saving as the present charitable deduction for a taxpayer in the 50% bracket.

If Congress feels that a 50% credit for all donor-taxpayers is not proper, a graduated credit--based on a taxpayer's adjusted gross income could be permitted. If Congress is concerned that some donors would avoid paying taxes entirely through charitable gifts, a limit could be placed on the credit (similar to the present percentage of adjusted gross income ceiling for the charitable deduction). The present carry-over rules could be maintained.

Thank you.

Sincerely yours,

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Director of Planned Giving
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Washington, D.C. 20510

WRITTEN STATEMENT FOR INCLUSION IN PRINTED RECORD OF SENATE FINANCE COMMITTEE HEARINGS ON FLAT-RATE TAX PROPOSALS (September 27-29, 1982)

Proposals to simplify the income tax structure of the nation must be given serious consideration by all thoughtful citizens and responsible organizations, since the remarkable success of our voluntary compliance approach depends on the people's ability to understand their taxes and their perception that the system is, on the whole, a fair one. Both of these underlying prerequisites are threatened by the present complexity of the Tax Code and its numerous deduction provisions.

However, lest a pendulum be pushed too far too fast, it must be remembered that our economic system is complex and a simplistic tax structure that ignored the variety of taxable situations could, itself, quickly come to be seen as inherently unfair under many circumstances.

As an educator for most of my life and the present chief executive of a state university-related public foundation, my specific concern is with the charitable deduction for gifts to benefit qualified education, religious, health, cultural, social assistance and other nonprofit organizations.

I understand that proponents of the elimination of all deductions including the charitable deduction have observed that people were contributing to charity long before there were income taxes and charitable deductions. May I respectfully suggest that although the widows gave their mites to the church and there were occasional generous benefactors of a hospital or college, the past had no comparable pattern of broad support of nonprofit organizations from all economic levels such as is encouraged by our existing system of charitable tax incentives.

Since 1969, there has been growing awareness of the advantages of "life income gifts" through qualified charitable remainder trusts which make it possible for middle economic classes to consider very significant charitable arrangements. Any sweeping simplification that wipes out these incentives and the efforts of hundreds of institutions to educate their natural constituencies on this way of giving would seriously set back the local and regional organizations that can be most responsive to the needs of society with the greatest cost efficiency (compared to channelling the same amounts through the federal government and back to one place or another, for one purpose or another).

It seems clear that business and industry will be unable to make up the amount of federal funding support being lost to local institutions. To remove at the same time from our social machinery a key factor in private individual support could be a blow from which hundreds or thousands or worthy organizations and institutions might never recover, and the damage could occur too quickly to permit remedial action in many instances.

Others more versed in the intricacies of taxation can address the various options open for modification of a flat-rate tax plan to preserve at least the present incentive levels for charitable giving. My plea is that this specific issue be very carefully addressed before the rush for simplicity harms our total society more than the present complexity.

Respectfully submitted,

D. B. Varner, Chairman
University of Nebraska Foundation

VIRGINIA TAXPAYERS ASSOCIATION

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LYNCHBURG, VA. 24505

Statement by Kenneth White, President
Opposing Proposals for a Flat-Rate Income Tax
before
United States Senate Committee on Finance
Hearings September 27-29, 1982

Mr. Chairman, my name is Kenneth White and I am President of the Virginia Taxpayers Association. In addition to conducting for almost 10 years the more usual activities of a state taxpayer organization, such as fighting increased gasoline taxes, increased state expenditures and excessive state general obligation bonds, the Virginia Taxpayers Association has the distinction of being the only organization in the country that correctly told the Senate Committee on Banking, Housing and Urban Affairs July 30, 1979 at the confirmation hearing of Paul A. Volcker as Federal Reserve chairman that, quoting from our prepared statement then, "inflation can be expected to accelerate at a dangerous rate under his (Volcker's) administration, and his nomination should therefore be rejected by the United States Senate." (UNQUOTE). While in recent months there has appeared to be, on the surface at least, some decline in the dangerous inflation that did in fact follow Volcker's confirmation, it has only come about following bankruptcy of thousands of American businesses caused largely by ruinous interest rates imposed by the same Volcker as a "corrective measure", and we submit that every taxpayer and consumer in this nation would today be far better off if the Senate had listened to the Virginia Taxpayers Association and refused to confirm Volcker in 1979, for this one man at the head of our banking system these last three years has cost all of us untold billions, through his disastrous hiking of interest rates, and indeed billions in taxes just from increased interest on the national debt. Part of our statement at that time was placed in the Congressional Record by Senator Jake Garn, now Chairman of the Senate Banking Committee, on August 1, 1979, page S 11301.

The Virginia Taxpayers Association has been on the prevailing side in two other appearances before congressional committees. One was our testimony May 1, 1980 before the House Ways and Means Committee against the then-proposed withholding tax on interest and dividends, which received favorable comment in Barron's Magazine among other national publications. The other was our testimony before the Senate Judiciary Committee June 21, 1979 on the intolerable cost to taxpayers of an additional federal paid holiday, which was placed in the November 9, 1979 Congressional Record in its entirety, page E 5547.

While admittedly the various proposals for a flat-rate income tax now before the Finance Committee appear to offer the very attractive feature of simplifying paperwork and causing less time and trouble to a great many people, we in the Virginia Taxpayers Association regret that many otherwise conservative members of Congress, as well as outside publications and organizations which have recommended such a tax, have not thoroughly researched this very important question, including a review of the basics of income tax law itself as set forth by the Supreme Court.

First, though, we should make very clear one outstanding fact that we believe all proponents of the flat-rate tax will agree on: That the primary motivation behind this tax is not at all to accommodate lessened government expenditures. Indeed, a number of the proponents argue that, if the flat rate is set at the right level --- perhaps somewhere around 15 per cent --- the new tax will actually help in bringing in enough revenue to balance the budget and eliminate the budget crisis. In other words, it will not be necessary to reduce to any significant degree or at all the present monstrous level of government spending! This is right where the whole flat-rate tax idea falls apart --- even in advance of legal considerations --- for those of us who have been in leadership of the taxpayer movement long enough to acquire some sophistication in considering proposed legislation. For certainly at the core of taxpayer movement principles for almost the last two decades has been, and still is today, realization that government at all levels is too big and is spending too much of our money, and that we should certainly not support any tax measures whatever that facilitate extravagant public spending. It is indeed regrettable that so many otherwise sound-thinking public leaders in and out of Congress should have allowed themselves to be misled in favoring this flat-rate tax proposal. For any tax change such as that now proposed, designed actually to produce more revenue, will help take away from government the urgent need and incentive to drastically slash public spending and is therefore definitely counter-productive. The fact is, as almost all dispassionate analysts would agree, that the private economy of the United States is being choked to death by insatiable governmental demands for the limited funds that are available for both public and private use, and we simply cannot continue in any kind of free society unless Congress acts now to reduce government appropriations which are literally impossible for this economy to support.

But let us look further into what kind of a tax the income tax really is. The Governmental Research and Development Corporation, in discussing Senator Charles Grassley's S. 2372 and House companion bill H.R. 5868, calling for a Treasury study of the flat-rate tax, which would be "the most significant change in the federal tax system since the first income tax law was adopted in 1913", explains that this would bring about a change from our precent Net Income Tax (NIT) system to a new Gross Income Tax (GIT) system. Necessary to a proper understanding of this matter is realization that "income", which is not defined in the Internal Revenue Code itself, means not simply "receipts" but rather "profit" or "gain". The Supreme Court, in Eisner v. Macomber, 252 U.S. 189, defined "income" as "the gain derived from capital, from labor, or from both combined..." (emphasis added). Note that the "gain" is not the capital or labor themselves but is separated therefrom. See also:

> "....One does not derive 'income' by rendering services and charging for them." Edwards v. Keith, 231 F. 110.

> "Receipts are not synonymous with income." U. S. v. Clark, 211 F.2d 100 (emphasis added).

> "...'income' as used in the statutes, should be given a meaning as not to include everything that comes in. The true function of the words 'gains' and 'profits' are to limit the meaning of the word 'income'..." Southern Pacific Co. v. Lowe, 238 F. 847 (emphasis added

> "Income within the meaning of the 16th Amendment and the Revenue Act means gain derived from, and not accruing to, capital or labor or both combined." Staples v. U. S., 21 F.Supp. 737 (emphasis added).

> "Congress has taxed income, not compensation..........If there is no 'gain', there is no 'income'." U. S. v. Conner, 303 F.Supp. 1187 (emphasis added).

> "Profits mean the advance in the price of goods sold beyond the cost of purchase and in distinction from wages of labor." Maddox v. International Paper Co., 47 F.Supp. 829 (emphasis added).

> "There is a clear distinction between profit and wages or compensation for labor. Compensation for labor cannot be regarded as profit within the meaning of the law." Oliver v. Halstead, 196 Va. 992 (emphasis added).

> "Reasonable compensation for labor on services rendered is not profit." Lauderdale Cemetery Association v. Matthews, 345 Pa. 239 (emphasis added).

The Supreme Court comprehended these statements about the meaning of "income" in Merchants' Loan, etc. v. Smietanka, 255 U.S. 509, when it said: "The word 'income' must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Federal Corporation Excise Tax Act" (emphasis added). The Corporation Excise Tax Act of 1909 (36 Stat. 112) just referred to was also the subject of another clarifying Supreme Court decision, Flint v. Stone Tracy Co., 220 U.S. 107, which described the tax in question as "A tax....on corporations, joint stock companies, associations organized for profit and having a capital stock represented by shares, and insurance companies, and measured by the income thereof, (which) is not a tax on franchises of those paying it, but a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organization of the character described in the act" (emphasis added).

This same tax, Flint said,

> "is not a direct tax but an excise: . . . . it is an excise on the privilege of doing business in a corporate capacity and as such is within the power of Congress to impose;........not being direct taxation, but an excise, the tax is properly measured by the entire income of the parties subject to it." (at pgs. 108-109, emphasis added).
>
> "Indirect taxation includes a tax on business done in a corporate capacity; the difference between it and direct taxation imposed on property because of its ownership is substantial and not merely nominal.
>
> "Excises are taxes laid upon the manufacture, sale or consumption of commodities, within the country, upon licenses to pursue certain

occupations and upon corporate privileges; the requirement to pay such taxes involves the exercise of the privilege and if business is not done in the manner described no tax is payable." (ibid., at 110, emphasis added).

Not altering, modifying or overruling Flint v. Stone Tracy Co. in any way but rather building upon it, the 16th Amendment and the two landmark Supreme Court cases interpreting it immediately afterward simply acted to assure constitutionality of Flint and the kind of tax it discussed. One of these two landmark cases, Stanton v. Baltic Mining Co., 240 U.S. 103 (1916), said flatly:

> "The Sixteenth Amendment conferred no new power of taxation but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged" (emphasis added).

Just prior to Stanton in the same year, the Supreme Court also held in the other landmark case, Brushaber v. Union Pacific Railroad Co., 240 U.S. 1, which likewise has never been overruled, that the income tax is an indirect tax, rather than a direct tax, and that the

> "command of the (16th) amendment that all income taxes shall not be subject to the rule of apportionment by a consideration of the source from which the taxed income may be derived forbids the application to such taxes of the rule applied in the Pollock case (Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601) by which alone such taxes were removed from the great class of excises, duties and imposts subject to the rule of uniformity and were placed in the other or direct class."

To summarize, what we have today as brought out in the beginning of this discussion is a Net Income Tax (NIT) system, where the income tax is an indirect excise tax based on a government-bestowed privilege, although this truth has been carefully concealed from the American public by the Internal Revenue Service, government officials and the media generally, and the Virginia Taxpayers Association has publicly caught a former Secretary of the Treasury in lying about it (see our (in part) attached testimony before the House Ways and Means Committee on Law Day, May 1, 1980, which has never been refuted).

The proposals for a flat-rate tax now before the Finance Committee would move from this Net Income Tax (NIT) system, which as we have seen is supported by the 16th Amendment, although much of today's application of that system is emphatically not so supported, to an entirely new "gross income" tax system where the word "income" is not actually or legally such at all but merely means "receipts". Unfortunately for the proponents of this new tax, there is at present no constitutional foundation for such a change and no way for a mere act of Congress to lawfully bring it about.

We are not sure, with all the precedential law on the books today, whether a single constitutional amendment would be sufficient to legally back up this proposed flat-rate tax. But even if it would be adequate in law, we must warn congressional backers of the flat-rate idea against such a constitutional amendment, for the process of ratification by the states would involve so much public discussion that the truth about our present Net Income Tax (NIT) system would finally become known by a sufficiently large segment of U. S. citizens to create an even more unstoppable income tax revolt than already exists.

There is neither time nor space to cover a second pertinent subject here --- whole legal briefs have been written about the unlawful nature of today's "money" --- but we must nevertheless briefly remind this Committee that with our present counterfeit currency --- Federal Reserve Notes which are not evidences of wealth but only evidences of debt ---

hardly anyone today has any <u>real income</u>. As the Supreme Court has said:

> "Lawful money of the United States (can be) only gold and silver coin or that which by law is made its equivalent, so as to be exchangeable therefor at par and on demand, and does not include a currency which, though nominally exchangeable for coin at its face value, is not redeemable on demand." <u>Bronson v. Rhodes</u>, 74 U.S. 229, 274, 19 L.Ed. 141.

At least as often as a brand-new kind of "income" tax is proposed in Congress, it is the duty of all such elected officials to recognize this truth, unpleasant though it may be for those in the U. S. government today.

Finally, we want to assure members of this Committee who have justifiably shown great concern this year over the matter of so-called "compliance" with today's tax system, that the fast-growing underground economy will definitely <u>not</u> be dried up by a flat-rate "income" tax. (We say "justifiably", but we certainly do not agree with Congress's so far totally unsatisfactory response to the undeniable reality of this situation.) Too many honest, upright, dedicated and patriotically-motivated citizens now know the truth about congressionally-promoted lawlessness in the present application of our tax system to be satisfied with such a change. And with the proposed "gross income" tax being really a gross <u>receipts</u> tax, it does not require any detailed study of law to notice that today when the government is supposed to tax only <u>net income</u> it cannot reach its grasping hands into as much of the taxpayer's material substance as when it is empowered --- whether lawfully or not --- to tax <u>gross receipts</u>. Certainly, informed taxpayers will not stand still when they become fully aware that an initial, say 15 per cent, rate of tax on gross receipts could almost without debate in Congress be hiked to 20, 25 or 30 per cent in the not distant future to meet "emergency situations".

In conclusion, all of us are aware that this Committee's action and that of Congress in passing H.R. 4961, the Tax Equity and Fiscal Responsibility Act of 1982, in derogation of Article I, Section 7 of the United States Constitution is now before the U. S. District Court, and it is our fervent hope that out of this, and the deliberations on tax proposals now before this Committee, the Constitution itself, our freedom, and yours also, will finally survive. Thank you.

#

PRESIDENT'S PROPOSAL FOR WITHHOLDING ON INTEREST AND DIVIDENDS

Testimony by
Kenneth White, President,
Virginia Taxpayers Association
May 1, 1980

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

APRIL 30 AND MAY 1, 1980

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(NEXT TWO PAGES
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be very badly advised and strongly resisted by taxpayers across the country.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE VIRGINIA TAXPAYERS ASSOCIATION

Mr. Chairman, my name is Kenneth White and I am President of the Virginia Taxpayers Association. In addition to conducting for the last seven years the more usual activities of a state taxpayer organization, such as fighting increased gasoline taxes, increased state expenditures and excessive state general obligation bonds, and working for the right of initiative and referendum, the Virginia Taxpayers Association has the distinction of being the only organization in the country that correctly told the Senate Committee on Banking, Housing, and Urban Affairs July 30, 1979 at the confirmation hearing of Paul A. Volcker as Federal Reserve chairman that, quoting from our prepared statement then, "inflation can be expected to accelerate at a dangerous rate under his (Volcker's) administration, and his nomination should therefore be rejected by the United States Senate." We submit that every taxpayer and consumer in this nation would have been far better off if the Senate had listened to the Virginia Taxpayers Association and refused to confirm Volcker at that time, for this one man at the head of our banking system these last nine months has cost all of us untold billions, through his disastrous hiking of interest rates, and indeed billions in taxes just from increased interest on the national debt. Dr. Leland E. Traywick, Director of the Bureau of Business Research at the College of William and Mary, is only one of the qualified economists who has documented the extraordinary error—if indeed it is only an error—of Volcker's devastating high interest policies, and we believe quite a number of congressmen today would agree that the Virginia Taxpayers Association was right last July 30. So we hope that our recommendation and counsel today will bear more fruit before this distinguished Committee than what we had to say about Volcker, part of which was placed in the Congressional Record of August 1, 1979, page S11301. The Virginia Taxpayers Association was perhaps more successful on June 21, 1979 in testifying before the Senate Judiciary Committee on the intolerable cost to taxpayers of an additional federal paid holiday, since Congress has decided, for the time being at least, not to go ahead with such a holiday. The VTA's complete Senate Judiciary Committee was placed in the Congressional Record of November 9, 1979, page E5547.

The first thing the Virginia Taxpayers Association must say to this Committee is that the same Administration which is now asking Congress to enact a withholding income tax on dividends and interest is also giving to Congress and the American people totally false and misleading information on the crucial question of what income tax law is all about. On November 8, 1979 President Carter's Secretary of the Treasury, G. William Miller, repeatedly told the Committee on Ways and Means both in oral and prepared testimony on the Tax Restructuring Act of 1979, that the U.S. income tax is "*direct* tax" (emphasis added). That this very plain and elementary statement is absolutely contrary to the facts is shown by a Library of Congress analysis which we have attached as Exhibit 1-B, and which makes clear that the basic landmark Supreme Court cases on the income tax, *Brushaber* v. *Union Pacific Railroad Co.*, 240 U.S. 1 (1916), and *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103 (1916), have declared unmistakably that the income tax is an indirect tax. Omitted from this Library of Congress page is the exact statement in *Stanton* v. *Baltic Mining Co.* (supra), which is vital to our understanding of this subject, to with that "Taxation on income was in its nature an *excise*" (emphasis added). We call your attention to the fact that no Supreme Court case subsequent to *Brushaber* and *Stanton* v. *Baltic Mining* has ever overruled their basic finding that the income tax is an indirect excise tax, as the Library of Congress study agrees, so that it is well settled in the law that the income tax is an indrect excise tax. Such an important fact is hardly one that all of Secretary Miller's legal advisers can be ignorant of, so that Miller's entire Department of the Treasury here stands convicted, by their own deliberate falsehood, of corruption of the law which is supposed to guide and control this nation.

Incidentally, two additional very significant comments must be made about this page from the Library of Congress analysis: (1) *Brushaber* here speaks about an income tax on dealings in property, but not about a tax on property. Dealings in property in *Brushaber* refers to income to a corporate entity (see infra) from buying, selling and improvement of property, not income from more passive and/or static interest and dividends such as this Committee is now discussing. (2) *Stanton* v. *Baltic Mining* declares that the "Sixteenth Amendment conferred no new power of taxation." This very clearly means that after the Sixteenth Amendment was passed

Congress could not collect any new tax that it could not collect before; thus the so-called income tax was not really a new or basically different tax but simply another excise tax, this time measured by income (see infra)).

Now what are the implications to us here today of this indirect excise income tax? It is clear we have no choice but to follow the relevant authoritative case law and see where we stand before considering the matter now before the Committee. An abbreviated compilation of relevant findings is as follows:

"An *excise* is an impost for a *license* to pursue certain callings or to deal in special commodities or to exercise particular *franchises*." (*East Ohio Gas Co.* v. *Tax Commissioner of Ohio*, 43 F.2d 170, 172, emphasis added),

and:

"The terms *excise tax* and *privilege tax* are synonymous." (*American Airways* v. *Wallace*, 57 F.2d 877, 880, emphasis added)

and:

"The Corporation Tax, as imposed by Congress in the Tariff Act of 1909, is *not a direct tax but an excise:* * * * it is an *excise on the privilege of doing business in a corporate capacity* and as such is within the power of Congress to impose; * * * not being direct taxation, but an excise, *the tax is properly measured by the entire income* of the parties subject to it. * * * (*Flint* v. *Stone Tracy Co.*, 220 U.S. 107, at 108–109.)

"A tax, such as the Corporation Tax imposed by the Tariff Act of 1909, on corporations, joint stock companies, associations organized for profit and having a capital stock represented by shares, and incurance companies, and *measured by the income thereof*, is not a tax on franchises of those paying it, but a *tax upon the doing of business with the advantages which inhere in the peculiarities of corporate* or joint stock *organization* of the character described in the act. * * *" (Ibid., at 109.)

"Indirect taxation includes a *tax on business done in a corporate capacity; the difference between it and direct taxation imposed on property because of its ownership is substantial and not merely nominal.*

Excises are *taxes laid upon the manufacture, sale or consumption of commodities*, within the country, upon *Licenses to pursue certain occupations* and upon *corporate privileges; the requirement to pay such taxes involves the exercise of the privilege and if business is not done in the manner described no tax is payable.*", (Ibid., at 110.)

"Even if the principles of the equal protection provision of the Fourteenth Amendment were applicable there is no such arbitrary and unreasonable classification of business activities enumerated in and subject to the Corporation Tax Law as would render that law invalid. There is a sufficiently substantial *difference between business as carried on in the manner specified in the act and as carried on by partnerships and individuals* to justify the classification." (Ibid., at 111.) (All emphasis added),

and:

"The word 'income' must be given the same meaning in *all* of the Income Tax Acts of Congress that was given to it in the Federal Corporation *Excise* Tax Act." (*Merchants' Loan, etc.* v. *Smietanka*, 255 U.S. 509, 519 (1921), emphasis added),

and:

"State law creates legal interests and rights. The federal Revenue Acts designate what interests or rights *so created*, shall be taxed." (*Morgan* v. *Commissioner*, 309 U.S. 105, emphasis added),

and:

"The right to contract about one's affairs, including the right to make contracts of employment, is a part of the 'liberty' of the individual protected by the 5th Amendment." (*Adkins* v. *Children's Hospital of D.C.*, 361 U.S. 525),

and:

"A State may not impose a charge for the enjoyment of a right guaranteed by the Federal Constitution." (*Murdock* v. *Pennsylvania*,

and:

"The legislature and the people may not choose to deny a fundamental constitutional right as a means of collecting revenue." (*United States* v. *State of Texas*, 252 F. Supp. 234),

and:

"The Supreme Court has unmistakenly determined that taxes imposed on subjects other than income, e.g., franchises, privileges, etc. *** are not income taxes, although measured on the basis of income." (*Keasley & Matteson Co.* v. *Rathensies*, C.C.A., Penna., 133 F.2d 894, 897 (1943)).

Term 'Direct Tax' Misused for Years, Misunderstood

George Washington stated in his Farewell Address to the American people in 1796: "The basis of our political system is the right of the people to make and to alter the Constitution of government. But the Constitution which at any time exists, until changed by an explicit and authentic act of the whole people, is sacred and obligatory upon all."

By Arthur J. Porth

The term "direct tax" has been misused and misunderstood for years, and, as a result, many serious problems have arisen. The purpose of this article is to explain and show the proper meaning of this phrase.

The study of the phrase "direct in the Constitutional sense" starts with a crisis in communication such as was faced by Galileo. He could not convince the people that the earth was round because they had been so indoctrinated that the earth was flat that they were mentally unable to conceive of the earth as being anything but flat.

In our government, the Internal Revenue Service is under no obligation to educate the citizens concerning the requirement of apportionment for certain taxes. As a result, most people have never heard of a tax that is required to be laid by apportionment, and both time and repetition are required for the concept to become understood.

A mention of the phrase "direct in the Constitutional sense," even to attorneys, will be met by a questioning stare. Very few of our people have ever heard of the phrase. But be assured that it was well understood by the members of the Constitutional Convention, to the readers of the "Federalist Papers," the judges in the Pollock case, and in the Brushaber case, and the congressmen who drew up the 16th Amendment.

The first time the author encountered the phrase was in the case of "Frank R. Brushaber vs Union Pacific Railroad Co.," 240 US 1, on page 11.

The phrase "direct taxes" is first found in the U.S. Constitution in Art. I, Sec. 2, Cl. 3: "Representatives and direct taxes shall be apportioned among the several states which may be included within this union . . ." The second time it appears is in Art. 1, Sec. 9, Cl. 4: "No capitation, or other direct tax, shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." In both cases we find the term "direct taxes" used in connection with the terms "apportioned" and "in proportion."

SPREADING TAX BURDENS

Just what do the terms "apportioned" and "in proportion" mean? They refer to a system of spreading tax burdens upon the states directly, but indirectly upon the people of the state.

The terms are clearly explained in the case of "Charles Pollock vs Farmer's Loan & Trust Co.," 158 U.S. 601, in which the Supreme Court explained that it required several steps. It required a budget on the part of the federal government. It also required a census of the population in all the states.

Then, based on both the budget and the census, the tax to be laid upon each state would be the budget divided by the census and that figure multiplied by the numer of people in the state in question.

But this tax would not be applied against the individual by the federal government. Each state would be responsible for collecting from its citizens its apportioned sum.

The delegates to the convention that drew up the Constitution were very knowledgeable about taxes. After all, they had just emerged from a war based upon their refusal to be taxed without representation and so they were determined that the wealth of the people who provide for the support of the government would only be taxed according to representation.

They intended that the money required

A. J. Porth is a nationally known author and lecturer on the Constitution and taxation.

to run the government would be derived primarily from imposts and duties and other excises. But not under the gravest of situations would the wealth of the citizens be taxed; that if property were to be burdened, it would not be a simple matter.

That such was the intent of the Constitutional Convention is shown on page 16 of the Brushaber case, in which the Supreme Court states: "The classification of 'direct' was adopted for the purpose of rendering it impossible to burden, by taxation, accumulations of property, real or personal, except by the regulation of apportionment."

The importance of an understanding of the difference between direct taxes applied by apportionment and of duties, imposts and excises became a matter of national importance in connection with the tax of 1894, in which the Supreme Court, in the Pollock case, after hearing and re-hearing, stated the following:

- "We adhere to the opinion already announced that, taxes on real estate being indisputably direct taxes, taxes on the rents or income of real estate are equally direct taxes.

- "We are of the opinion that taxes on personal property, or on the income of personal property, are likewise direct taxes.
- "The tax imposed by sections 27 to 37, inclusive, of the Act of 1894, so far as it falls on the income from real estate and of personal property, being a direct tax within the meaning of the Constitution, and, therefore, unconstitutional and void because not apportioned according to representation, all those sections, constituting one complete scheme of taxation, are necessarily invalid."

In this opinion, the court clearly defined what direct taxes are and ruled that they must be applied by apportionment to be Constitutional.

In the same case, Justice Harlan stated: "Congress cannot subject to taxation . . . either the invested personal property of the country, bonds, stocks, and investment of all kinds, or the income arising from the renting of real estate, or from the yield of personal property, except by . . . the rule of apportionment among the states."

Also in the same case, Justice Jackson stated: "The decision of the court, holding the income tax law of August, 1894 void, is based upon the following propositions:

- "That a tax upon real and personal property is a direct tax within the meaning of the Constitution, and, as such, in order to be valid, must be apportioned among the several states according to their respective populations.
- "That the incomes derived or realized from such property are inseparable incidents thereof, and so far partake of the nature of the property out of which they arise as to stand upon the same footing as the property itself.

"From these premises the conclusion is reached that a tax on incomes arising from both real and personal property is a 'direct tax' and subject to the same rule of apportionment as a tax laid directly on the property itself, and not being so imposed by the Act of 1894, according to the rule of numbers, is unconstitutional and void."

So, as a result of the "Pollock" decision, it was definitely settled that taxes on real or personal property were direct taxes, and so could only be applied by the regulation of apportionment, and therefore, the country was without an income tax law.

TAFT'S WISHES

When the 61st Session of Congress assembled in 1909, President William H. Taft addressed it and revealed that his chief concerns were to raise additional revenue, but to do so in accordance with the Constitution and thereby avoid litigation. He mentioned that recent court decisions had shown that corporations could Constitutionally be subjected to federal taxes.

There were those in the Senate who were antagonistic to the Supreme Court for its decision in "Pollock." These members wanted to repeat the provisions of the Act of 1894 and thereby test the court.

Among such members was Sen. Norris Brown of Nebraska. On June 17, 1909, he presented S.J.R. 39, which read as follows: "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population."

At the same time, for the record Senator McLaurin of Mississippi stated: "I think if the senator from Nebraska will change his amendment to the Constitution so as to strike out the words 'and direct taxes in Clause 3, Section 2, of the Constitution,' and also to strike out the words, 'or other direct' in Clause 4 of Section 9 of the Constitution, he will accomplish all that his amendment proposes to accomplish and not make a Constitutional amendment for the enacting of a single act of legislation."

On July 3, 1909, this suggestion of Sen. McLaurin was offered as an amendment. The amendment was rejected. By this vote, the words "and direct taxes," in Clause 3, Section 2, Article I, and the words "or other direct" in Clause 4, Section 9, Article I of the Constitution stand unchanged, and the Constitution remains unchanged.

On July 5, 1909, Senator Bristow of Kansas offered a substitute for S.J.R. 39. It also read: "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population."

By request of Sen. Bristow, the number of S.J.R. 39 was changed to S.J.R. 40.

S.J.R. 40 became the 16th Amendment of the Constitution, but the word "direct" was omitted. The 16th Amendment reads: "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 "Gould vs Gould," 245 U.S. 211, the court stated: "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out."

So, the 16th Amendment did not create a new form of tax, a direct tax not subject to apportionment.

This conclusion is supported by the court in the Brushaber case. In its opinion, the court stated that all the objections of the plaintiff could be grouped together inasmuch as they were all based on an erroneous assumption, that the 16th Amendment had created a new form of tax, a direct tax not subject to apportionment.

It is further supported by the "Beeland Wholesale Co. vs Kaufman," 174 S. Rep. 517. A "state can tax its citizens personally, provided no Constitutional provisions are violated, but the federal government cannot tax citizens personally except in proportion to census."

Also, referring to U.S. Supreme Court Digest, Lawyers Edition, Vol. 14 p. 404, 405, 1970·

"d. A tax on income, so far as it applies to rents or income from real estate, is within the provision of the U.S. Constitution against direct taxes except when laid in proportion to population. 'Pollack vs Farmer's Loan and Trust Co., 158 U.S. 601."

So, from the fact that S.J.R. 39 called for a direct tax without apportionment and that resolution did not pass; and S.J.R. 40 at one time also called for a direct tax without apportionment but in the final form the words "direct tax" were removed, and in the final form as passed by Congress the 16th Amendment did not contain the words "direct tax," there can be only one conclusion. Namely, the 61st Congress did not intend the words "direct tax" to be a part of it.

By leaving out words which would have required a direct tax, the Congress complied with the wishes of President Taft. It had provided a tax by which corporations could be reached. It was in accordance with the Constitution. It would not result in the litigation, which would have been certain had it done otherwise.

NOTE

The 61st Congress was well aware that "No tax can be imposed without express legislation authorizing it; and unless the intention of the legislature to lay the tax be explicitly and distinctly shown by unambiguous words, the public cannot be charged with its burden; for, if there be reasonable doubt of the intent, it will be denied." "John R. Stanton vs Baltic Mining Co.," 240 U.S. 103.

A LAND GRANT UNIVERSITY

VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Blacksburg, Virginia 24061

OFFICE OF THE PRESIDENT

October 11, 1982

WRITTEN STATEMENT FOR INCLUSION IN PRINTED RECORD OF SENATE FINANCE COMMITTEE HEARINGS ON FLAT-RATE TAX PROPOSALS (SEPTEMBER 27-29, 1982)

Most of us in higher education probably support the Reagan administration's attempts to create a more equitable tax system. However, the passage of a flat-rate tax that precludes credits or deductions for charitable giving may prove very damaging for the many colleges, universities, and service organizations across the nation that depend so heavily upon private donations.

Since taking office, President Reagan has urged the private sector to accept more of the fiscal responsibility for social, educational and cultural programs. In many cases, the adoption of these programs by localities has resulted in an upgrading of the quality of service. But the benefits of this move will be diminished considerably if new laws remove the tax incentives from charitable giving.

While most donors contribute because they believe in the merits of a program or institution, the charitable deduction allows them to give much more than otherwise possible. Those of us in higher education agree that a reduction in private donations would severely affect the caliber of the programs now offered, because quality offerings require money . . . especially at a time when graduates with a high degree of technological education are so badly needed. At Virginia Tech, we turn away thousands of applicants each year because of space shortages, limited scholarship funds and the like. Take away private donations and you have removed one of the buffers that keep tuitions comparatively low. With reduced government funding and lower private giving, the only other source is higher tuition, a move which forces education into an unplanned yet creeping elitism.

I think I speak for many in higher education, in urging you to study a more equitable tax system, but maintain a tax program which allows, at the very least, a charitable deduction, if not a 100% tax credit for charitable contributions. Deductions and credits carry a dual benefit for donors: one, most obviously, it lessens the out-of-pocket impact of the gift; and two, it provides a subtle yet effective way to recognize and thank donors for their generosity.

I hope you will not give the responsibility for educational programs to the private sector, then take away the incentive for accepting it.

Sincerely,

William E. Lavery

William E. Lavery
President

WEL:bwg

WOODBERRY FOREST SCHOOL
WOODBERRY FOREST, VIRGINIA
22989

ALL OFFICES:
703-672-3900

September 30, 1982

Written Statement For Inclusion in Printed Record of Senate Finance Committee Hearings on Flat-Rate Tax Proposals (September 27-29, 1982)

Mr. Robert E. Lighthizer, Chief Counsel
Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Lighthizer,

While supporting the general concept of a flat-rate tax, Woodberry Forest School, a 501(c)(3) charitable institution, is very concerned with the possible adverse affect of a flat-rate tax on contributions to our school and to other charitable institutions.

If a flat-rate tax is enacted, we strongly endorse the concept of allowing a credit of 50 percent of the amount of charitable gifts made. The tax credit could also be a progressive credit - based on a tax payer's adjusted gross income, and a ceiling could be placed on the credit to assure that donors do not entirely avoid paying taxes by making charitable gifts. The present five year carryover rule could also apply.

Charitable contributions form the life blood of many of this country's finest institutions. Whatever changes are made in current income tax legislation must preserve an incentive for all Americans to support these institutions.

Sincerely,

Peter G. Rice

Peter G. Rice
Treasurer

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western union **Telegram**

SENATOR DOLE RPT DLY MGM
CAPITOL ONE DC

SENATOR DOLE I WOULD BE GLAD TO APPEAR BEFORE THE SENATE FINANCE COMMITTE TO PRESENT AN ALTERNATIVE TO THE PRESENT INCOME TAX. AT THIS LATE DATE I WOULD APPRECIATE AT THE LEAST THE INSERTION OF THIS SIMPLE HURRIED SUMMARY OF THIS ALTERNATIVE INTO THE WRITTEN TESTIMONY OF THE SENATE FINANCE COMMITTEE. I AM AN ACCOUNTANT AND HAVE HAD 20 YEARS EXPERIENCE IN TAX PREPARATION. AT THE PRESENT TIME APPROXIMATELY 1/3 OF MY BUSINESS GROSS INCOME IS DERIVED FROM INCOME TAX PREPARATION. I CONSIDER THE PRESENT INDIVIDUAL AND CORPORATE INCOME TAX STRUCTURE AND PROCEDURE TO BE UNPRODUCTIVE, UNWIELDY, ARBITRARY, CONFISCATORY, AND OPPRESIVE TO THE POINT OF CHARACTERIZING IT AS BEING A "SWORD OF DAMACLES" HANGING OVER THE HEAD OF EVERY TAX PAYING CITIZEN. WITH THE PRIME PURPOSE OF TAXATION TO BE THE MOST COST EFFICIENT METHOD OF FUNDING THE OPERATION OF GOVERNMENT I WOULD REPLACE THE PRESENT TAX STRUCTURE OF OUR GOVERNMENT-WHICH INCLUDES ALL TAX REVENUE RAISING LAWS-WITH A DIRECT SALES TAX ON THE CONSUMER LEVEL ONLY...COVERING SALES OF ANY KIND. THE NET EFFECT OF SUCH A TAX WOULD BE A PROFOUND REDUCTION IN NON PRODUCTIVE ACTIVITY SUCH AS ACCESSIVE GOVERNMENT...RESULTING IN SUBSTANTIAL REDUCTION IN THE COST OF CONSUMER GOODS; THE RICH PAYING THE GREATER PORTION SINCE THEY WOULD SPEND MORE; GREATLY REDUCING IF NOT ELIMINATING THE ABILITY OF DISHONEST CITIZENS FROM PAYING TAXES; A GREATER PRODUCTIVITY; AND A MORE FREE SOCIETY SINCE THE TAX PAYING CITIZEN WOULD BE FREED FROM ALL THE RAMIFICATIONS OF OPPRESSIVE TAX LAWS. AN ADDITIONAL RESULT, POSSIBLY THE MOST IMPORTANT, WOUDL BE THAT EVERY SINGLE AMERICAN WOULD HAVE AN INTEREST IN THE FINANCING OF GOVERNMENT SINCE EVERY TAX INCREASE OR DECREASE WOULD DIRECTLY AFFECT HIM OR HER.

FREDERICK E LEWIS
5348 BALLARD AVE NORTHWEST
SEATTLE WA 98107

16:09 EST

IPMPOMX WSH

An open letter to:

President Ronald Reagan
Senator Carl Levin
Senator Donald W. Riegle, Jr.
Representative Harold S. Sawyer

Dear Senator Levin,

It's time for fundamental changes in our tax system. This letter describes a simple tax system which increases taxes on "big spenders", but lowers the tax on wealthy who reinvest more of their earnings. It strongly supports private enterprise by encouraging savings and capital accumulation.

The new tax system has three simple features.

1. The current income tax structure is modified.
   - Marginal tax rates are raised back up to 70%.
   - "Earned income" receives no special treatment, and is also subject to the higher marginal rates.
   - Interest expense is no longer deductible.

2. Individuals can elect to place their investment assets in a special "Personal Investment Trust" (PIT).
   - The PIT must hold all investment assets of the individual.
   - Withdrawals from the PIT are taxable income to the individual.
   - Deposits to the PIT are deductible.
   - Assets for personal use, such as residence, a yacht, or decorative art, are excluded from the PIT.

3. The PIT is subject to a separate income tax.
   - Low rate, such as 10%.
   - Taxable income includes:
     - Interest (except tax-exempt interest)
     - Dividends
     - Capital gains (no special treatment)
     - Individual deductible deposits
   - Deductions from income include:
     - Capital losses
     - Withdrawals (taxable to the individual)
     - Investment management expenses
     - Interest expense on loans to the PIT
     - Depreciation
   - Adjustments to tax include investment tax credit.

Special treatment will be granted on purchase of primary residence.

- ° Net cash paid (purchase price plus expenses and taxes less amount of loan) will be deductible in the year of purchase.
- ° 10% of net cash paid will be added to taxable income each subsequent year for ten years, or until sale.
- ° On sale within ten years, the remaining "10% years" will be accelerated and taxable in the year of sale.
- ° On sale, net gain is added to taxable income.
- ° Interest paid on mortgage receives a tax credit equal to the PIT tax rate (10%).

This tax system has considerable and diverse advantages.

- ° Savings and capital accumulation is encouraged.
- ° Lavish spending by the wealthy is discouraged.
- ° Income is taxed at low rates if reinvested.
- ° Income is taxed at high rates if used for consumption by high income taxpayers.
- ° Indefinite carry forward from high income years is permitted.
- ° Greater capital accumulation will mean more jobs.
- ° Greater savings will mean lower interest rates.
- ° Abandons the discredited "trickle-down" theory of spending by the wealthy.

Attached you will find examples including a tax table, and sample calculations on three individuals, showing differences between the current and proposed systems.

I trust this proposed tax system will receive careful analysis from you and your staff. I will be happy to assist your staff in further development of the principles embodied in the system.

Yours very truly,

Dale E. Lamps

Dale E. Lamps
6486 Woodbrook S.E.
Grand Rapids, MI 49508
(616)942-0409

September 22, 1982

cc: Various newspapers in Michigan and the Chicago area.

PROPOSED TAX TABLE (single return; Tax years beginning after 1984):

(1) Taxable Income **	(2) Tax on Col. (1) **	(3) Rate on Excess **
$ 53,300	$16,115	50%
$ 84,000	$30,465	60%
$112,000	$53,265	70%

** For taxable income under $53,300, tax table is unchanged from current law.

PIT tax rate: 10%.

THREE EXAMPLES: Smith, Jones and Murphy, for the year 1984.

- Each has taxable earned income of $150.000 plus investment income of $150,000.
- Each files a "single return".
- Tax using current table is $137,935.
- After tax income is $162,065.
- Smith spends $50,000 and invests $102,065.
- Jones spends $100,000 and invests $62,065.
- Murphy spends $150,000 and invests $12,065.

Smith under the NEW SYSTEM would invest $150,000 of investment income, plus a PIT deposit of $73,070, for a total of $223,070. His total tax is $49,237, down from $137,935. His spendable income remains at $50,000.

Taxable income	$150,000
PIT deposit	-73,070
NET	$ 76,930
Tax	-26,930
Spendable income	$ 50,000
Investment income	$150,000
PIT deposit	+73,070
PIT taxable income	$223,070
10% PIT tax	$ 22,307
Total tax	$ 49,237

	SMITH	JONES	MURPHY
PIT deposit (withdrawal)	$ 73,070	($ 76,217)	($219,663)
Income tax	$ 26,930	$126,217	$226,629
PIT tax	$ 22,307	$ 7,378	($ 6,966)
Total tax	$ 49,237	$133,595	$219,663
Current law tax	$137,935	$137,935	$137,935
Personal spending	$ 50,000	$100,000	$150,000

would continue to provide a significant tax incentive for high income individuals to give to charitable institutions. Without this incentive I am quite certain that giving levels by individuals to charitable institutions will decline significantly.

If Congress is unwilling to allow a 50% credit for all tax payers, a progressive credit based on a tax payer's adjusted gross income should be allowed. To assure that donors do not entirely avoid paying taxes by making charitable gifts, a ceiling could be placed on the credit. The present five year carry over rule could also apply. Thank you for your consideration of my viewpoint on this matter.

Most sincerely,

David B. Madeira

Dr. David B. Madeira
Director of College Advancement
College Counsel

m/419d

MESSIAH COLLEGE
CHRIST PREEMINENT

Grantham, Pennsylvania 17027 (717) 766-2511

September 24, 1982

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, DC 20510

Dear Sir:

I write to you, as an administrator in private higher education, to express my concern regarding proposed changes in our income tax system. It has come to my attention that Congress is considering proposals regarding flat-rate tax structures instead of the current progressive system.

Generally speaking I support the concept of a flat-rate tax system. I do believe that it is preferable to our present progressive system for several reasons. It would, of course, be much more simple and thus less costly to administer. It would also eliminate the problem of bracket creep which currently pushes tax payers into higher tax brackets. Third, it would end the current "marriage penalty" which in our present structure results in higher taxes for two-earner married couples. And fourth, it would help stop tax evasion schemes and therefore add revenues to the federal government.

However, I am very much concerned about the impact of such a system on charitable giving. I am in accord with the President's position that most social services should be provided by the states and/or the private sector. I strongly believe that the federal government should get out of most of the social services field. However, in order to do so we must be careful to ensure that individuals will sufficiently support charitable institutions. Therefore, I urge you not to consider a simplified tax system that would eliminate the charitable tax deduction. Instead, it would be much better to propose a low flat-rate tax system which would provide either a charitable deduction or, better yet, a tax credit.

Therefore, I would like to propose the following suggestion: Congress should enact the flat-rate tax structure which would allow a <u>credit</u> of 50% of the amount of charitable gifts made in any tax year. This would then be the equivalent of the present charitable deduction for a tax payer in the highest 50% tax bracket. The allowance of such a credit