A FAIR, SIMPLE, AND PRO-GROWTH TAX REFORM

Jack Kemp

Politics and Economic Theory

In any serious discussion of tax reform the relative roles of the politician and the economist need to be examined. I know that some theories of public choice take a rather dim view of politicians, and perhaps not without reason—just as many people today take a rather dim view of economists. But we cannot dispense with politicians, any more than we can dispense with economists. What we need are politicians and economists who are better at understanding and dealing with reality. I would like to suggest that this requires us carefully to observe the limits of pure theory. Economic or political theory is a more or less useful abstraction from the lives of real people. But each abstraction takes us further away from that concrete reality. For example, general equilibrium theory, useful as it is, has no role for the entrepreneur; in the same way, some public choice models have no role for the entrepreneurial politician. It is the economist's job to determine what is desirable and achievable from the point of view of economic policy; it is the politician's job to determine, with the help of experts from other fields, what is desirable and achievable from the point of view of social policy; and we need everyone working together to come up with the best tax reform plan. No single perspective is enough.

I offer this caveat for the following reason. Last year in testimony to the Senate Finance Committee, I commented at some length upon what I consider a remarkable fact about federal tax reform. In the world of tax economists, there are two competing consistent theories of tax reform—the comprehensive income tax, and the consumption tax. Each of these theories has been worked out in considerable detail

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for decades by leading tax economists. Each has its own partisans. Yet of the three tax reform proposals that are generally agreed to have the best chance of enactment by the Congress, none is a consistent embodiment of either theory. In key areas like depreciation and capital gains, Bradley-Gephardt and the Treasury plan shade toward the comprehensive income tax; but in others, such as the treatment of retirement pensions, they follow the treatment of the consumption tax. Kemp-Kasten has more of the incentives for saving and investment which characterize the consumption tax than either of the other plans; yet one of its distinguishing features is an exclusion for *labor* income, and Kemp-Kasten is the most favorable in its treatment of fringe benefits. In short, each of the three plans is a hybrid of the two "pure" approaches, though each has its own unique mixture.

We could explain this by saying that politicians never do what they are supposed to. Or, this apparent inconsistency could reflect consistency to a higher principle. It is apparently inconsistent for a sailboat to tack back and forth instead of sailing directly from Point A to Point B; but it turns out to be the quickest way. Of course, if you are driving a motorboat, it is another story. But that is really my point: we have to recognize the limits of any theory that tells you how to plot a course but abstracts from whether you are in a sailboat or in a motorboat. When it comes to the ship of state, it is the job of politicians to observe those kinds of distinctions, and this may help explain the different perspectives of the politician and the economic theorist concerning tax reform.

I am not saying you have to compromise your principles in order to achieve something politically. On the contrary, the only way you can accomplish anything in the long run is if your principles are fixed. If we want a whole loaf, we may only be able to get half a loaf; but we will not get a single slice if we cannot decide whether we want bread or buttons. Too often we fail because we change our principles rather than trying to change reality; because it is easier. As somebody once remarked, if more of our politicians were idealists, we might get something practical accomplished.

Now, the politicians who have been most entrepreneurial in moving the issue of tax reform have all gravitated toward a similar set of political ground rules. First, the new tax code must be "revenue neutral" in a static sense, neither raising nor losing revenue, apart from the dynamic effects resulting from new incentives. Second, the new tax code must not significantly shift the distribution of the federal tax burden on individuals by income class, compared with current law. Third, the new tax code should significantly lower marginal tax rates compared with current law, and so far as possible, minimize

the distortions of economic decisions which are due to the tax code. Finally, tax reform should encourage economic growth, not hinder it. You can argue with any one of these limitations on policy, but I believe these are roughly given.

Both the pure flat income tax and the pure flat consumption tax violate some of these objectives. Briefly, a pure flat rate, comprehensive income tax tends to shift the tax burden from the top to the bottom of the income scale; or else, with a sizable income tax threshold, the tax burden will be shifted toward the lowest income families who continue to pay taxes, if revenue neutrality is to be maintained. A pure comprehensive income tax also tends to maintain or increase the disparity of treatment of certain economic activities, such as consumption and saving.

A pure consumption tax has a worse problem distributionally, because so much saving, which would be tax deferred under a consumption tax, is done by upper income taxpayers. To maintain distributional neutrality, a pure consumption tax would have to maintain fairly high marginal tax rates. The transition to such a system can also be quite long and complex. And a consumption tax as usually understood tends to discriminate against certain taxpayers, such as families with children, whose station in life requires them to "consume" more than other taxpayers of an equal income—though I will argue that raising children should be viewed in many ways as an investment.

I would not like to leave you with the impression that the major tax reform plans are without any consistent principles. My purpose, in fact, is precisely to put forward the philosophy behind Kemp-Kasten in some detail. Within the broad political agreement that exists on principles of tax reform, however, there can be surprising differences in philosophy. Hence, in addition to stating the general case for tax reform, there is a need to state the specific case for Kemp-Kasten.

Kemp-Kasten: General Outlines

Most of you are probably aware of the broad outlines of the Kemp-Kasten "Fair and Simple Tax" (FAST). But perhaps it is less clear how the specific provisions are interrelated. And you may not be aware of some significant improvements to our bill, especially concerning the treatment of capital gains and depreciation, which were added when our plan was reintroduced in the new Congress on 30 January 1985 (H.R. 777, S. 325). Let me first describe the proposed

reform of the individual income tax, then capital gains, and finally the business side.

As I said, I cannot give you a single rigorous tax theory about Kemp-Kasten. But I can give you a consistent social philosophy for it. I consider the "Fair and Simple Tax" first and foremost a "pro-family" tax reform. In many important respects we have been guided by considering the impact of the tax code on the traditional one-earner family of modest means with children. We try to do our best by everyone, and we have special provisions favorable to senior citizens, the working poor, single people, and two-earner couples. After all, a family does not stop being a family when the children grow up and the parents grow old. But on the whole the traditional family is our norm—a norm, I might add, that is not culled from polling data or from statistics about the way Americans live, but rather from an idea of how we think they would prefer to live if they had the chance. There is, if you will, a natural-law basis for our bill, though one which sees the family rather than the individual considered in the abstract as the basic unit of society.

Treatment of Individuals

The details of Kemp-Kasten's treatment of individuals are fairly easily described. Concerning the tax base, we retain the current deductions for mortgage interest, real property taxes, charitable contributions, and catastrophic medical expenses, as well as the tax deferral of all kinds of retirement saving. We also retain the exclusion for employer-provided health and life insurance. Many of the other tax preferences in the tax code are eliminated. The personal exemption is doubled to $2,000, and the exemptions and zero bracket amounts are indexed for inflation.

Wage Exclusion

A prime distinguishing feature of Kemp-Kasten is that instead of three marginal tax rates—as in Bradley-Gephardt or the Treasury I proposal—we have a 24 percent flat tax rate on taxable income, combined with a "progressive" or "disappearing" exclusion. In general, taxpayers may exclude one-fifth of wages and salaries up to the amount they pay on social security tax. The social security wage base is expected to be $41,700 in 1986, which would make the maximum wage exclusion $8,340 in that year. The wage base is indexed by law to grow with inflation and real average wages.

There are two special rules. First, taxpayers with wages and salaries less than $10,000 for single people, or $15,000 for married cou-

ples, may exclude 20 percent of income from any source up to those amounts. Second, two-earner couples with combined wages in excess of the social security wage base may exclude 20 percent of the total amount on which they paid the payroll tax.

The exclusion figured in this way is phased out at upper incomes by adding back an amount equal to 20 percent of a taxpayer's income in excess of the social security maximum taxable earnings base. This means the exclusion falls to zero at twice the FICA wage base, or $83,400 in 1986.

When you phase out a benefit according to an income test, the phasing out causes an increase in effective marginal tax rates—in this case from 24 percent to 28.8 percent (1.2×0.24). Our earlier versions of the bill had a "notch" when the effective marginal tax rate fell from 28 percent to the flat 25 percent rate once the wage exclusion was completely phased out. Also, the exclusion provided for non-wage income was not phased out. In the new bill, we have modified the phaseout so that it applies to both labor and capital income, and the marginal tax rate effectively stays at about 28 percent for all taxpayers above the social security wage base. After the exclusion falls to zero, the continued phaseout behaves like a small surtax that keeps the effective marginal tax rate at 28.8 percent for all upper income taxpayers.

We believe the flat rate plus wage exclusion has several major advantages over progressive income tax rates. It allows a much higher tax-free income threshold than the other tax reform plans without greater cost. It also allows a lower marginal tax rate at the top. It substantially equalizes the tax rates on labor and capital income, resulting in a virtually flat combined income and payroll tax rate at all incomes above the income tax threshold. Finally, it avoids the tax burden shifting associated with a pure flat income tax rate.

In order to explain these advantages, let me return to our philosophy, and examine the combined effect of all the Kemp-Kasten provisions on American families and households.

The Wage-Earner

For many years there existed a distinction between employment and investment income for upper-bracket taxpayers, which most tax experts agreed should be removed. This distinction was removed in the 1981 tax act, when the top rate on investment income was cut to the 50 percent maximum tax rate on labor income. However, there still exists a distinction between labor and capital income at middle and lower incomes, due to the fact that workers pay a marginal tax rate that is higher by the amount of the payroll tax. Under current

law the payroll tax is added on top of the personal income tax rate for labor income, but not capital income. Since the payroll tax base stops at about $40,000, the marginal tax rate on labor income can be higher at a lower income level than at a higher income level. For this reason, a purely flat income tax rate without a partial wage exclusion would not really be flat: a 24 percent flat rate would really be a 31 percent combined tax rate below $40,000, and 24 percent above $40,000. The two problems exist under current law and all tax reform plans except Kemp-Kasten.

For example, in 1986 a nonitemizing single taxpayer earning $35,000 would pay marginal tax rates of 34 percent under current law, 26 percent under Bradley-Gephardt, and 25 percent under Treasury I on *capital* income—but 41 percent under current law, 33 percent under Bradley-Gephardt, and 32 percent under Treasury I on *labor* income. Because of the wage exclusion and flat rate, under Kemp-Kasten the same taxpayer would pay 24 percent on capital income and 26 percent on labor income.

Viewed by income level, the combined marginal tax rate structure above the income tax threshold behaves as follows under the various plans. Current law: the tax rate starts at 18 percent, rises to 41 percent, falls to 34 percent, then rises to 50 percent. Bradley-Gephardt: the tax rate starts at 21 percent, rises to 37 percent, then falls to 30 percent. Treasury I: the tax rate starts at 22 percent, rises to 42 percent, then falls to 35 percent. Kemp-Kasten: the tax rate starts at 26 percent for labor income, 24 percent for capital income, and ends at 28 percent for both.

Though Kemp-Kasten raises about the same amount of individual income tax revenue as Bradley-Gephardt, and more than Treasury I, the Kemp-Kasten wage exclusion permits both a higher income tax threshold and a lower top marginal tax rate than under either alternative. For a family of four, the sum of personal exemptions and the zero bracket amount is about the same under all three plans: $11,800 under the Treasury plan, $11,500 under Bradley-Gephardt, and $11,300 under Kemp-Kasten. But the wage exclusion raises the income tax threshold under Kemp-Kasten 25 percent higher, to $14,125, or almost twice the $7,700 threshold under current (1985) law. For a single taxpayer, the income tax threshold is $5,750 under Kemp-Kasten, compared with $4,800 under the Treasury plan, $4,600 under Bradley-Gephardt, and $3,430 under current law.

Besides having the highest tax-free level of income at the bottom, Kemp-Kasten has the lowest marginal tax rate at the top. Kemp-Kasten raises about the same amount of revenue in static terms from

taxpayers over $100,000 as the Treasury plan, despite a much lower top marginal tax rate—28 percent instead of 35 percent.

This is due in large part to the flat rate and disappearing wage exclusion. The exclusion effectively lowers the marginal tax rate from 24 percent to 19 percent below about $40,000, while phasing out the exclusion effectively raises the marginal tax rate from 24 percent to about 28 percent above $40,000. However, Kemp-Kasten raises more revenue and results in greater progressivity of the tax burden than an ordinary system of progressive rates of 19 percent and 28 percent, for two reasons.

First, the exclusion applies to wages and salaries, but not generally to interest and dividends. As I mentioned, this offsets the payroll tax and equalizes the tax rates on labor and capital income. This raises more revenue from a number of sources of nonwage income than an ordinary system of progressive tax rates.

Second, deductions and exemptions are deducted against the 24 percent flat rate, even when the effective marginal tax rate is 19 percent or 28 percent. This increases the value of deductions below about $40,000, and reduces them slightly above $40,000, compared with the effective marginal tax rate. The result is greater progressivity in the tax burden than would result from an ordinary system of progressive income tax rates.

Families with Children

One reason I call Kemp-Kasten a "pro-family" tax bill is its treatment of the personal exemption. In general, we believe that people, and especially children, should not be treated as so many consumer durables, like refrigerators and sailboats, but rather as investments in human capital.

The tax code has traditionally offered some relief for families with children through the personal exemption. Yet if the personal exemption, which was $600 back in 1948, had been indexed since that time for inflation, it would be more than $2,500 today. If it had been indexed as a share of total income, the exemption would be more than $5,500 today. By almost any measure the decline in the personal exemption has been the largest single change in the income tax in the postwar era. Because of this and other changes in tax law, the rise in the tax burden since the Second World War has been about twice as fast for families with children as for single taxpayers and childless couples.

Bradley-Gephardt increases the exemption for adults to $1,600, but reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986, and also repeals inflation indexing of these

amounts. However, because of the higher bottom tax rate, the value of the exemption for each child rises from $114 to $140 a year. Since the Bradley-Gephardt plan allows the exemption only against the 14 percent bottom tax rate, the exemption is worth $140 for all taxpayers, including those in the 26 percent and 30 percent tax brackets. This represents a reduction of the tax value for the exemption in the top bracket from $500 to $140.

Kemp-Kasten doubles the personal exemption for everyone to $2,000 and retains indexing. Treasury I also increases the personal exemption to $2,000, plus indexing; but because of the different rate structures, the effect of the $2,000 exemption is different under Treasury I than under Kemp-Kasten.

With progressive tax rates, as under Treasury I, the value of a deduction rises with your income. Under the Treasury plan, the value of each child exemption rises from $114 to $300 at the bottom, but it rises from $500 to $700 in the top tax bracket. Under Kemp-Kasten, all deductions, exclusions, exemptions, etc., are worth 24 cents on a dollar. The difference is especially important with the personal exemption for dependent children. Under Kemp-Kasten, the value of each exemption at a low income more than quadruples, from $114 to $480 a year, while in the top bracket the value of the exemption remains about the same, $480 compared with $500 under current law. The increased tax value is concentrated at middle and low incomes. Because the personal exemption is such a large revenue item, this is another reason why the top marginal tax rate can be lower under Kemp-Kasten than under the Treasury plan.

Both Bradley-Gephardt and the Treasury plan repeal the child care credit and replace it with a deduction for child care expenses. Kemp-Kasten repeals the credit without replacing it with a deduction. While this is relatively more favorable to traditional one-earner families with children, under realistic assumptions (that is, assuming child care expenses bear some reasonable relationship to the additional income earned by the second wage earner in a family), in general the Kemp-Kasten treatment is absolutely more favorable for low- and moderate-income two-earner families than either Bradley-Gephardt or the Treasury plan. For example, a nonitemizing family of four earning $15,000, with the second spouse earning a third of the income and child care expenses equal to a tenth of the family's total income, pays a federal income tax in 1986 of $393 under current law, $475 under Bradley-Gephardt, $419 under Treasury I, and $168 under Kemp-Kasten. With only one earner and no child care expenses, the federal tax is $868 under current law, $532 under Bradley-Gephardt, $480 under Treasury I, and $168 under Kemp-Kasten.

In this way, Kemp-Kasten provides the same tax treatment to all families with children, regardless of the parents' employment status. Any other approach seems to imply that the effort of the parent who stays at home to care for the children is worth less than if he or she worked outside the home. It does not seem fair to recognize the expense of earning a second income, but ignore the cost of giving up a second career, which often goes with the decision of a spouse to remain at home to raise the children.

Two-Earner Couples

Kemp-Kasten does remove a bias against two-earner couples that exists under current law and the other major reform plans. All three plans repeal the "marriage penalty" deduction, which is a current-law exclusion of 10 percent of the wages of the lesser-earning spouse, up to a maximum $3,000 deduction. When this feature was enacted in 1981, one justification was that a second income can often put a couple into a higher tax bracket, putting two-earner couples at a disadvantage relative to single taxpayers earning the same combined income. The deduction was an attempt to offset this "marriage penalty." However, it created a new problem of equity. Now, two families with exactly the same income and itemized deductions can pay a different federal tax—the tax for a two-earner family being lower than for a one-earner family. In all three major tax reform plans, repeal of the second-earner deduction is justified by the flattening out of marginal tax rates—and Kemp-Kasten has the flattest combined marginal tax rates.

However, a two-earner family with combined wages in excess of the social security payroll tax base pays a higher social security payroll tax and therefore a higher combined marginal tax rate than other taxpayers on the same income. This is because a family with one wage-earner pays the payroll tax on up to about $40,000; but a family with two wage-earners can pay tax on up to twice that amount. Under Kemp-Kasten, two-earner couples may figure out their 20 percent wage exclusions separately and add the two, if this results in a larger total exclusion. This offsets 5 of the 7 percentage-point increase in the combined marginal tax rate that occurs under current law and the other tax reform plans. In a sense, then, the Kemp-Kasten wage exclusion acts like a second-earner deduction for married couples.

The Working Poor

Families currently living in poverty pay rather stiff rates of federal income tax. The poverty level in 1985 is $11,101 for a family of four, while the income tax threshold for a family of four is $9,440 (including

the earned income tax credit), or almost 20 percent lower. Much of the worst impact of inflationary bracket creep has been felt by low income families, who used to be exempt from income tax but have been swept on to the tax rolls by inflation. The tax disincentives are compounded because in many cases the disposable income obtainable through transfer payments for not working is almost as great as or even greater than after-tax wages at a comparable income. This is the famous "poverty trap."

Kemp-Kasten addresses this problem in several ways. One way is significantly to raise the tax-free threshold of income. The income tax threshold for a family of four is increased from $9,440 to $14,125. The income tax threshold for a single head of household with two dependents is increased from $8,375 to $10,750. This removes about 1.5 million of the lowest income taxpayers from the tax rolls, and indexing will keep them off the rolls permanently as long as they are poor.

Another Kemp-Kasten change is to modify the earned income credit in order to reduce high effective marginal tax rates at low incomes. Under current law, the earned income credit is 11 percent of earned income up to $5,000. The maximum credit of $550 is constant between $5,000 and $6,500, and is then reduced by 12.22 percent of income in excess of $6,500. The credit disappears at $11,000. Since the phaseout of the credit adds a marginal tax rate of 12.22 percent to the statutory tax rate, and the bottom income tax brackets overlap the phaseout range of the earned income tax credit, this can result in fairly high effective marginal tax rates under current law and under the other tax reform plans. For example, a single head of household earning $10,000 with one dependent faces a marginal income tax rate of 26 percent under current law and under Bradley-Gephardt, and 24 percent under Treasury I, plus the 7 percent payroll tax rate and the 50–75 percent effective marginal tax rates from forgoing transfer payments.

Kemp-Kasten reduces these effective marginal income tax rates by coordinating the earned income credit and the normal income tax thresholds. We increase the credit from 11 percent to 15 percent, thereby increasing the maximum credit from $550 at $5,000 to $600 at $4,000. But we phase out the credit completely at $8,000—just below the $8,250 tax threshold for a single head of household—in order to end the overlapping which causes the spike in effective marginal tax rates. This reduces effective federal marginal income tax rates on the working poor by about 25 percent below current law and the other tax reform plans. Kemp-Kasten also indexes the earned income credit for inflation, for the first time.

Important as the "poverty trap" is, cutting high effective marginal tax rates alone will not magically cure poverty. The more we understand about the causes of poverty, the more we are drawn to the conclusion that it has at least as much to do with the stability of families as with after-tax income. While this question goes far beyond the realm of tax policy, I believe that the "pro-family" aspects of Kemp-Kasten should be considered as an integral part of its anti-poverty strategy.

Homeownership

The Kemp-Kasten philosophy is unabashed in believing that homeownership ought to be encouraged. Families should be encouraged to become property owners in general, because it increases their economic independence and self-reliance; but homeownership is especially important. I believe that more than nostalgia has made the house with the white picket fence a traditional part of the American dream. Every family needs a piece of property that represents its special zone of freedom and even self-expression.

One of the interesting features of Kemp-Kasten is that in addition to cutting the tax burden, it increases the value of homeownership for typical families earning less than the median income. Our bill retains the deductions for mortgage interest and real property taxes. And as with the personal exemption, the value of these deductions is increased at moderate and lower incomes, though reduced at high incomes. The effective marginal tax rate on wages is 19 percent, because of the exclusion, but deductions are worth the full 24 percent flat tax rate. According to the National Association of Homebuilders (NAHB), Kemp-Kasten would reduce the cost of homeownership by 3 percent for a typical family earning $20,000 a year, while the Treasury and Bradley-Gephardt plans would increase the cost by 6 percent and 10 percent respectively.

Incidentally, the treatment of homeownership under current law and Kemp-Kasten is essentially similar to its treatment under a consumption tax: families must pay principal out of after-tax income, but the imputed rent is not taxed. I do not believe that tax theory requires us to punish homeownership.

Investment in Human Capital

While Kemp-Kasten contains more of the savings and investment incentives of a consumption tax than either Bradley-Gephardt or the Treasury plan, it differs significantly in its approach to investment in human capital. Kemp-Kasten disallows the deductibility of interest for consumer credit, which is more stringent than either Bradley-Gephardt, which allows all interest up to the amount of investment

income, or the Treasury plan, which allows all interest up to the amount of investment income plus $5,000. Kemp-Kasten makes an exception, however, for interest on education loans, on the theory that this reflects investment in human capital.

Progressivity plays a role here as well. Progressive tax rates plus tax deferral of retirement savings, as with individual retirement accounts (IRAs), are favorable to capital income because a taxpayer is generally in a lower tax bracket after he retires than when the deduction is made. Progressivity has the opposite effect, though, for the few deductions allowed for investment in human capital, because a person is generally in a low tax bracket when the investment is made, but the increased value of personal services push the taxpayer into a higher tax bracket. The Kemp-Kasten treatment of deductions is therefore more favorable to investment in human capital than either current law, a progressive consumption tax, or the other tax reform plans.

Although Kemp-Kasten repeals the state and local income and sales tax deduction, we retain the deduction for property tax for reasons beyond encouraging homeownership. In particular, the property tax is almost always devoted to local education, and retaining the deduction is a way of offsetting the bias against investment in human capital.

Like current law and the other two plans, Kemp-Kasten continues the deduction for catastrophic medical expenses—unreimbursed costs which exceed 10 percent of adjusted gross income. However, Kemp-Kasten also preserves the exclusions for employer-paid health and life insurance. If it is permissible to compare human beings with physical capital, these costs could be viewed as depreciation allowances for human capital. We believe that private rather than public insurance of risk should be encouraged where possible. When the private sector is discouraged from providing for such basic needs, the usual result is to increase the pressure for public provision.

Bradley-Gephardt taxes both employer-paid health and life insurance; the Treasury plan taxes group term life insurance premiums and caps the exclusions for health insurance. Proponents of these approaches have pointed to extravagant use of fringe benefits by highly paid executives. However, Kemp-Kasten effectively curtails the inordinate attractiveness of fringe benefits at upper incomes by cutting the value of deductions in half in the top tax bracket, through marginal tax rate reduction. Once again, however, the Kemp-Kasten treatment actually increases the value of the medical and life insurance exclusions at low and moderate incomes.

Senior Citizens

Kemp-Kasten has two primary features that help senior citizens. First, Kemp-Kasten increases the personal exemptions for each senior citizen from $2,080 to $4,000 (which amount is indexed for inflation). (Bradley-Gephardt increases the total exemptions to $2,600, while the Treasury leaves the exemption at $2,000, plus a special credit at low incomes.) Second, the special rule allowing the 20 percent exclusion to apply to all income up to $10,000 (single) or $15,000 (joint) is designed to protect senior citizens who live mostly from investment income rather than from wages (which benefit from the wage exclusion). These amounts are indexed for inflation. Together, these two provisions substantially increase the income tax threshold for senior citizens—from $7,700 to $14,125 for a retired couple, and from $4,470 to $8,250 for a retired single person.

In addition, reducing the top income tax rate from 50 percent to 28 percent, and continuing the exclusion for income from general-obligation municipal bonds, is beneficial to people whose income is primarily from investment of lifetime savings.

The deductibility of property taxes is also especially important for senior citizens. For retired homeowners who have paid off the mortgage, it is often the largest itemized deduction. And because the property tax is a tax on capital rather than on income or consumption, its incidence is greatly magnified. Assuming a 4 percent real rate of return, a 2 percent property tax is equivalent to a 50 percent marginal income tax rate. Under current law, federal deductibility can mean the difference between a 25 percent and a 50 percent income-tax-rate-equivalent.

The "96 Percent Bracket"

Beyond these general advantages, Kemp-Kasten addresses a number of anomalies in current tax law that affect senior citizens, largely due to the lack of coordination between the income tax code and other government programs. A combination of tax and benefit provisions can result in what has been called the "96 percent bracket" for senior citizens, though it can actually exceed 100 percent. These high tax rates are caused by an interaction of the following provisions.

First, the "retirement test" reduces social security benefits by 50 cents for every dollar above $7,320 earned by those between the ages of 65 and 70. This creates, in effect, a 50 percent marginal tax rate on wages and salaries for social security beneficiaries.

Second, the 1983 social security amendments effectively increased the federal marginal income tax rate on many senior citizens to at least 150 percent of the statutory rate. This is because a taxpayer

must add 50 cents in benefits to taxable income for each dollar of income above a certain threshold of redefined adjusted gross income—$25,000 for single taxpayers and $32,000 for married couples—until one-half of benefits are taxed. For a taxpayer in the 30 percent tax bracket this effectively raises the rate to 45 percent. Finally, such taxpayers must also pay ordinary federal, state, and local income and payroll taxes.

In addressing these problems, we face a number of complicated issues. How should social security be treated? Under the current system benefits are partly based on contributions and partly redistributive. The system is funded by deductible employer contributions, nondeductible employee contributions, and even general revenues, thanks to a temporary income tax credit and the fact that income tax levied on social security benefits is returned to the social security trust fund. Within the system, redistribution occurs not only between income classes but across generations. Any treatment must take into account someone already retired, someone who retires this year, and someone who will retire in 50 years.

Most of these issues simply cannot be addressed within the context of income tax reform. In general, in Kemp-Kasten we have tried to reduce excessively high marginal income tax rates on senior citizens without changing the basic structure of social security.

Kemp-Kasten eliminates the "96 percent bracket" in two ways. First, the bill phases out the retirement test, by cutting the benefit reduction from 50 to 25 cents on a dollar of earnings immediately, and zero benefit reduction after five years. Second, the bill reduces the marginal taxable amount of social security benefits, from 50 to 25 cents per dollar of income in excess of the adjusted income thresholds, although up to half of benefits may still be taxed.

The result is a substantially reduced effective marginal tax rate. For example, a retired couple with $32,000 in adjusted gross income and $12,000 in social security benefits would have been in the 25 percent federal income tax bracket in 1984 before the new method of taxing social security benefits was enacted. The new method of taxing benefits effectively pushes the family from the 25 percent bracket into the 42 percent bracket on investment income, while the retirement test adds another 50 percent marginal tax rate on wages and salaries. Together with the payroll tax, this results in a 99 percent effective marginal tax rate on wages.

Kemp-Kasten's provisions reduce the effective marginal tax rate due to the retirement test from 50 percent to 25 percent, then to 0 percent. The effective marginal federal income tax rate is cut from 42 percent to 24 percent, both because of marginal tax rate reduction

and because of the new method of taxing social security benefits. The combined effective marginal federal tax rate on this family's wages is ultimately cut from 99 percent under current law to 31 percent under Kemp-Kasten.

Investment Incentives

Capital Gains

An especially important feature for the encouragement of initiative and risk-taking is the treatment of capital gains. The Treasury plan taxes capital gains as ordinary income but indexes the capital basis for inflation. Bradley-Gephardt taxes capital gains in full without indexing. The first version of Kemp-Kasten resembled the Treasury treatment, except that we had a 25 percent instead of a 35 percent top tax rate on ordinary income and a 10-year transition period during which taxpayers could choose a 25 percent capital gains exclusion in lieu of indexing.

On reflection, we decided that there are two kinds of investors who must be considered, and that no single, simple treatment was likely to make them whole. The typical investor holds an asset for a long period and receives a fairly modest real rate of return; for this investor, indexing the capital basis is very important to avoid the taxation of capital as income, as was the case throughout the 1970s. However, the entrepreneur and the high-risk venture capitalist typically have a basis in an investment that is very low or even zero, and they seek a high real rate of return as the reward for successfully risking their capital. When a stock goes from 50 cents to 10 dollars, indexing the 50 cents does not help much. Taxing the gain as ordinary income, therefore, would penalize the risk-taker, especially if the top tax rate rises from 20 percent to 35 percent as under the Treasury plan.

We decided in our new bill to offer two permanent options. Under the current version of Kemp-Kasten, in any year, a taxpayer may elect to have his capital gains taxed as ordinary income with indexing, or else forgo the indexing and receive a 40 percent exclusion (or in the case of corporations, a reduced 20 percent alternative capital gains rate). With the 40 percent exclusion, the top marginal tax rate on capital gains would effectively be reduced from 20 percent to about 17 percent for individuals. I believe this approach is fair both to the ordinary investor and to the entrepreneur or venture capitalist.

Corporate Provisions

For business, all three major tax reform plans lower the corporate tax rate into the low 30s, and repeal the investment tax credit and

many other corporate tax preferences. However, both Bradley-Gephardt and Treasury I move in the direction of depreciation according to the comprehensive income tax, under which write-off periods try to approximate the estimated useful lives of assets. This approach has been criticized by some for increasing the cost of capital for new investment, and for increasing the disparities in present values of depreciation allowances between short- and long-lived assets.

On the other hand, current law has been criticized because the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) depreciation allowances enacted in 1981, when inflation was expected to continue in double digits, can result in an outright subsidy when the discount rate is low enough—that is, the capital cost can exceed the value of expensing when inflation is low. Yet at higher rates of inflation, capital cost recovery falls short of expensing, by amounts that increase with asset-class life. Part of this disparity comes from the fact that not all kinds of investment qualify for the investment tax credit. And because both ACRS and the investment tax credit are heavily "frontloaded," current law has also been criticized for lending itself to tax shelters based on up-front cash flow rather than economic value.

The first version of Kemp-Kasten kept the current-law ACRS depreciation, repealed the investment tax credit and most other corporate tax preferences, and lowered the top corporate tax rate to 30 percent, with a reduced 15 percent rate for small business earning below $50,000. This in itself went a long way toward removing the disparities in effective tax rates across industries and among different kinds of investments, while maintaining incentives for capital formation. However, we found a way to improve upon it.

The new version of the bill cuts the top corporate tax rate from 46 percent to 35 percent (with rates of 15 percent below $50,000 and 25 percent up to $100,000) and modifies the ACRS depreciation allowances into something we call the Neutral Cost Recovery System (NCRS). NCRS is designed to provide the present value of investment expensing without some of its practical problems. We keep the same asset classes as ACRS, but the write-off period is slightly lengthened and the total write-off is increased to include inflation indexing and a 3.5 percent real rate of return.

For example, the ACRS five-year class, which includes most business machinery, becomes six years, but the total write-off is increased from 100 percent of the initial cost to 110 percent plus indexing. Assuming 5 percent inflation, on a $1,000 investment a company could therefore write off $1,153 over six years instead of $1,000 over

five years. Similarly, the three-year class for vehicles becomes four years and the write-off increases from 100 percent to 106 percent plus indexing; the 18-year class for real estate becomes 25 years and the total write-off is 148 percent plus indexing.

In each case the present value of the depreciation allowance is equivalent to expensing, assuming a 3.5 percent real rate of return on capital, which is approximately the postwar average. Kemp-Kasten therefore removes both the outright subsidy to new investment at low rates of inflation, and the bias against capital investment at high rates of inflation. A recent study by Bonilla (1985), for the Institute for Research on the Economics of Taxation (IRET), compared the neutrality of tax treatment of depreciable investment under various tax plans. According to Bonilla (p. 1):

> The inflation-indexed Neutral Cost Recovery System (NCRS) included in the Kemp-Kasten "FAST" proposal would much more nearly satisfy the inter-asset neutrality criterion, at any rate of inflation, than either RCRS [the Treasury plan] or ACRS-ITC [current law]. It would also effectively eliminate the prevailing income tax bias against investment in durable capital. It is an innovative approach to resolving the problem of the front-loaded ACRS-ITC without the adverse effects on the cost of capital in the RCRS [Treasury proposal].

Since the write-offs are stretched out, the plan avoids the up-front revenue costs of pure expensing; in fact, NCRS would raise corporate receipts for several years. Because capital cost recovery under Kemp-Kasten is "backloaded" compared with current law (after the first year, which uses a half-year convention, the write-offs are straight-lined in round percentages), NCRS and the sharply reduced marginal tax rates under Kemp-Kasten reduce the possibilities for tax shelter while increasing after-tax incentives for capital investment. This treatment effectively eliminates the double taxation of corporate income, eliminating the need for integration schemes which add to the complexity of the tax code. Finally, industries that face high effective tax rates under current law because they cannot take advantage of items like the investment tax credit will benefit substantially from the reduced corporate tax rates and increased present value of depreciation for plant.

Conclusion

Until now, the focus of tax reformers has been on the consensus which exists in favor of comprehensive federal tax reform to lower tax rates and simplify the tax code. The proponents of tax reform—Senators Bradley and Kasten, Congressman Gephardt and myself,

the Treasury—have already begun working to achieve a good tax reform bill. Now that this consensus is clear even to opponents of tax reform, it is appropriate to focus on the details that will make for the best consensus bill in the Congress.

The name on a bill makes less difference than the contents. But I think that several elements in the Kemp-Kasten approach make it a good one. We do not claim that it is the last word in tax policy: in fact, we have introduced three successive versions precisely because we thought of ways in which it can be improved; we may do so again if we find it desirable. I have not exhausted the case for Kemp-Kasten, but I hope that I have outlined the philosophy behind it and some of its major advantages for American families, workers and savers, businessmen and entrepreneurs.

This is where would-be tax reformers must begin and end—with the lives of the people whose effort, thrift, and initiative represent the vital force of our economy. We have a chance that comes once in a lifetime, to alter the course of a policy which will fundamentally affect those lives for a generation or more. I am confident that this year Congress will rise to the challenge and enact a good tax reform plan.

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