THE ROUTE TO A PROGRESSIVE FLAT TAX

Robert E. Hall and Alvin Rabushka

Introduction

The tax-reform movement, in its current phase, came to life in 1982. Our role in the movement began with an article we wrote for the *Wall Street Journal* on December 10, 1981, in which we first proposed our flat rate tax. The public, media, and politicians latched onto the idea of radical simplification and reform of the federal income tax, making it the most widely discussed national economic issue of 1982. Members of Congress rushed to introduce more than a dozen flat tax proposals. Some were pure, tithe-like, 10 percent flat tax rates on all income, with no deductions of any sort permitted. Others were so-called modified flat taxes with two, three, or four tax-rate brackets and sharply diminished deductions, but retaining the more popular ones such as home-mortgage interest and charitable contributions.

Today there are four main contenders, which have received the bulk of publicity and analysis and are likely to remain the chief alternatives to the current tax system. The most publicized plan is that of the U.S. Treasury, put forward in November 1984. Democratic Senator Bill Bradley of New Jersey and Congressman Richard Gephardt of Missouri are sponsors of another well-known proposal. They call their plan "the fair tax," which is also the title of Bradley's recent book. The chief congressional rival to Bradley-Gephardt has been proposed by Republican Congressman Jack Kemp of New York and Senator Bob Kasten of Wisconsin. Its acronym, FAST, stands for "fair and simple tax." It has the semiofficial blessing of the Republican establishment.

Our own plan continues to draw attention, though it is offered as an ideal, rather than as a politically practical compromise. It is

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pending in Congress in the form of a bill introduced by Senators Dennis DeConcini and Steven Symms. Details are available in our new book, *The Flat Tax*.

Virtually all participants in the modern tax-reform movement are concerned about improving incentives by limiting tax rates. Congressman Gephardt has acknowledged his conversion from purely distributional concerns to restoring incentives, noting that "since we are all supply siders, I think it is worth mentioning that our plan contains a very substantial work incentive."

It is abundantly clear that any serious reform of the income tax must embody two features: it must broaden the tax base and it must sharply reduce the high top marginal rates. It should make evasion uneconomic, undesirable, and harder to get away with. Participants in the underground economy should find it more attractive to surface. Tax shelters must become less enticing. In short, individuals and business firms must find earning higher incomes (and keeping most of each dollar) more attractive than saving taxes (now often 50 cents on each dollar).

The Hall-Rabushka Proposal

Not all ideas about the flat tax are the same. Our proposal sometimes suffers by association with proposals that are not progressive or do not take the problem of investment incentives seriously. In a nutshell, our flat tax proposal puts a tax of 19 percent on all consumption above a generous exemption ($12,600 for a family of four). It is progressive where it counts most, for the poor and near-poor. It has strong investment incentives because a consumption tax, by definition, puts no tax on investment.

Our proposal takes advantage of the administrative convenience of the value-added tax. The VAT is the most reliable way to put an airtight tax on all consumption. Investment incentives in the VAT are straightforward and comprehensive: All investment spending is expensed. The cumulative effect of a tax on value added with first-year write-off of investment is to put a tax on consumption. Such a tax provides the degree of investment incentive most widely recommended by economists.

The VAT in its usual form is not a satisfactory national tax because it is not progressive. If a tax were built in to everything purchased by all families, including the poor, it would be an unjust burden on lower-income families. In particular, a switch to a VAT from the current system would dramatically shift the burden of the tax toward lower incomes.

Our proposal modifies the VAT in one central way: Under a standard VAT, the part of the tax that applies to wage earnings is paid by business as part of the overall VAT (in fact, this part is a large fraction of the total). In our modification, the tax on wage earnings is paid by the worker instead of the business. The worker can take a generous exemption, based on family size, against wage income before applying the 19 percent tax. As a consequence, our version of the VAT is strongly progressive for low and middle incomes. Even families earning $25,000 pay an average tax rate less than half the 19 percent paid by the highest earners.

Our two tax forms (illustrated in Figure 1) are almost self-explanatory about the details of the system. People who are not involved in operating businesses just fill out Form 1. Only their wage, salary, and pension income is taxed. Businesses of all types (not just corporations) fill out Form 2. The two forms together put a 19 percent tax on value added, with full write-off for investment and the exemption to make it progressive.

At every level of earnings, our Form 1 has a lower tax than does the existing Form 1040. Families who derive all of their incomes from earnings will gain from a switch to our system, no matter what their level of earnings.

One of the most important features of the VAT, shared by our system, is its ability to control leakage in the tax system. An important type of leakage today comes from interest payments. Interest is business income that is taxed as it is earned at the business under a VAT. But in the current tax system, interest is allowed as a deduction for the payer and is not taxed until and unless it is declared as income by the receiver. Through a great variety of means, legal and illegal, over $100 billion in interest is deducted by businesses but never taxed as income for individuals. A VAT is an airtight solution to the problem of interest leakage.

We see our proposal as setting a high but practical ideal for tax reform. It really would be possible to have a 19 percent tax on a broad base that is progressive, has strong investment incentives, and raises the same revenue as the current system. Of course, we recognize that the political system may grind out a tax improvement that falls short of our ideal. We will discuss briefly some modifications of our proposal that preserve its most important features. Later, we will look at the problem in the opposite way—how other proposals could be improved by modifications incorporating our ideas.

First, we have developed a transition proposal to handle the problem of lost interest deductions. Without loss of revenue, the government can permit people already committed to fixed interest rates to

FIGURE 1

HALL-RABUSKA SIMPLIFIED FLAT-RATE TAX FORMS

Form 1 — Individual Wage Tax — 1985

Your first name and initial (if joint return, also give spouse's name and initial)	Last name	Your social security number
Present home address (Number and street including apartment number or rural route)		Spouse's social security no.
City, Town or Post Office, State and ZIP Code	Your occupation ▸ / Spouse's occupation ▸	

1 Wages and Salary	1	
2 Pensions	2	
3 Total *(line 1 plus line 2)*	3	
4 Personal allowance		
(a) ☐ $9000 for married filing jointly	4(a)	
(b) ☐ $4500 for single	4(b)	
(c) ☐ $8000 for single head of household	4(c)	
5 Number of dependents, not including spouse	5	
6 Personal allowances for dependents *(line 5 multiplied by $1800)*	6	
7 Total personal allowances *(line 4 plus line 6)*	7	
8 Taxable wages *(line 3 less line 7, if positive, otherwise zero)*	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 — 1985

Business Name	Employer Identification Number
Street Address	County
City, State and ZIP Code	Principal Product

1 Gross revenue from sales	1	
2 Allowable costs		
(a) Purchases of goods, services and materials	2(a)	
(b) Wages, salaries and pensions	2(b)	
(c) Purchases of capital equipment, structures, and land	2(c)	
3 Total allowable costs *(sum of lines 2(a), 2(b), 2(c))*	3	
4 Taxable income *(line 1 less line 3)*	4	
5 Tax *(19% of line 4)*	5	
6 Carry-forward from 1984	6	
7 Interest on carry-forward *(10% of line 6)*	7	
8 Carry-forward into 1985 *(line 6 plus line 7)*	8	
9 Tax due *(line 5 less line 8, if positive)*	9	
10 Carry-forward to 1986 *(line 8 less line 5, if positive)*	12	

continue their tax deductions. Banks or other interest-earners would have to pay a special 19 percent tax on those interest earnings attributable to people who are *continuing to deduct the interest.*

Second, certain categories of other deductions could be retained without compromising the basic principles of our proposal. For example, deduction of state and local property taxes could be continued. The deduction can be rationalized on the grounds that most property taxes support education, and deduction of investment in education is the counterpart of deduction of other forms of investment. Continuation of the deduction for at least some types of charitable contributions might also be justified on the same grounds.

Third, a compromise might involve a tax schedule that is not entirely flat. What really matters is that all tax rates, including the top one, be low enough to avoid distortion. A system with two brackets, say at 15 percent and 25 percent, would probably satisfy this criterion. It would work in the following way: All business income on Form 2 would be taxed at 25 percent. Wage earnings would be exempt up to the proposed level, then taxed at 15 percent to, say, $25,000, and then at 25 percent for the amount above $25,000.

Fourth, full write-off of investment is not absolutely essential, though we believe that the consumption principle associated with the write-off is highly desirable. A system with partial write-off might be acceptable, or even the continuation of accelerated depreciation and the investment credit.

The Treasury Proposal

In *Tax Reform for Fairness, Simplicity, and Economic Growth,* the U.S. Treasury set forth a detailed plan for comprehensive tax reform. Though it is apparent that many of the ideas in the Treasury proposal will never make it into law, it is worth noting how its good features could be combined with some of our ideas to get a workable improvement in the tax system.

The principal features of the Treasury plan are:

1. Modest reductions in marginal rates. The top personal rate would fall from 50 to 35 percent, and the corporate rate from 46 to 33 percent.
2. Elimination of all investment incentives. Write-offs would be limited to economic depreciation.
3. Full taxation of capital gains except for adjustment for inflation.
4. Inflation adjustment would reduce the fraction of interest income that is taxable and the fraction of interest spending that is deductible.

5. Insurance and medical fringes included in personal taxable income.
6. Dividends half deductible to corporations.
7. Cap on individual interest deductions other than home mortgage and elimination of most charitable deductions and all state and local tax deductions.

Except for the interest deduction cap, all of these provisions fit into the general framework of making the tax system a pure income tax. The most severe criticism of the Treasury's proposal has come from those concerned with the adverse impact of an income tax on saving and investment. Because an income tax taxes both original earnings and the return on the portion of the earnings that is saved, an income tax provides a disincentive for saving and investment. Congress has modified the tax system to make it more of a consumption tax by providing the investment tax credit, accelerated depreciation, and 60 percent exclusion of capital gains. The Treasury wants to roll back this progress toward a consumption tax.

We foresee the possible development of a politically feasible and economically efficient tax reform by combining some of the features of the Treasury proposal with the basic idea of a consumption tax. Some of the changes in the proposal that might be part of this reform are:

1. First-year write-off for all investment, in place of economic depreciation. Elimination of the investment tax credit would remain part of the reform.
2. Lower top marginal rates for personal and corporate taxes to around 25 percent.
3. Comprehensive withholding of taxes on interest and dividends by business at the 25 percent rate. Full deductibility of dividends by corporations. The deductibility of interest and dividends by corporations against their 25 percent rate and the withholding for the personal tax at the same rate would offset each other.
4. Place a 25 percent tax on the sale of business assets. Eliminate the capital gains tax on individual gains in the stock market.
5. Instead of including fringe benefits as phantom income on individual tax returns, tax them at the 25 percent rate at the business level. This would mean that businesses would not be allowed to deduct the cost of those fringes.

This revised version of the Treasury proposal takes care of all of the major defects of the existing proposal.[1] First and foremost, it would provide the strong investment incentives missing from the proposal as it stands. Second, by providing full deductibility of corporate dividends, it gives complete integration of corporate and personal taxes. Third, by providing airtight withholding on dividends and interest, it solves the problem of leakage on these items. Fourth, by eliminating personal capital gains taxation and taxing underlying corporate sales of assets instead, another major source of leakage would be eliminated. Fifth, by having businesses rather than individuals pay the tax on fringe benefits, the proposal gains in political acceptability at no sacrifice in economic efficiency. The revised Treasury proposal would be exactly the Hall-Rabushka proposal except for having one or two extra brackets in the tax schedule.

The Bradley-Gephardt Proposal

Like other tax reformers, Senator Bradley and Congressman Gephardt advocate lowering tax rates and broadening the tax base. Senator Bradley's book, *The Fair Tax*, sets forth the justification for and specifics of his reform measure.

Bradley and Gephardt call their plan a "comprehensive individual income tax proposal." The plan puts a basic tax at a rate of 14 percent on all income above an exemption level. Two surtax rates at higher levels of income add to the progressivity of the tax. The plan retains the most popular deductions in the current code: home-mortgage interest, charitable contributions, state and local income taxes and real property taxes, exclusion for social security and veterans' benefits, and exemption of interest on municipal bonds.

The most significant modification to present law is to treat the value of employer's contributions toward health and insurance premiums as cash income. Another key change from current law is the limitation placed on the remaining legal deductions. The two surtax rates would be imposed against total income, not taxable income, so the itemized deductions do not reduce the surtax. Everyone's itemized deductions count against the same 14 percent basic tax, and are therefore worth only 14 cents on the dollar. Today, the value of an itemized deduction reflects the taxpayer's top marginal rate. Under Bradley-Gephardt, the value of an itemized deduction would be a

[1]Treasury II (1985), which was released after this paper was written, does not effectively address the problems with Treasury I and is still far from our revised Treasury proposal.

flat 14 percent. In effect, Bradley-Gephardt would remove most, but not all, of the value of deductions for higher income taxpayers.

To the extent that the real estate industry and charitable lobbies would be up in arms about eliminating the deductibility of interest and contributions under a flat tax, they would find little respite in Bradley-Gephardt. If the benefits of deducting mortgage interest are topped at 14 cents on the dollar, and if the subsidy for being charitable is no more than 14 cents on the dollar, both sets of current beneficiaries will find Bradley-Gephardt hard on their constituencies. Of course, the two members of Congress would argue, as would we, that people will increase their charitable giving as their real incomes rise (despite the smaller subsidy in the deduction) and that reduction of the top marginal rates will supply essential incentives for pursuit of a better performing economy.

Bradley and Gephardt have estimated that 80 percent of all taxpayers would pay at the simple 14 percent rate on their taxable income, the lowest rate in effect before the 1981 Reagan tax cuts.

The two surtax brackets would apply to the difference between total income and $40,000 (for joint returns) or $25,000 (for single persons). In other words, a family earning $90,000 would have to pay an additional 12 percent tax on all income between $40,000 and $65,000, and an additional 16 percent on income between $65,000 and $90,000. First, of course, the family would have to calculate the basic 14 percent tax liability on all taxable income, which excludes allowable deductions and personal exemptions.

As explained in *The Fair Tax*, Bradley-Gephardt would lower the corporate rate from the current maximum of 46 percent to a flat 30 percent. By eliminating the current exclusion for 60 percent of long-term capital gains, it would raise the business capital-gains tax from 28 to 30 percent. It would take away some of the accelerated depreciation in the 1981 tax cut by stretching out the current 3 to 15 year schedule, depending on the particular investment, to between 4 and 40 years. It would end the investment tax credit along with the exclusion of certain fringes.

Bradley justifies slower depreciation rates on the grounds that his proposed depreciation schedule accurately reflects the useful life of investments, in comparison with the 1981 accelerated schedules that treat investments too generously. In other words, he rejects the principle of the consumption tax, which provides an incentive in the form of a first-year write-off. Bradley calculates that his tax would collect from corporations the same revenue being collected under current law. Less depreciation would offset the lower flat-rate corporate tax of 30 percent.

Bradley-Gephardt comes up short on the test of administrative efficiency. So long as business income from interest, dividends, rents, royalties, capital gains, professional activities, and farming is taxed at the individual level, as it will be in their plan, underreporting will persist, though it may diminish due to the lower top rate. The only successful way to tax such income is to tax it at its business source. So long as several tax brackets remain, people face incentives to shift income from high-bracket to low-bracket family members, and similar ploys.

Bradley admits that he and Gephardt have retained a handful of deductions because they are politically popular and, he claims, they promote fairness. Retaining these deductions will reduce the tax base by several hundred billion dollars. Unless they successfully contain the lawful deductions to the few they have chosen, lobbyists will ultimately get Congress to reinstate many of the other equally meritorious deductions they propose to repeal. Success on that front will put the tax system back where it started, with a shrinking tax base and the need to impose higher marginal rates.

Bradley and Gephardt are aware that the taxation of fringe benefits is one of the most badly needed reforms of the tax system. Unfortunately, they have chosen the wrong way to solve the problem. They would require that employers inform their workers about the value of the fringes each receives. The workers, in turn, would have to report the value as phantom income on their tax returns. They would have to pay tax on income they never receive. Even if they have no interest in a fringe benefit and value it at zero, they will have to pay tax according to a valuation assigned by the employer. There is no limit to the amount of phantom income a worker may have to pay tax on. Again, taxation at the source would be a far more workable principle (and politically more attractive, surely). Instead of making workers pay tax on phantom income, eliminate the deduction of fringes by the employer.

A much better version of Bradley-Gephardt could be created by fusing the administrative principles of our proposal with their tax rates and brackets. Extend the Bradley-Gephardt 30 percent corporate tax to all business, and eliminate all interest and fringe deductions under it. Make the personal tax apply only to wages, salaries, and pensions. The improved version would capture far more business income, eliminate the double taxation of dividends, and apply a much more practical technique to the taxation of fringes. It would be much fairer than Bradley-Gephardt, because a much larger fraction of the income going to the rich would be effectively taxed.

Kemp-Kasten

Republican Congressman Jack Kemp and Senator Bob Kasten introduced the semiofficial Republican entry in the tax-reform derby rather late, with a starting date of April 1984. It bears the acronym FAST, meaning "fair and simple tax," but, again, we will refer to it by the names of its sponsors. In general, Kemp-Kasten would broaden the tax base by eliminating most tax preferences or loopholes and imposing on that broader base a uniform 24 percent rate. Corporations would pay a 30 percent standard rate, with a 15 percent break for small businesses earning up to $50,000 in taxable income.

Like Bradley-Gephardt, the two Republicans do not integrate the corporate and individual income taxes, but reform each separately. First the individual income tax: Kemp-Kasten would eliminate most deductions, credits, and exclusions, but would increase the personal exemption to $2,000 (for men, women, and children alike) and raise the standard deduction (zero bracket) to $2,700 for a single person or head of household and $3,500 for joint returns. Adding these numbers means that single taxpayers would start paying tax after $5,875 and a family of four is exempt from income taxes until it earns $14,375; the latter figure is substantially above the 1984 poverty line figure of $11,101 and the 1983 combined standard deduction and personal exemption of $7,400.

Kemp-Kasten will retain deductions for charitable contributions, mortgage and other interest paid, real property taxes, and medical expenses above 10 percent of adjusted gross income. Current treatment will be accorded to retirement annuities (IRAs, Keoghs, social security), military and veterans benefits, employer-provided benefits (fringes), foreign-source income, nonprofit tax-exempt bonds, employee business expenses, and moving expenses.

Although the measure would provide a standard rate of 24 percent, Kemp-Kasten builds a measure of graduation into the rate by granting a special exclusion of 20 percent of wage and salary income up to the social security wage base (about $40,000 in 1985), which would be gradually phased out as incomes approach $100,000. Thus, the effective rate up to $40,000 would be 20 percent, and the rate would rise in 1 percent increments until the standard 24 percent level bites at $100,000 and above. In the event income is less than $10,000, Kemp-Kasten will define any form of income as earned and thus eligible for the lower 20 percent effective marginal rate.

A key feature is the plan's emphasis on indexing for inflation, which encompasses personal exemptions, the zero-bracket amount, and the capital basis on which capital-gains taxes are computed. Thus inflation will not reduce the value of these exemptions (as would be the case in Bradley-Gephardt), nor would inflation impose taxes on nominal capital gains that did not represent real gains. During a 10-year transition period, the effective capital-gains tax rate would be 19 percent at the taxpayer's option, without indexing.

The features of the corporation income tax would be more generous than in Bradley-Gephardt. Although the tax rate of 30 percent is the same, Kemp-Kasten will retain the 1981 accelerated depreciation schedule, which permits write-offs of equipment in 3 to 5 years and of structures in 15 years. It will cut the capital-gains tax rate from 28 to 20 percent and provide for a foreign-income tax credit.

It should be noted that fringe benefits remain untaxed in Kemp-Kasten, still providing an incentive to channel compensation away from cash income to fringes. A top marginal rate of 24 percent, however, will make these less attractive than under current law.

The failure to integrate the corporate and individual income taxes means that Kemp-Kasten would continue the double taxation of dividend income—first at 30 percent on corporate profits, and then at 24 percent when received by individuals. The combined maximum rate will be 46.8 percent, a serious disincentive. Assuming smart businessmen take their income from capital gains instead of dividends, the combined total tax on entrepreneurship would be 43.3 percent, still a worrisome level.

Kemp-Kasten fails to deal with the two biggest sources of leakage in the tax system: fringe benefits and untaxed interest. Consequently, it will have to rely on high tax rates, especially on entrepreneurship, to generate its revenue. As with the Treasury proposal and Bradley-Gephardt, a much improved version could be made by taking the key administrative ideas from our plan and combining them with the Kemp-Kasten tax schedule. Taxation of interest and fringes at the source would be the key to improving this proposal.

Conclusion

The current push for tax reform is only part of a broad, long movement to unwind the mistakes built into the tax system during the Depression and World War II. Major tax rate reductions occurred in 1964, 1969, and 1981. Improvements in investment incentives were made in 1954, 1962, and 1981. If the 1985–86 round can get the top marginal rate down to 25 or 30 percent and consolidate investment incentives with first-year write-off, it will be another important milestone in the long process of improvement.

Questions of whether the tax schedule is exactly flat, or precisely what deductions are to be allowed to individuals, are quite subsidiary to the central issues of lower rates and proper investment incentives. We favor a system where deductions are completely eliminated and taxation occurs at the source of income, because this system maximizes the tax base and permits the truly low rate of 19 percent. But other systems, which continue some deductions and have somewhat higher rates, could come close to the benefits of the ideal system we have proposed.

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REVENUE AND DISTRIBUTIONAL IMPACTS OF THE HALL-RABUSHKA FLAT TAX PROPOSAL

Eric W. Cook

It seems appropriate that, because I work for the Joint Committee on Taxation, I emphasize a political perspective in my analysis of the paper by Professors Hall and Rabushka (1985), advocating a flat tax. Most of the other major tax reform proposals generally attempt to be revenue and distributionally neutral. This means that they are designed to neither increase nor decrease taxes, in both the aggregate and by specific income classes. These are the issues of primary concern to policymakers. Therefore, I intend to concentrate on the revenue impact of the Hall-Rabushka tax plan as well as its effect on the distribution of tax liabilities across income classes.

Background on the Joint Committee on Taxation

Before proceeding with my discussion of the Hall-Rabushka tax plan, I would first like to provide a little background about the Joint Committee on Taxation. In addition to the five members from the Senate Finance Committee and the five members from the House Ways and Means Committee, the Joint Committee on Taxation consists of a professional staff whose responsibilities include the analysis of virtually all tax legislation that goes before the U.S. Congress. The Joint Committee on Taxation is strictly nonpartisan.

It is the Joint Committee on Taxation that has analyzed the Bradley-Gephardt, Kemp-Kasten, and Roth-Moore tax reform proposals, as well as several others. These analyses, in which incidentally I have participated, have relied substantially on the Treasury Department's Individual Income Tax Model. This model, which is used exclusively

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by the Joint Committee and the Treasury Department, uses actual tax returns that are weighted to simulate the taxpaying population. Proposals are analyzed by comparing the tax liability that would result under a present-law base to that of a given alternative. The Individual Income Tax Model has proven to be a reliable and useful tool for providing policymakers with assessments of the revenue effects of changes in the tax code both in the aggregate and by income class.

The Revenue Impact of the Hall-Rabushka Plan

Professors Hall and Rabushka contend that their flat rate tax would result in revenue neutrality in a manner similar to that of the Treasury's November 1984 proposal (Treasury I). The plans are similar in that both propose a tax cut for individuals to be equally offset by tax increases for businesses. They differ in that the Hall-Rabushka plan would go much further in shifting the relative tax burden from individuals to businesses.

My analysis of the Hall-Rabushka plan, which used the Individual Income Tax Model as the basis for most of the estimates, confirms the accuracy of Hall and Rabushka's estimate of what the revenue impact would have been for individual income taxes in 1983. They estimate that in 1983 the Hall-Rabushka plan would have raised about $80 billion less than the actual amount of approximately $285 billion. Also, I would add that, using the macroeconomic assumptions of the Congressional Budget Office (CBO), the Hall-Rabushka tax plan would lose about $100 billion from projected present-law tax liabilities of individuals in 1986. By 1990, the Hall-Rabushka plan would have a tax liability shortfall for individuals of about $115 billion without indexation of the personal allowances and the dependent's exemption amount. If indexation were retained, the plan would lose about $180 billion by 1990 from individual income taxes.

These substantial tax cuts are to be offset by tax increases for businesses, which would represent an approximate doubling of business taxes. These tax increases are to result from the repeal of the deductibility of employer contributions for social security taxes and fringe benefits. These deductions amounted to about $300 billion in 1983. In addition, the interest paid deduction for businesses would be repealed, which amounted to over $550 billion in 1982.

The tax increases resulting from these repealed deductions would be diminished, however, by expensing. Briefly defined, expensing is the full deductibility of investment in a depreciable asset in the year of the investment. Excluding investment in used property, in

1982 investment in structures, plant, and equipment amounted to about $550 billion, whereas business depreciation in 1982 amounted to over $225 billion. These figures suggest that depreciation deductions would be significantly increased under the Hall-Rabushka tax plan.

The purpose for citing these statistics is that these repealed deductions and expensing represent dramatic changes in firms' deductions. Consequently, there would be large shifts in firms' tax liabilities. It is possible that the firms experiencing large tax increases would choose to conduct business in other countries that afford more favorable tax treatment. It is also possible that these same firms simply would discontinue operating entirely. As a consequence, it is uncertain whether these changes would actually translate into the tax increases estimated by Professors Hall and Rabushka.

Assessment of the impact on business taxes of the Hall-Rabushka tax plan is very complex and difficult to predict, especially using aggregate data. Therefore, I am uncertain about its impact in this area, and I am skeptical about the estimate of the amount of tax increases for businesses that would be necessary to offset the income tax cuts for individuals.

The Distributional Impact of the Hall-Rabushka Plan

The distribution of individual income taxes by income classes under the Hall-Rabushka plan would be one where most income classes would receive a tax cut, but the tax reductions would significantly favor the wealthy. In fact, using 1983 income levels and 1986 tax law, the overall distributional effect would be a 3 percent tax cut for the below $20,000 income class, a 6 percent tax cut for the $20,000 to $50,000 income class, a 30 percent tax cut for the $50,000 to $100,000 income class, and finally, a 70 percent tax cut for the above $100,000 income class.

This result follows because the present system, contrary to what many believe, is significantly progressive with the top 25 percent of the income distribution paying about 70 percent of individual income taxes in 1983, the top 7 percent paying about 40 percent, and the top 1 percent paying about 20 percent. Because the average tax rate for the above $200,000 income class exceeds 25 percent, a 19 percent tax rate generally will result in a significant shifting of the relative tax burden from the wealthy to the lower- and middle-income classes.

Conclusion

The distributional problem of shifting the relative burden of taxes to the middle- and lower-income classes under the Hall-Rabushka plan possibly could be remedied by full inclusion of capital gains, interest, and dividend income combined with an alternative rate schedule with a top rate of 30 percent or higher. If corporate integration were still a primary goal, a dividend deduction for corporations is an alternative approach that generally is regarded to be a more equitable approach than other alternatives. Although corporate integration may be a desirable goal and a single tax rate might be simpler, it is the issue of vertical equity that is generally of more importance to policymakers. Therefore, a tax reform plan that attempts to achieve simplicity and corporate integration should also carefully consider the distributional impact in order for it to be politically viable.

The expensing portion of the Hall-Rabushka plan, which is the component that makes the plan a consumption tax, very easily could turn into a significant tax sheltering device. As a result, instead of reducing tax avoidance behavior, tax shelters might actually be encouraged because of the large depreciation deductions that this would permit in excess of the actual amount of money invested. An alternative approach to taxing consumption is one that is employed in the Roth-Moore bill with its super-savers accounts, which are similar to expanded IRA accounts with no penalties for withdrawals.

If these changes were made to the Hall-Rabushka tax plan, not only would the plan be made more equitable, but the revenue impact would also be much more predictable and, as a result, more likely to be able to raise a comparable amount of revenue as present law.

Most of the criticisms that I have made of the Hall-Rabushka plan involve normative judgments and are thus political in nature. I believe that the Hall-Rabushka proposal represents a significant contribution to the overall tax reform debate. In fact, their work of the last several years has played a major role in shaping the current tax reform movement.

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