

BOOK REVIEWS

Low Tax, Simple Tax, Flat Tax. By Robert E. Hall & Alvin Rabushka. New York: McGraw-Hill, 1983. Pp. iv, 137. \$18.95, pap. \$9.95.

*Reviewed by Daniel L. Simmons**

Although the idea of a flat tax has been around for some time, our plan is a fresh, carefully constructed step up from the current tax system. It works. It is fair, simple, and easy to understand. It increases incentives to work, save, and invest. It saves billions of dollars in paperwork. It lowers interest rates immediately. It balances the federal budget in a few short years. It creates new jobs and raises living standards. It supports the values of honesty and integrity of the American people. (P. iv).

These modest claims appear in a memorandum to the President of the United States and members of Congress from Professors Robert E. Hall and Alvin Rabushka printed as the preface to their intriguing book *Low Tax, Simple Tax, Flat Tax*. Hall and Rabushka claim credit, which they undoubtedly deserve, for the recent surge of interest in flat tax proposals (pp. 19-20).¹ In this election year, as in most recent presidential elections, tax reform is a topic of extended debate. Hall and Rabushka's proposal adds a significant component to the deliberation. For this reason alone, their book deserves serious consideration.

The book begins with a litany of all that ails the current United States income tax system. Hall and Rabushka estimate that, because of the complexities of the existing income tax structure, the cost of reporting and verifying tax liability is approximately nine to ten billion dol-

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¹ The authors explain that the idea of a flat tax is not a new discovery, citing Milton Friedman's 1962 proposal in his book *Capitalism and Freedom* (p. 130). However, they point to their December 10, 1981 article in the *Wall Street Journal* as the beginning of the current interest in flat tax proposals (p. 19). This interest in flat tax proposals, including the Hall-Rabushka plan, remains active. See, e.g., Hershey, *Whoever Wins in November, A Tax Overhaul Is Coming*, *N.Y. Times*, Apr. 15, 1984, § 4, at 1, col. 2.

lars above what is actually paid in tax (p. 6). They cite high marginal rates of taxation as one of the primary causes of both mounting illegal tax evasion within the underground economy and legal avoidance through exploitation of tax loopholes (pp. 9-14).² They point out that the federal tax burden has grown from 2.6% of Gross National Product in 1913, when income tax was imposed under the sixteenth amendment, to more than 20% today, and state, "The income tax is a direct culprit of this growth, providing 48 percent of all government revenue." (P. 9).³

Hall and Rabushka also cite an interesting list of so-called loopholes, which reduce the tax base and thereby increase required rates of taxation. Loopholes can be described as deductions from income or credits against actual tax liability which are enacted by Congress to further some social policy or to provide an incentive for a particular economic activity. Hall and Rabushka would eliminate provisions allowing individual deduction for contributions to Individual Retirement Accounts and Keogh plans,⁴ the deduction for alimony,⁵ all of the itemized de-

² The authors recognize that high marginal rates are not the sole cause of tax evasion, adding that "rising noncompliance is a direct response to the higher taxes people are paying as they are pushed by inflation into higher tax brackets" (p. 11). In this writer's view, an equally significant cause of tax evasion may be a belief among evaders that the tax system is no longer fair in its application of progressive tax rates. The average taxpayer probably believes that other, generally higher income, individuals avoid tax liability through fancy tax shelters or other carefully crafted schemes. Many people have seen advertisements for yachts, airplanes, and expensive automobiles as tax shelters, in addition to more sophisticated shelters in real estate, oil and gas, and the like. Those who do not seek tax shelters may believe, as expressed by a self-employed acquaintance, that failure to report portions of income is just the "poor man's tax shelter." See also McIntyre, *Lessons for Tax Reformers from the History of the Energy Tax Incentives in the Windfall Profit Tax Act of 1980*, 22 B.C.L. REV. 705, 738 (1981) (discussing unfairness perceived by taxpayers who see others enjoying benefits of tax loopholes).

³ It may be somewhat exaggerated to blame the income tax for the growth of government. It is hard to believe that revision of the income tax will eliminate significant claims for desirable federal spending — claims for federal social welfare benefits from one group to pressures for increased defense spending from another. It is often argued, however, that government spending has increased in real terms because of the impact of inflation on the graduated rate structure. CONGRESSIONAL BUDGET OFFICE, INDEXING THE INDIVIDUAL INCOME TAX FOR INFLATION 15 (1980). Note, however, that during the period 1967-79, Congress came close to offsetting the effects of inflation on the overall tax rate with tax reductions. *Id.* at 14-15. Most of these tax reductions have been in the form of increased personal exemptions and the standard deduction, which benefit low and moderate income taxpayers relatively more than upper income taxpayers. *Id.* at 15 n.4.

⁴ I.R.C. §§ 219, 401-409A. The current Code provisions allowing tax free accumu-

ductions including interest, state and local taxes, medical expenses and charitable contributions, and "gimmicks for special interest groups and for particular social effects" (pp. 12-13). The tax base "leakage" also includes fringe benefits, which the authors say quantitatively comprise the bulk of corporate and individual incomes that are not required to be reported under the current Code (p. 14). Depreciation, on the other hand, is a form of leakage not to be condemned, as depreciation deductions "are in the tax system to provide incentives to invest, and simply removing them would be harmful to capital formation" (p. 15).

Hall and Rabushka point out that the Internal Revenue Code is so riddled with special provisions for social and economic planning, including extensive incentives for investment, that it has become unworkable (pp. 46-47). Whatever the cause of the problem, most people, tax lawyers and academics included, would agree that the need for tax reform is paramount if the system is to retain credibility. The question is whether Hall and Rabushka's flat tax proposal provides that reform.

Hall and Rabushka's proposal rests on four basic principles (p. 32):

- (1) All income should be taxed only once, as close as possible to its source.⁶
- (2) All types of income should be taxed at the same low rate.⁷

lations for retirement represent in part a revision of the tax base from an income tax to a consumption tax. Retirement savings, and the earnings generated by those savings, are not taxed until consumed by withdrawal from the qualified plan. Hall and Rabushka argue that a consumption tax based on a 100% deduction for capital investment is appropriate for business (p. 48), but reject application of the same principle to the compensation income of individuals by eliminating favorable treatment for retirement savings.

⁵ I.R.C. §§ 71 and 215 require the recipient of qualified alimony payments to include the payments in gross income and permit the payor to deduct the payment.

⁶ The author's use of the term "source" is somewhat confusing in that some income, such as wages, is taxed to the recipient, while other forms of income, such as fringe benefits and interest (which represents payment to the owner of capital for its temporary use), is taxed to the payor rather than the recipient. In the case of wages and fringe benefits, one may say that the source of the income is the recipient's labor. Using the same reasoning, the source of interest must be the capital producing the interest rather than the income of the payor. If the source of interest is the payor's earnings which are directed to the supplier of borrowed capital, the source of wages and fringe benefits must also be the payor's earnings directed to the supplier of the labor.

Hall and Rabushka say that their first principle of taxation is violated by the existing tax system because some income, such as fringe benefits, is never taxed at all, some income, such as corporate dividends, is taxed twice, and interest income often escapes taxation through such devices as interest free loans and exempt bonds (p. 32).

⁷ The authors claim that the flat tax is fair to most Americans because it taxes all

(3) The poorest families should pay no tax, and lower-income families should pay a smaller fraction of their incomes in tax than do those with higher income families.

(4) Tax returns for both families and businesses should be simple enough to fit on postcards.⁸

The simple tax system proposed by Hall and Rabushka consists of two separate taxes — an individual compensation tax and a business tax. The tax base for the individual compensation tax includes actual receipt of wages, salaries, and pensions. Employer provided fringe benefits are not taxable to the employee because these items are instead taxed at their “source,” the employer’s business income (p. 35). The employer is not allowed to deduct the cost of employee fringe benefits (pp. 38-39). The tax base does not include interest or dividend income, both of which are also taxed at the source, the payor, who is not allowed a deduction for these expenditures or distributions (pp. 37, 39).⁹

income only once at the same rate. “Much of the middle class is stunned by the fact that they pay marginal tax rates approaching 50 percent, which only the upper classes paid 20 years ago.” (P. 22). While this may be an argument for lower taxation, it does not necessarily support a flat rate schedule. Rather than progressive rates, the increased burden of taxation on middle income individuals may be the result of both increased demands for revenue by the federal government (p. 9), and a shift of the tax burden away from the poor with increased zero bracket levels and dependency exemptions and from the wealthy with increased incentives such as accelerated artificial accounting losses and tax credits which may be used to shelter disposable income from taxation.

⁸ Hall and Rabushka write:

Simplicity of tax forms and tax laws is not just a matter of limiting the deforestation of America through the Internal Revenue Service’s appetite for paper. Complicated taxes require expensive advisors for taxpayers and equally expensive review and audit by the government. A complicated tax invites the taxpayer to search for a special feature that can be twisted to escape the taxation of some income or give an advantageous deduction to some expense. And complicated taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and widespread outright evasion. (P. 33).

It should be noted that the very first manifestation of our current income tax, enacted to finance the Civil War in 1861, required only four pages in the statute book. As pointed out by Professor Bittker, the “founding fathers foresaw almost none of the really troublesome issues that have plagued the federal income tax for the last thirty or forty years.” Bittker, *Reflections on Tax Reform*, 47 U. CIN. L. REV. 185, 189 (1978). Bittker warns that the proponents of simplified broad-based tax systems may “have seriously underestimated its potential for complexity and unfairness and that, however appealing as an ideal, it would if enacted soon be castigated as another ‘disgrace to the human race.’” *Id.*

⁹ This taxation at the source is possible because the flat rate is applied to all income. Interest income is taxed at the same rate whether taxed to the recipient or to the payor

Compensation income is to be reduced by personal allowances of \$6200 for a joint return by a married couple, \$3800 for a single individual, and \$5600 for a single head of household (p. 35).¹⁰ There is also an exemption of \$750 per dependent.¹¹ The total allowance for a family of four would be \$7700 which provides a floor below which there is no taxation. The allowances permit the poorest families to escape taxation and provide a degree of progressivity. The allowances are to be indexed to the cost of living. No other deductions are available. The resulting "taxable compensation" is subject to a flat rate of 19%.

Hall and Rabushka provide a postcard size return that requires all information necessary to compute tax liability under their proposal (p. 35). The taxpayer need only report total wages, salaries, and pensions, subtract allowances based on marital status and number of dependents, multiply the difference by the flat tax rate of 19%, take account of withholding, and pay the tax owing or apply for a refund (pp. 35-36).

The computation of tax liability by a wage earner who does not itemize deductions under the existing system does not substantially differ from the Hall-Rabushka proposal, except for Hall and Rabushka's exclusion of interest and dividend income from the individual tax base and the flat rate.¹² Instead of subtracting personal allowances and dependency exemptions, and multiplying income by 19%, the individual taxpayer currently refers to the appropriate column of the tax rate ta-

who is not allowed a deduction for interest expenses.

¹⁰ These allowances build in a small marriage penalty of \$266 for every couple $([\$3800 \times 2] - \$6200) \times 19\%$.

¹¹ The simple code defines a dependent as "a son, stepson, daughter, stepdaughter, mother, or father of the taxpayer, for whom the taxpayer provides more than half support" (p. 121 app. A). Unlike the current Code, *see* I.R.C. § 152(a)(9), the simple code does not provide an allowance for an unrelated individual residing in the taxpayer's home who is supported by the taxpayer.

In addition, there is no additional exemption for the blind or for individuals over age 65, as under the current Code, *see* I.R.C. § 151(c), (d). Hall and Rabushka explain this omission:

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. (P. 92).

¹² Eliminating itemized deductions from the existing tax code, deductions that generally represent expenditures not related to the production of income, *see* I.R.C. §§ 62, 63(f), would also greatly simplify record keeping and filing requirements for the salaried employee.

bles to find tax liability. The Hall-Rabushka simple tax form is shorter than existing forms in part because the former requires less verifying information than does the latter.

The more radical part of the Hall-Rabushka plan is their proposed business tax. The business tax is applied to all income derived by an enterprise other than wages, salaries, and pensions actually paid (p. 37). Hall and Rabushka describe the business tax as a "comprehensive withholding tax on all types of income" because it includes all income other than compensation income taxed to other taxpayers (p. 37). The taxation of income items at the source is possible only because, unlike a graduated rate structure, the flat rate treats all taxpayers and all types of income the same.

The base for the business tax includes all proceeds from the sale of products and services produced by business (p. 38). Allowable deductions include the cost of goods, materials, and services purchased for the production of good and services (p. 38).¹³ The business taxpayer may also deduct wages, salaries, and pensions actually paid.¹⁴ There are no deductions for fringe benefits, interest, or dividends that are taxed at the source, the payor, in order to avoid leakage (pp. 36-37). In addition, there is no deduction for state and local taxes (p. 39).¹⁵ On the other hand, the business taxpayer receives a 100% write-off for investments in plant, equipment, and land, which are treated as current busi-

¹³ These deductions are said to be appropriate because a portion of business proceeds "amount to the resale of things the firm purchased; the tax is already paid on them because the seller also has to pay the business tax" (p. 38). The proposal allows ordinary business expenditures including "the actual cost, if reasonable, of travel and entertainment expenses for business purposes" as deductions (p. 120 app. A). The simple tax code proposed by Hall and Rabushka, (pp. 119-22 app. A), ignores the problems of defining reasonable business expenditures for travel or entertainment thereby eliminating complex portions of the Code, *see, e.g.*, I.R.C. § 274, but not the problem itself. Hall and Rabushka argue that extravagant business expenditures would not be a problem where deductibility is worth only 19% as opposed to 46% or 50% under the current Code (p. 114).

¹⁴ Again these items are eliminated from the business tax base because they are taxed directly to the recipient at the time of payment (p. 38).

¹⁵ Hall and Rabushka state:

The elimination of deductions for state and local taxes holds both for the business tax and for the individual compensation tax. The present system with full deductions encourages people to get some of their economic services through state and local governments, rather than in the private marketplace. A town is better off financing its trash collection through deductible taxes on businesses and families than through nondeductible payments from families to private trash collection services. Elimination of deductions makes the town neutral in the choice, as it should be. (P. 39).

ness expenditures (pp. 39-41). Businesses with a negative taxable income because of this large investment write-off would be allowed an unlimited carry-forward of the negative tax to reduce future tax liability (p. 41). The government would not refund this negative tax. Instead, the negative amount would be increased annually by the market rate of interest (p. 41).¹⁶ Proceeds from the sale of business assets would be included in the business gross income subject to the 19% flat rate (p. 48). Capital gains from equity investments would not be subject to tax (pp. 48-49).

Hall and Rabushka claim that, at the same level of economic activity, the 19% rate imposed upon their broadened tax base will produce more revenue than the existing system (p. 75). They add that increased revenue would be generated by the stimulated activity attributable to tax reform (p. 75).¹⁷ Whether or not this is true, there is another side to the proposal which must be considered. Using their own figures based on 1979 dollars, the Hall-Rabushka tax plan represents a massive shift of the tax burden from persons with incomes in excess of \$44,196, to those with incomes below that figure. This shift of the burden of taxation is a fundamental part of the proposal, although Hall and Rabushka attempt to minimize its effect.

Hall and Rabushka acknowledge that "many people's taxes will rise a little right after the tax reform. But quickly everyone will benefit from the increased econom[ic] activity that will accompany a dramatic improvement in the incentives facing the most critical participants in

¹⁶ Hall and Rabushka note that "whenever the government starts writing checks, clever people will abuse the opportunity through fraud and legal maneuvers" (p. 41).

The 100% write-off allows the business taxpayer to defer tax liability on current income that is offset with the capital write-off. When the capital investment produces income in later years, there will be no allowance for the capital cost of producing income which is then taxed in full. Thus, the tax on income earned in the year of the capital expenditure is paid in later years on income earned without reduction for the cost of its production. The government lends the amount of this deferred tax liability to the taxpayer as an investment incentive. It may be more appropriate to require the taxpayer to pay interest on the deferred tax liability rather than giving the taxpayer an interest payment on the already interest free loan, as Hall and Rabushka suggest. See Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225, 259 (1979).

¹⁷ The authors write:

[Our analysis of budget deficits] illustrate[s] a point about the simple flat tax of central political importance: It is possible to reduce tax rates dramatically and yet raise revenue and close the deficit at the same time. Further, our computations so far do not consider any supply-side effects — everything comes from the enormous enlargement of the tax base accomplished by the simple flat tax. (P. 76) (emphasis in original).

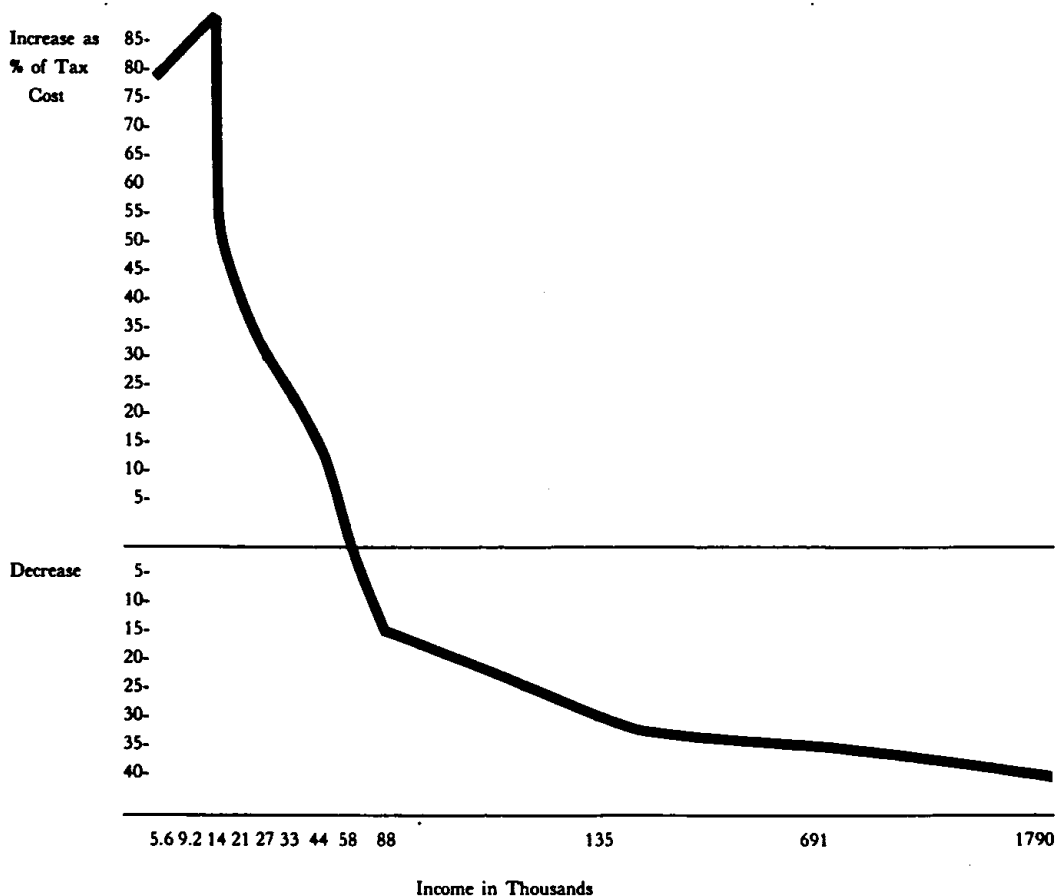
our economy.” (P. 93). The extent of this tax increase is demonstrated by Appendix C of the book (pp. 124-25). A person with an augmented income of \$5687¹⁸ would bear increased tax costs amounting to 3.4% of income. A person with augmented income of \$9232 would see her tax increased by 5.2% of income. Hall and Rabushka refer to these increases as “slight” (p. 53). The increases are more than slight, however, when analyzed as percentage increases in actual tax cost, an analysis not used by Hall and Rabushka. Again using the figures from Appendix C, the taxpayer at the \$5687 income level would see her tax cost increased from \$247 under the current system to \$440 under the proposed system, a percentage increase of 78.1%. The taxpayer in the \$9232 income bracket would suffer an 84.5% increase in actual tax cost. These increases continue up to the \$44,196 level, where tax cost is increased by 13.5%. Thereafter, actual tax cost would decline under the Hall-Rabushka proposal, a 1.5% decline at an income level of \$58,753, a 31% decline for the taxpayer with \$251,870 of augmented income, and a 41.1% decline for the taxpayer with income of \$1,792,476. Appendix C is reproduced on the facing page with the addition of a fifth column showing the percentage increase or decrease in actual tax cost.¹⁹

¹⁸ These income figures are derived from total income received by families and individuals by income group and are adjusted to account for an approximation of items omitted from adjusted gross income such as fringe benefits and other forms of leakage. The figures are also adjusted to account for extra business income not contained in adjusted gross income in the form of retained earnings and other components of business income. The authors apportion this extra business income to adjusted gross income categories in proportion to dividends received in each category. The personal and dependent allowances used to compute the simple tax are adjusted to reflect the effect of inflation since 1979 (pp. 59, 124-25 app. C).

¹⁹ Column added to the original is labeled “Change as a % of income” (p. 125 app. C).

Augmented income	Current tax	Simple tax	Change as a % of income	Change as a % of tax liability
5,687	247	440	3.4%	78.1%
9,232	574	1,059	5.2	84.5
11,635	905	1,494	5.1	65.1
14,099	1,250	1,919	4.7	53.5
17,629	1,726	2,535	4.6	46.9
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21,244	2,246	3,166	4.3	41.0
27,663	3,260	4,318	3.8	32.5
33,505	4,286	5,404	3.3	26.1
44,196	6,532	7,417	2.0	13.5
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58,753	10,333	10,182	-0.3	- 1.5
88,750	18,640	15,879	-3.1	-14.8
135,079	34,191	24,681	-7.0	-27.8
251,870	67,973	46,870	-8.4	-31.0
691,239	202,384	130,382	-10.4	-35.6
1,792,476	577,080	339,652	-13.2	-41.1

In graphic form, the relative percentage change in actual tax cost looks like this:



The shift in the burden of taxation raises the issue of equity within the income tax system. Is it equitable for wealthier Americans to bear a higher burden of taxation, as they do under the current system, because of their ability to pay based upon their income level or standard of living?²⁰ Hall and Rabushka would answer this question with a qualified no.²¹ If you accept the idea that higher income individuals should bear a proportionately greater share of the tax burden, and an additional shift of the burden of taxation from higher income to middle income Americans is not to your liking, you may have some reservation about the proposal.²²

Hall and Rabushka's justification for a shift of the tax burden is found in theories of supply-side economics. Under these theories, the solution to economic doldrums is found in an increase in available investment capital through reduced levels of taxation. The benefit of reduced taxation must go to higher income taxpayers because they are the persons best qualified to use the money for the benefit of all. Thus, Hall and Rabushka write:

If we are right that improved incentives will actually raise real incomes by 9 percent after 7 years, then it won't take too long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax is to reduce after-tax income by 5 percent; as soon as the economy has grown by an extra 5 percent thanks to tax reform, those families will be back to where they were. As growth continues, they will ultimately come out at least 4 percent ahead. (P. 60).²³

²⁰ These measures are suggested in U.S. TREAS. DEP'T, BLUEPRINTS FOR BASIC TAX REFORM 27-33 (1977).

²¹ The flat tax is somewhat progressive as long as there is a floor of income not subject to tax. *See infra* text following note 32.

²² Hall and Rabushka complain that, in opposition to the flat tax, "Intellectuals have charged that a flat tax of 20 percent or less would substantially shift the tax burden from wealthier to lower- and middle-income households." (P. 24). Before agreeing with the last point in the text, one should consider whether she is willing to be branded as an evil "intellectual."

²³ The authors also state that:

The high-income groups include two types — one alert and sensitive to taxes, and the other more passive. We guess that the alert group far outnumbered the passive group, but it is hard to pinpoint the alert group, because their tax-avoidance tricks make them inconspicuous in the tables. High marginal tax rates drive the alert group into all kinds of activities to escape taxation, and the whole economy suffers from this distortion. On the other hand, the high rates pick up a good deal of revenue from the passive group. It's a worthwhile trade to give up a good part of the revenue from the passive group in order to get the alert, sensitive group back into their most productive activities, but it comes at a cost in revenue. (Pp. 59-60).

This analysis assumes, of course, that the direct benefit of tax reform realized by the "big earners" will be passed on to those whose tax burden is increased. It is clear that the efficacy of the Hall-Rabushka proposal is hinged on the trickle-down theory of supply-side economics.²⁴

The principal incentives of the Hall-Rabushka plan are lower marginal rates of taxation to produce increased productivity and a 100% write-off for investment in plant, equipment, and land to induce increased investment. Each of these will be considered separately.

The Incentive of Lower Rates

Hall and Rabushka explain the incentive of lower marginal rates as follows:

The great majority of economically active Americans would face improved incentives for productive effort under the simple tax. In 1979, married taxpayers had marginal rates under 18 percent only if their taxable income was less than \$7600. The majority of families in that year had marginal tax rates of 24 percent or higher and just 19 percent had incomes so low or deductions so high that their marginal rates were below 18 percent. Even these figures understate the improvement in incentives, because many of the couples taxed at low rates are in school or are retired. Only 7 percent of gross income was earned by couples taxed below 18 percent on the margin. Half of all gross income was taxed at marginal rates of 28 percent or higher. The net effect of equalizing marginal rates at 19 percent is a dramatic improvement of incentives for almost everybody who is economically active. (Pp. 53-54).

In reality, the Hall-Rabushka proposal provides little if any incentive in terms of actual dollar savings for taxpayers below the median income levels. Under current tax law, the married taxpayer with no children who reached the 18% bracket in 1979, and who did not itemize deductions, paid an effective tax of 6.6% of gross income. Under rates for 1984, that person's effective rate of tax on gross income would be 5.7%. The effective tax rate under the Hall-Rabushka proposal would be 6.7%, an increase over both 1979 and 1984 tax liability.²⁵ If

²⁴ Hall and Rabushka discount the role of supply-side theory in recent economic performance. In explanation of the economy's failure to respond to the 1981 tax cuts, they state, "Supply-side economics may become discredited from the performance of the economy in the first two years of the Reagan administration. But it is important to understand that President Reagan's tax reductions were not a real test of supply-side economics." (P. 17).

²⁵ Using the same rate table as Hall and Rabushka, I.R.C. § 1(a), in effect for taxable years ending before December 31, 1981, a married couple with taxable income of \$7600 would pay tax of \$630 on gross income of \$9600. Gross income is computed by adding \$2000 representing personal exemptions for husband and wife to taxable

the same taxpayer had sufficient income to reach the 24% bracket, the effective rate of tax under current tax law would be 12.6% in 1979, and 9.7% in 1984. The effective rate of the Hall-Rabushka simple tax at this income level would be 12.5%,²⁶ a slight decrease for 1979, and an increase for 1984. The married taxpayer reaching the 28% bracket in 1979 paid tax at an effective rate of 14.7%, and will pay 11.2% of gross income in 1984. The effective rate of the simple tax on this couple would be 13.7%.²⁷ The Hall-Rabushka proposal provides little, if any, incentive in terms of actual dollar savings for taxpayers below the median. Bear in mind that the comparisons in this paragraph ignore the impact of other parts of the Hall-Rabushka proposal, such as taxation of fringe benefits. The comparisons of Appendix C of the book provide a more accurate comparison of effective tax differences and demonstrate that, at these income levels, the Hall-Rabushka proposal would result in increased tax cost.²⁸

Hall and Rabushka state that what matters to people in economic decisionmaking "is how much of any extra dollar of earnings they keep after taxes" (p. 54). This is the heart of most challenges to progressive tax rates. It is undoubtedly true that the marginal rate of return is a factor considered in contemplating additional labor or capital investment. A logical person, however, is not likely to find investment incentive in a system that offers fewer dollars in exchange for lower marginal taxation of the last dollar. The incentive to earn more under the Hall-Rabushka plan exists only for those persons whose income exceeds the level at which there is a positive reduction of taxes. The in-

income. The effective rate of tax is 6.6%. The tax on 1984 income of \$9600 would be \$546.

The simple tax on \$9600 income reduced by the \$6200 personal allowance for married couples filing a joint return is 19% of \$3400, or \$646, an effective rate of 6.7%.

²⁶ Under the rate tables used by Hall and Rabushka, a married taxpayer filing a joint return enters the 24% bracket with taxable income of \$16,000. For a childless couple who do not itemize deductions, that would require gross income of \$18,000 derived by adding back personal exemptions of \$2000. The effective rate of tax is 12.6%. The 1984 tax would be \$1741, an effective rate of 9.7% of gross income. The simple tax on this income would be \$2242, 19% of \$18,000 less the personal allowance of \$6200. The effective rate is 12.5%.

²⁷ For taxable year 1979, the 28% bracket was reached with \$20,200 of taxable income, which would require gross income of \$22,200 for a married couple with no children who did not itemize deductions. Tax on this amount was \$3273, 14.4% of gross income. Tax under the 1984 tables is \$2497, 11.2% of gross income. The simple tax would be \$3040, 19% of \$22,200 less the personal allowance of \$6200. The effective rate is 13.7%.

²⁸ See *supra* note 19 and accompanying text.

centive is insignificant for the majority of taxpayers. Again, the efficacy of the plan depends upon the belief that increased investment incentive for the highest income taxpayers will trickle down to the lower income individuals who bear the cost of the incentives.

Hall and Rabushka also claim that the flat tax offers a particular incentive to married women to enter the labor market. They write:

There is simply no doubt about the sensitivity of married women to economic incentives. Every study has shown a systematic tendency for women with low after-tax wages and high incomes from their husbands to work very little. Those with high after-tax wages and lower incomes work a lot. It is an altogether reasonable inference that sharply reduced marginal tax rates on married women's earnings will further stimulate their interest in the market. (P. 55)

It is equally reasonable, and perhaps more realistic, to infer that married women earning low after-tax wages hold low status jobs lacking sufficient rewards to motivate them to work if their husbands already produce high income. Likewise, higher income earners, male or female, probably hold higher status positions providing substantial satisfaction in addition to monetary rewards.²⁹ An analysis of the potential impact of reduced taxation as a pecuniary incentive must consider the broad socioeconomic distinctions between productive and unproductive behavior that operate in a capitalist economy.³⁰ The incentive to individual productivity provided by the Hall-Rabushka proposal pales when compared with the rewards for increased personal productivity and punishments for sloth already built into the economic system.

Aside from the question of incentives, lower marginal rates offer significant benefits to the tax system. Hall and Rabushka point out that lower rates would reduce the economic benefit of tax avoidance and evasion, thus reducing the incentive to expend resources on such activities (p. 7). Lower marginal rates would also reduce the government subsidy for excessive business expenditure.

With a current corporate profits tax at 46 percent, a firm can provide its employees with highly subsidized benefits. Under our plan, the subsidy element in expenses falls from 46 cents to 19 cents on the dollar, and disappears altogether for fringes. . . . We would expect business managers to watch their expenses more closely in a 19 percent world. (P. 114).

Lower marginal rates would also reduce the benefit of some debt fi-

²⁹ The relevant inquiry would examine whether married women earning a wage comparable to their husbands are motivated to work in the compensated labor force, or whether the current tax structure provides an effective disincentive to them.

³⁰ Okun, *Further Thoughts on Equality and Efficiency*, in *INCOME REDISTRIBUTION* 29 (C. Campbell ed. 1977).

nanced tax shelters, although as discussed below, the tax shelter problem would continue to exist under the Hall-Rabushka plan.

A flat tax is not necessary to derive the benefits of lower marginal rates. Lower marginal rates are possible with a graduated rate structure applied to a broader tax base. Hall and Rabushka would reject such a proposal because imposing the tax burden on higher income taxpayers restricts economic incentive.³¹ In addition, they point out that replacing the graduated rate tables with a uniform flat rate would eliminate the incentive to shift income to persons in lower tax brackets (pp. 32-33).³² A flat rate also allows taxation of some income items, such as interest and fringe benefits, to the payor at a uniform rate.

Whether to adopt a flat rate, or to retain a graduated rate structure, is primarily a question of the degree of progressivity desired in allocating the burden of taxation among income levels. Hall and Rabushka stress that the exemption from the tax base provided by personal and dependents' allowances has a progressive result. The effect of the allowances on the effective or actual rate of tax is greater at lower income levels. A lower income person pays a lower effective rate of tax than the person with a higher income (pp. 24-26). Unlike a graduated rate structure, however, progressivity in a flat rate structure declines as income increases. Under a flat tax with an exemption for low levels of income, the rate of increase in the effective rate of taxation slows as income levels increase. A graduated rate schedule maintains or accelerates the effective tax rate.

³¹ Hall and Rabushka make this statement with respect to the Bradley-Gephardt tax plan that proposes a basic rate of 14% with a surtax ranging from 6% to 14% (p. 105). See H.R. 6944, 97th Cong., 2d Sess. § 2, 128 CONG. REC. H5201 (daily ed. Aug. 5, 1982); S. 2817, 97th Cong., 2d Sess. § 2, 128 CONG. REC. S9958 (1982). The proposal is basically a progressive rate schedule ranging from 14% to 28%. The Bradley-Gephardt plan would also repeal the deduction for capital gains. Hall and Rabushka write that "a tax increase on the most productive part of our population, coupled with a higher levy on venture capital, [is] not a recipe for renewed economic growth" (p. 105).

³² The existing tax system has devised a reasonably effective means of dealing with attempts to shift income away from the person who has earned it. See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940); *Burnett v. Leininger*, 285 U.S. 136 (1932); *Lucas v. Earl*, 281 U.S. 111 (1930); *Salvatore v. Commissioner*, 29 T.C.M. 89 (1970); I.R.C. §§ 671-679. Also note that the problem is not entirely eliminated under the Hall-Rabushka proposal. Taxpayers could still attempt to shift income to their children to use the child's personal allowance. Hall and Rabushka's simple tax code lacks any provision for dealing with this problem.

The Tax Base

A flat tax rate does not by itself guarantee lower marginal or effective rates of income taxation. Lower marginal rates are possible using either a graduated rate schedule or a flat rate, but only if the tax base upon which the percentage rate structure is imposed is sufficiently enlarged. The definition of the tax base in terms of the items to be included or excluded is separate from the type of rate structure to be adopted, but the two are related in that the larger the tax base, the lower the rate necessary to raise a given amount of revenue.³³

The Hall-Rabushka plan enlarges the tax base through increased taxation of fringe benefits, elimination of nonbusiness deductions currently available to individuals such as interest, medical expenses, and charitable contributions, and by taxing the value of services rendered by banks and insurance companies. The plan also contains some reductions in the tax base, such as the 100% write-off for capital investment and the elimination of taxation on capital gains from equity investments. These latter items will be considered first.

Business Investment Incentives

The proposed 100% write-off for business investment in plant, equipment, and land is said to provide a significant incentive for business to direct capital into these areas. Hall and Rabushka write:

The high tax rates of the current tax system significantly impede capital formation. On this point almost everybody agrees. The government's solution to the problem has been to pile one special incentive on another, creating a complex and unworkable maze of regulations and tax forms. Existing investment incentives are appallingly uneven in their effect. Capital projects taking full advantage of accelerated depreciation, the investment tax credit, and the deductibility of interest are actually *subsidized* by the government, not taxed at all. But equity-financed projects not eligible for fast depreciation are taxed heavily. Investment incentives severely distort the flow of capital into the most favored areas. (Pp. 46-47).³⁴

³³ The nature of the tax base affects the progressivity of the tax rate. Providing reductions in the tax base available only to high income taxpayers, such as accelerated capital allowances useful as tax shelters, reduces the effective rate of tax on upper incomes and thus reduces the degree of progressivity.

³⁴ These problems could also be eliminated by a depreciation policy aimed only at computing annual profit rather than as a method of providing an investment incentive. Depreciation deductions might be limited to the same sort of depreciation patterns used for financial reporting purposes. Recapture problems could be eliminated by recognizing that capital gain is caused in part by excessive depreciation claims. Providing ordinary income treatment for gain on disposition of depreciable property, perhaps with an upward basis adjustment for inflation, would eliminate recapture. Such a measure

Hall and Rabushka's solution replaces all the existing incentives with a single incentive: the complete deduction of all capital expenditure.

On balance, the Hall-Rabushka proposal provides a somewhat lower direct incentive to investment in most forms of tangible depreciable property, but increases the incentive to invest in undeveloped land and improvements to land. The value of a capital expense deduction under a 19% tax scheme is slightly greater than the first year value of the existing investment tax credit and accelerated capital recovery deduction to an individual taxpayer in the 50% bracket. The current capital recovery scheme provides additional deductions in subsequent years, however, so the overall tax savings for capital investment in depreciable assets, and thus the investment incentive, is greater for most depreciable property under current law than under the Hall-Rabushka proposal.³⁵ The Hall-Rabushka plan also allows a deduction for investment in land that is currently subject to neither the investment credit nor accelerated capital recovery. In addition, the 100% write-off would apply to improvements to land that are subject to capital recovery but not the investment tax credit. For these types of investments, the Hall-Rabushka plan is more favorable to the business taxpayer than existing incentives. Clearly the real estate investor derives the greatest additional incentive from the capital write-off proposal.

The Hall-Rabushka plan offers the apparent advantage of simplicity. It contains the same tax-shelter potential as current law, however, in that the government would continue to subsidize debt financed capital investment with tax savings in excess of capital actually invested. The real estate tax shelter would become even more attractive as a place for investment capital. For example, instead of paying tax on \$100,000 of business income, the real estate investor may make a 19% down payment on investment real estate costing \$100,000. In effect, the government has provided the down payment. The deduction for investment shelters other income from taxation.³⁶ As long as rental income

would assist in creating an enlarged tax base which could compensate for the loss of accelerated depreciation with lower tax rates.

³⁵ Under I.R.C. §§ 38, 46, and 168, the first year write-off and tax credit returns approximate 18% of an investment in three year property and 17% of an investment in five year property. In the second year, three and five year property would return another 18% and 10% of the original investment, respectively. The return on 10 year property is less: 14% the first year, 6.6% the second year. The value of these deductions is slightly less for a corporate taxpayer paying a maximum rate of 46%. The Hall-Rabushka proposal would return a flat 19% in the first year only.

³⁶ Hall and Rabushka's simple tax code appears to allow a business to file any num-

from the investment is sufficient to pay principal and interest, the investor could increase her capital wealth annually with 19% investments and avoid tax liability. Current real estate tax shelters work essentially the same way; while the first year return from existing shelters is not as great as that provided under the Hall-Rabushka proposal, the tax return continues over several years. Of course, a day of reckoning will come when a property must be sold and the full amount reported as taxable gain. In the meantime, the investor has had the use of the government's money and retains the growth on capital.³⁷

As under current law, a capital intensive industry would be able to offset current earnings with capital investment that represents the cost of future earnings from plant and equipment. The deduction allows reduced taxation of current profit based on the cost of future earnings.³⁸ Government subsidy for capital investment, whether in the form of a 100% write-off or the existing accelerated capital recovery plus the investment tax credit, is a preference to capital intensive industry over

ber of returns for its various subsidiaries or units, so that losses of one business may offset income of another (p. 122 app. A). The authors state that business losses cannot reduce compensation income (p. 87). Thus, a sole proprietor or independent contractor may use tax shelters, but the compensated employee may not. The tax shelter problem could be eliminated by restricting the deduction of losses to income from the business activity producing the loss. Of course, the same is true of the current tax system. The tax shelter problem could also be eliminated by restricting artificial accounting losses to the activity producing the loss. Congress, however, has refused to enact such a system. See H.R. 10612, 94th Cong., 1st Sess. § 101, 121 CONG. REC. 38,596 (1975); see also Simmons, *Nonrecourse Debt and Bases: Mrs. Crane Where Are You Now?*, 53 S. CAL. L. REV. 1, 60-68 (1979).

Hall and Rabushka assert that motivation for debt financed investment will be reduced by eliminating the deduction for interest. They also argue that eliminating the interest deduction will reduce interest rates. The interest deduction causes a reduction of the effective cost of interest, the same effect that is achieved by lower rates. The advantage of leveraged investment, the ability to produce higher marginal return with borrowed capital than can be achieved with equity investment, would remain. This is not a function of the tax law, although the tax law increases the return of leveraged investment with tax savings. The benefits of leverage are not altered by the Hall-Rabushka proposal. Nonetheless, Hall and Rabushka claim that their simple tax would place leveraged investment on the same footing as equity investment (pp. 56-57). Although Hall and Rabushka condemn incentives for leveraged investment over equity, they state at another point, "All told, borrowing for investment purposes will become a better deal, and an investment boom will surely follow the enactment of the simple tax." (P. 61).

³⁷ Note again that, in addition to this interest free loan to the taxpayer, the Hall-Rabushka proposal would provide the taxpayer with interest on any negative tax produced by an excess of deductions over income (p. 41).

³⁸ See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

service businesses in which the costs of producing income, employee wages, are deductible only against current earnings. In this sense, business is subsidized to invest in plant and equipment over human labor. Clearly, capital investment is necessary for the economy. The issue raised by both the Hall-Rabushka proposals and current tax law is whether the tax system should favor investment in capital intensive undertakings over service industry, or whether the tax law should be neutral as to this choice, allowing capital to flow unimpeded into the areas where it is economically productive. Hall and Rabushka favor the subsidy to capital investment.

Capital Gains

Hall and Rabushka's proposal includes gain on disposition of plant, equipment, and land in business income subject to the full 19% tax rate (p. 48). Thus, the cost of plant, equipment, or land is deducted in full on acquisition, and the sale proceeds are taxed in full on disposition.

Capital gain on equity investments would not be subject to taxation, because "[t]o tax the immediate capital gains of the stock would be double taxation." (P. 49). Hall and Rabushka argue that the market value of stock is the capitalization of future earnings. An increase in market value reflects potential enhanced earnings that will be taxed when realized by the corporation (pp. 48-49). This approach contains not only an incentive for equity investment, but an incentive for corporations to accumulate earnings for tax free reinvestment using the 100% write-off. In this fashion, the capital value of equity stock would grow to be realized by shareholders tax free. Here again, the Hall-Rabushka proposal contains significant incentives for persons who have capital to invest at the expense of wage earners and service industries. Hall and Rabushka answer this concern by stating:

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. (P. 88).

This analysis ignores the possibility that shareholders may realize their gains by selling the stock on the market, or to another firm which has use for the underlying capital assets. At this point, the purchaser of the stock might liquidate the company and claim the capital write-off to avoid taxation of gain.³⁹ Hall and Rabushka's three page simple tax

³⁹ The simple tax code would require recognition of gain on an in-kind distribution

code does not deal with this and other problems of corporate liquidation and reorganization. In combination, the 100% capital write-off and the absence of any tax on equity investment may make it possible for the owners of a closely held business to postpone taxation indefinitely, and avoid it altogether with a sale of stock.

The simple tax would also eliminate taxation of gain on sales of owner-occupied housing. This is similar to existing tax law which allows most of such gain to go untaxed through the roll-over relief of section 1034 of the Code and the exclusion of \$125,000 of gain by individuals over fifty-five years of age.⁴⁰

Multinational Transactions

The Hall-Rabushka plan simplifies taxation of multinational transactions by limiting United States taxation to revenue from products sold within the United States, plus the value of products exported (p. 52). This provision eliminates all income earned abroad by United States citizens and domestic corporations from the tax base, and encourages further investment in tax haven countries which tax income at lower rates than the domestic rate.

Fringe Benefits

On the other side of the ledger, one of the major enhancements to the tax base in the Hall-Rabushka proposal is the inclusion of employee fringe benefits that currently escape taxation. This includes not only abusive benefits such as expensive automobiles, exercise facilities, and country club memberships, but also employer provided health insurance and pension contributions.⁴¹ The value of fringe benefits would be taxed at the source by denying any deduction to the business taxpayer

of assets to the shareholder (p. 120 app. A). This income would presumably be offset by a capital write-off on the liquidating shareholder's conversion of the assets acquired on liquidation to use in its own business. *See, e.g., Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

⁴⁰ *See* I.R.C. § 121. Section 1034 allows the tax free sale of a principal residence as long as the sale proceeds are reinvested in a new principal residence that is used within 24 months before or after sale of the old residence. I.R.C. § 1034.

⁴¹ These items represent two of the largest subsidies in the tax expenditure budget. The revenue loss in fiscal year 1984 is estimated to be \$21.3 billion for the exclusion of employer contributed health plans and medical payments, and \$60.7 billion for both employer and voluntary pension plans. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS G: TAX EXPENDITURES, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT G-32 (1984).

for the cost of providing them (p. 39).

Congress has grappled with the fringe benefit problem for decades without resolution. As Hall and Rabushka point out, fringe benefits enjoy a great advantage over cash wages because they are deductible by the business provider while their value to the employee generally escapes taxation (p. 39). The simple tax solution to the problem is sensible and may be applicable to the current tax system. Eliminating the deduction for the cost of fringe benefits not reported as compensation to the employee would terminate the tax benefit of this form of employee compensation.⁴² Not all subsidized fringe benefits are undesirable, however. The vice of the Hall-Rabushka proposal is that it tosses out the good with the bad. The government may have a substantial interest in insuring resources for both adequate health care among workers and sufficient retirement income. This is a social policy question with significant impact on the tax system. It may be more efficient and less expensive for the government to subsidize health care and retirement income through tax incentives than to incur the direct social welfare cost of providing benefits to those for whom these items would not otherwise be available.⁴³ It is also noteworthy that the elimination of the government subsidy to employee health insurance under the Hall-Rabushka plan represents an additional shift of cost to lower and middle income workers.

Interest

Hall and Rabushka describe interest as one of the most critical sources of leakage from the existing tax base (p. 15). They complain that numerous taxpayers deduct interest at high tax rates and direct interest payments as income to lower bracket taxpayers. In addition, interest income earned by qualified pension funds is not subject to taxation until the pension is actually distributed. Hall and Rabushka add that some taxpayers use a "simpler technique for saving the taxes on interest — they leave their interest income off their returns" (p. 16).

The simple tax solution to interest leakage is to tax interest at its source, the payor, by disallowing any deduction for interest and by excluding interest from the income of the recipient. Under this scheme, all interest paid is included in the tax base subject to the 19% flat tax. The

⁴² This suggestion is contained in H.R. 3525, 98th Cong., 1st Sess. § 2, 129 CONG. REC. H5056 (daily ed. July 12, 1983).

⁴³ Special Comm. on Simplification, A.B.A. Sec. of Tax'n, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW. 563, 567-68 (1979).

income used to pay interest is taxed without reduction on account of the interest paid. Elimination of the interest deduction applies to business and individuals alike.

Eliminating the tax benefit of the interest deduction increases the cost of borrowing. Hall and Rabushka assert that the increased cost of borrowed funds will cause interest rates to drop. In effect, they predict that interest will decline to a degree equivalent to the value of the tax subsidy for interest. They estimate that the net decline would be about a fifth (pp. 60-61). They note elsewhere, however, that because of the investment incentives contained in the simple tax, such as the capital write-off, borrowing for investment will become a better deal. "As the boom develops, borrowing will rise and will tend to push up interest rates." (P. 61).⁴⁴

The benefits and burden of the simple tax exclusion of interest from income and denial of deductions are carefully considered. Hall and Rabushka note that corporations received a net twenty-eight billion dollars of interest income in 1979; of these corporations, manufacturing corporations paid out a net twenty billion dollars and financial corporations and insurance companies received a net eighty-seven billion dollars. Financial corporations would derive a benefit from the interest proposal but this would be offset by Hall and Rabushka's proposed taxation of the value of bank and insurance company services that currently escape tax. Corporations producing goods and services would suffer "a small loss, which will pale against their trillions of dollars of total assets" (p. 70). The effect on individuals is said to be negligible. Hall and Rabushka assert that interest income reported on individual returns is almost exactly the same as interest deducted. The poor would gain, as interest income exceeds deductions up to 1979 adjusted gross incomes of \$18,000. In what they claim is the single most affected income group, 1979 adjusted gross incomes of \$25,000 to \$30,000, Hall and Rabushka state that the loss on net interest deductions of \$856 under the 19% tax rate is only \$163, or \$14 per month (p. 70).

Hall and Rabushka claim that the interest provision has its greatest impact on real estate partnerships. Partnership returns showed net interest deductions of fourteen billion dollars in 1979 (p. 71). Hall and Rabushka state that partnerships investing in assets eligible for leveraging "contribute to the excess investment in shopping centers, apartment buildings, and related projects" (p. 71). The benefit of leveraged invest-

⁴⁴ The authors add, "We can't be sure what will happen to interest rates after tax reform, but we can be sure that high interest, low investment stagnation will not persist. Either interest will fall or investment will take off." (P. 61).

ment is not dependent on the interest deduction, however. The interest deduction merely reduces the effective cost of borrowing. Hall and Rabushka assert that their proposal will also reduce the cost of borrowing by lowering interest rates. The tax shelter thrives on accelerated capital write-offs that reduce tax paid on income from different sources. The Hall-Rabushka proposal enhances the attraction of leveraged investment in real estate through its 100% capital write-off.

Elimination of the interest deduction will have a significant impact on housing. The existing system provides a reverse housing subsidy, a 50% benefit to the highest income individuals and no benefit to low income individuals.⁴⁵ Hall and Rabushka assert that if the loss of interest and property tax deductions increase the carrying cost of a house of a given value, the reduction of demand will cause a drop in housing prices (p. 63). They also stress that their proposal will cause an overall drop in interest rates.⁴⁶

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small — small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects — to reduce interest rates and related costs of funds (and so to stimulate housing and other asset markets) and to deny interest deductions (and so to depress housing). To a reasonable approximation, these influences cancel each other out. (P. 64).

Of course, as Hall and Rabushka point out, changes in the market value of housing will have no impact on the existing homeowner who has no interest in either selling or buying. To this person, "the loss of the tax deduction can be pure grief" (p. 65). But, not to worry, say Hall and Rabushka. The homeowner with a variable rate mortgage will be able to take advantage of the lower interest rates that will develop. The holder of a high interest fixed rate mortgage will be able to refinance at lower rates. Homeowners with pre-1973 mortgages with low rates do not lose much in any event: "their mortgages have such low interest payments, thanks to small principals and low interest rates,

⁴⁵ *Tax Subsidies as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures: Hearings before the Subcomm. on Priorities and Economy in Gov't of the Joint Economic Comm.*, 92d Cong., 1st Sess. 49-51 (1972).

⁴⁶ Hall and Rabushka argue that further mitigation occurs because the alternative return on equity invested in a house is reduced after tax reform. They argue that if the prospective buyer did not put wealth into a house, the money would be placed in an untaxed retirement fund. "The fund holds bonds; after reform, the interest rate on bonds would be perhaps 4 percentage points lower, and so the implicit cost of the equity would be lower by the same amount." (P. 64). This argument ignores the fact that the tax free imputed income from the use of the house partly or wholly offsets any lost income on an alternative investment of the equity.

that loss of deductibility isn't terribly costly" (p. 65). Those persons with fixed interest mortgages with rates approaching the lowered rates following tax reform, 12% mortgages acquired in the late 1970's, will suffer most: "They sustain a straightforward capital loss from the moment tax reform goes into effect." (P. 65). Again, not to worry: "The capital loss is no different from those suffered by diverse groups throughout the economy in the ups and downs of the past decade." (P. 65). The net gainers in all of this will be the saving and loan institutions whose portfolios of existing loans will increase in value as interest rates decline (pp. 65-66).

Charitable Contributions

Another significant government subsidy eliminated by the Hall-Rabushka proposal is the deduction for charitable contributions.⁴⁷ Hall and Rabushka's comments on this issue deserve serious consideration. They assert that total contributions to charitable causes from individuals and corporations were about ninety-four billion dollars in 1979, but that only twenty-four billion dollars was deducted on tax returns (p. 66).⁴⁸ They add that only seven billion dollars was claimed by families with taxable incomes in excess of \$35,000 and that well over half of the cash contributions to charity go to churches, generally from donors in the middle income distributions. They conclude from this:

Churches have nothing to fear from tax reform, and, like most people and institutions, would have much to gain from better economic conditions brought about by reform. In spite of their dominant position in gifts, churches are not the leaders in fighting tax reform that denies deductions. Instead, institutions serving the absolute economic and social elite — universities, symphonies, opera companies, ballets, museums — are protesting the loudest. No compelling case had ever been made that these worthy undertakings should be financed by anybody but their customers. A glance at the crowd in any of them will tell you that it is perverse to tax the typical American in order to subsidize the elite institutions. But granting tax deductions for gifts is precisely such a subsidy. (Pp. 66-67).

The counterargument is that the government subsidy helps to make these institutions more accessible. Forcing universities, museums, and

⁴⁷ The federal government subsidizes charities by returning a portion of every contribution to the taxpayer in the form of a deduction. The benefit depends upon the taxpayer's marginal bracket. The person in the 50% bracket receives tax savings equal to one half of any deductible contribution.

⁴⁸ Note that the figures used include the value of contributed time, which is not deductible under current law. Hall and Rabushka do not indicate what proportion of this \$94 billion represents deductible cash and property.

the like to support themselves through admissions or tuition may make these institutions even more elitist. Some may also believe that maintaining education and culture is valuable to society as a whole, even though many people do not participate directly. The charitable deduction raises questions of social policy. If government subsidies for such activity are determined to be appropriate, the tax incentive provides an efficient method for directing private capital into charitable undertakings without the necessity for governmental intervention in the choice of where that capital is to be placed. Government encourages contributions through the deduction, but remains neutral as to which institutions are the beneficiaries.

Banks and Insurance Companies

The recommendations for taxing banks and insurance companies are among the most interesting of the Hall-Rabushka proposals. The authors point out that banks obtain deposits from customers on which the banks pay little or no interest while compensating the depositor with services such as checking accounts. The depositor does not include the value of these services in income, but the bank deducts the cost of providing them. Hall and Rabushka state that these practices deprive the Treasury of at least five billion dollars in revenue (p. 49). Insurance companies behave similarly, compensating the customer for the use of funds (the premiums paid by the insured and accumulated by the insurance company) with lower cost insurance.

The solution proposed by Hall and Rabushka could apply to the current income tax system as well as to their flat tax. They would prohibit banks from "subtracting the price of financial services from interest payments. Instead, they should report market interest earnings on all accounts, and then subtract the price of the services explicitly." (P. 50). In essence, the difference between interest actually paid to depositors and the market rate of interest on borrowed funds would be included in the bank's income to represent the compensation paid by depositors for services rendered.⁴⁹ Insurance companies would be required

⁴⁹ Hall and Rabushka make this clear in an example based on the annual report of the Old National Bank of Evansville, Ind.:

The bank's annual report for 1981, . . . gives revenue from service charges and related fees of only about \$4.5 million. But the bank's depositors maintained balances of over \$350,000,000 during the year. Had they been paid market interest rates, they would have earned about \$50,000,000. Instead, they received only about \$20,000,000. The difference of about \$30,000,000 is the market value of the services provided to

to account for the difference between premiums actually paid and the full cost of insurance provided. Technically, the simple tax code accomplishes this result by defining business receipts to include "the market value of goods and services provided to depositors, insurance policyholders, and others with a financial claim upon the business, if not included in sales" (p. 120 app. A).

Problems of Transition

The Hall-Rabushka proposal represents a radical departure from the existing income tax system. The authors suggest, however, that the plan be enacted without transitional provisions. They point out that transitional rules would end the inherent simplicity of their tax reform and that "every special interest would seek grandfather clauses or postponement of the loss of benefits as long as possible" (p. 77). They also argue that, although certain sectors would face economic loss in the shift to their simple tax, overall the benefit of the predicted economic effect resulting from adoption of the simple tax would outweigh any loss suffered by the particular parties. On the other hand, it is clear that taxpayers have made substantial financial decisions in response to incentives contained in the current tax scheme. Equity would suggest that the economic cost of revising existing incentives be taken into account. Everyone is in favor of tax reform so long as it does not adversely affect the incentives that benefit them.⁵⁰ Because the income tax system affects every financial transaction in a complex society, tax reform is not simple. It is probably a political fact of life that any substantial tax reform will be required to account for the economic expectations built into the existing system, expectations that cannot be ignored on the basis of promised overall economic improvement.

CONCLUSION

Low Tax, Simple Tax, Flat Tax contains a complete and workable, but perhaps optimistically simplistic, system of taxation that may be described as tax reform for supply-side economics. The principal feature of the proposal is its shift of tax burden away from business and

the depositors by the bank, and appears along with the \$4.5 million [as gross revenue from sales]. (Pp. 50-51).

⁵⁰ In an often quoted doggerel, Senator Russell Long said:

Don't tax you,
Don't tax me;
Tax that fellow
Behind the Tree.

upper income earners, to the middle income wage earner. This shift is justified by the theory that increased capital in the hands of the productive supply-side of the economy will generate economic improvement to the benefit of all. Hall and Rabushka's proposal is must reading for anyone who accepts this economic philosophy.

The book is also a highly readable examination of what is wrong with the current income tax system. For this reason, it is valuable reading for anyone interested in the topic of tax reform, even though they may not agree with Hall and Rabushka's overall proposal. The suggestions regarding fringe benefits and taxation of banks and insurance companies may be particularly useful to policy planners and should be examined with care.