



## Kemp Commission Report: The Good, The Less Good, and the ...

### Tax Notes

January 29, 1996

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The Kemp Commission report represents a significant step forward in the long march toward replacing the current federal income tax with a new tax structure that is simple, economically rational and, therefore, consonant with the national interest. The report is also to be commended for highlighting the moral and ethical issues that are involved when, as at present, government uses the tax system to penalize saving, ration resources and regulate behavior, and in the process constrains our liberty and reduces our living standards to a degree that goes far beyond the amount of tax we pay. The incipient American tax revolution is about more than rational economics and the arcanities of tax accounting.

Many readers may have expected the report either to lay out the detailed operational structure of a new tax system of the commission's own making or to embrace one of the alternative tax structures already out in the public arena. That it did not do so, but, instead, stuck mostly to core principles that are important to nearly all the major alternative tax structures, is a large part of the reason the report is likely to have good consequences. It is hard to argue with the basic proposition of a neutral and, therefore, fair tax system that leaves to us the choice of how to conduct our personal and financial affairs.

Moreover, although the commission did stray somewhat into the area of tax architecture and recommend a single-rate tax system, it did so only in a generic sense, in recognition of the fact that any of the several already available alternative tax structures can have a flat tax rate. Therefore, it moved beyond rigid adherence to the confining structure of the Hall-Rabushka ("H-R") construct which has for so long been associated with a single-rate system that it had almost become definitional.<sup>(1)</sup> For proponents of a single-rate system (which I am not), this apparent new flexibility opens up greater opportunities for success. For one thing, they are free of the H-R limitation that mandates that wage income be included in the tax base at the individual level, but that interest, dividends, gains, and other returns to capital be excluded from the tax base at the individual level. Thus, if they wish, single-rate proponents can uniformly include both capital income and labor income in the individual tax base and, in both cases, allow a deduction for the amount of personal saving. When withdrawn from savings, all previously deducted amounts and earnings thereon would be taxed. Like a front-

end IRA, this tax-deferral approach to eliminating the tax bias against saving is more likely to be understood by the American people and to be enacted into law. Only economists readily understand and accede to the tax-exemption approach mandated by the H-R construct.

No longer being foreclosed by the H-R construct from having border tax adjustments for imports and exports, single-rate proponents can, if they wish, now implement the commission's recommendation that the new tax system be "territorial" in its application and have a more realistic expectation that the territorial rule would be enacted into law. Some advocates may advance a rationale for territoriality on a stand-alone basis, but it is not realistic to think that a territorial rule would actually be enacted unless accompanied by border tax adjustments such as are found in the USA tax and related alternative tax proposals.<sup>(2)</sup> The reasons are fairly obvious. Under a territorial system, U.S. companies that manufacture abroad for sale in foreign markets would pay no U.S. tax, and that is a correct result, but, absent a parallel export adjustment, companies that manufacture in the U.S. for export sale into those same foreign markets would be taxed. Absent an import tax, U.S. companies that manufacture abroad for sale back into the U.S. market would pay no U.S. tax, whereas companies that manufacture in the U.S. for sale in the U.S. would be taxed. Border tax adjustments and territoriality each have additional and separate merits of their own, but the combination of both is almost certain to be necessary for either to be enacted.

If the commission's report is as flexible as it appears to be insofar as concerns the structure of the new tax system, many good features are now available under a single-rate system, just the same as they have always been available under various multiple-rate systems that were never constrained by the H-R construct in the first place. All of the alternative tax structures, whether single-rate or multiple-rate, relieve the American people of the burdens of tax complexity and tax bias against saving.

The question then becomes, why the single rate? The case for lower marginal rates is impeccable, and proponents of a single rate often argue their case as if single and lower were synonymous, but, in fact, they are not. Further, as a practical matter, there is no such thing as a single-rate tax and the commission has not proposed one. Instead, like H.R. 2060, the commission recommends a "generous" level of tax-free income, which is the equivalent of a zero-rate bracket. Under H.R. 2060, for example, the exemptions are \$31,000 for a family with two children and \$41,000 for a family with four children, but these are probably only opening gambits and are likely to increase substantially as the 20 percent single rate in H.R. 2060 is increased to 25 percent or more to avoid major revenue losses. To point out that there are two rates, zero and 25 percent, may sound like hair-splitting, but the existence of the large zero bracket goes to the heart of the single-rate system and explains why it has consequences that, in my opinion, the commission did not fully come to grips with.

First, go back to the issue of lower marginal rates. It is obvious that a single-rate of 25 percent is lower than the rates of primary application under current law (28, 31, 36, and 39.6 percent). It is, however, also obvious that under a multiple-rate system, where large exemptions are not necessary, marginal rates could be reduced more than under a single-rate system where large exemptions are necessary. For example, a new three-rate system of 10, 15, and 20 percent with only a small amount of income exempt from tax, compared to a

new one-rate system of 25 percent with a large amount of income exempt from tax. It is a truism that the higher the level of exempt income, the higher will be the single rate and the higher the single rate, the greater the exemption level. Thus, at any given revenue yield, a single-rate tax does not necessarily achieve a lower marginal rate than a multiple-rate system. The opposite may be true.

Next, consider the pure, stand-alone argument for a single-rate tax. It is the classic case for a proportional tax where Mr. A's tax (\$25,000) is the same percentage of his income (\$100,000) as Mr. B's tax (\$12,500) is of his income (\$50,000). The idea that Mr. A should not be penalized for being more productive than Mr. B is an appealing principle, but the generous exemptions inherent in the commission's recommendation for a single-rate have already compromised this principle greatly and created a graduated tax. With a \$41,000 exemption in both cases, Mr. A would pay a \$14,750 tax ( $0.25 (\$100,000 - \$41,000)$ ), which is 14.75 percent of his income, whereas Mr. B would pay a \$2,250 tax ( $0.25 (\$50,000 - \$41,000)$ ), which is 4.5 percent of his income. On the other hand, it is unlikely that even these generous exemptions would make the single-rate system sufficiently "progressive" to satisfy critics to whom steep progressivity, equal to or greater than under present law, is an article of faith. Thus, the single-rate system departs from proportionality without neutralizing powerful political forces that, if they do not defeat tax restructuring altogether, are likely to either force a compromise on bedrock matters such as the savings deduction or to push the tax-exempt level under the single-rate system even higher.

Now, think about the single-rate system from a civics standpoint, and consider the problem that no one seems to talk very much about but that ought to be of the most fundamental concern to everyone without regard to ideology or political persuasion. Even at the levels currently contemplated, the exemptions will create a large class of taxless citizens who can vote for government and receive benefits from government, but who bear no part of the cost of government. If not immediately, certainly in the longer run as the tax exemption inevitably creeps farther up the income scale and the number of taxless voters increases accordingly, we face the clear danger of having created an overwhelming majority of voters who impose ever greater taxes on a minority of voters who pay all the tax at ever higher rates. It is one thing to have a modest zero bracket for the poor that is an innocuous ancillary to a multiple-rate system where everyone else pays some tax at some rate, no matter how low. It is quite another thing to make tax-exempt status, in and of itself, one of the defining elements of a new tax system and to extend that status on up into the middle class that includes nearly everyone.

Therefore, I would hope that those who follow the lead of the Kemp Commission would be as flexible on the single vs. multiple rate issue. They should consider a lower and flatter rate schedule with fewer rates and narrower brackets than under current law. A single rate tends to cause more problems than it solves.

#### **FOOTNOTES:**

1. Hall, Robert E. and Alvin Rabushka. *The Flat Tax*. 2d ed. Stanford: Hoover Institution Press, 1995, reprinted in *Tax Notes*, Special Supplement, Aug. 4, 1995.

2. USA Tax Act of 1995, as introduced in S. 722 on April 25, 1995, by Sen. Sam Nunn, D-Ga., and Sen. Pete Domenici, R-N.M.; Christian, Ernest S., and George J. Schutzer. "USA Tax System -- Description and Explanation of the Unlimited Savings Allowance Income Tax System," Tax Notes, Mar. 10, 1995, pp. 1481-1575.