

Fixing the Income Tax with the Fair Tax

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In 1985, we have six options for federal tax policy:

First, we can do nothing.

Second, we can impose some simple income tax surtax or rate increases.

Third, we might try to “muddle through” with another piecemeal package of tax loophole closers and revenue raisers, along the lines of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),¹ the abortive House and Senate deficit reduction packages of 1983,² and the Deficit Reduction Act of 1984.³

Fourth, we could move to replace the individual income tax with a personal expenditure tax.

Fifth, we could add a value-added tax (VAT) or a national sales tax (NST) to the federal tax system.

Sixth, we could fundamentally restructure our income tax, to make it fairer, simpler, less economically distorting, and more conducive to employment and productive investment.

This commentary recommends the last option as the soundest approach to federal tax reform and discusses the Fair Tax Act, which best restructures our income tax system.

I. *Facing the Deficits*

As is well known, the federal government is running unjustifiably large budget deficits: The fiscal 1984 deficit, at almost 5 percent of our gross national product, would be high by historic standards even for a recession year. For the second year of an economic re-

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1. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 U.S.C.).

2. See, e.g., H.R. 3475, 98th Cong., 1st Sess. (1983); H.R. 4170, 98th Cong., 1st Sess. (1983).

3. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C.).

covery and expansion, however, it is unprecedented.⁴

One argument in response to the outcry over high budget deficits is that they will go away with continued economic growth. Recent developments suggest that this argument is not valid. Despite unsustainably rapid growth in fiscal 1984, the deficit fell by only \$23 billion—from \$195 billion to \$172 billion.⁵ Even this progress is likely to be reversed in the coming years, as growth declines to a level more in keeping with the actual growth and productivity of our labor force. The Congressional Budget Office (CBO) projects a fiscal 1989 deficit of \$263 billion.⁶

A second defense of the current situation is that the deficit is harmless. However, federal government demands in the credit markets are absorbing a large share of our national savings, raising long-term interest rates, diverting capital from productive investment, and prolonging an international financial crisis. Only inflows of foreign capital have kept interest rates from going even higher, and those inflows have driven up the value of the dollar. The higher dollar has hammered our tradable goods industries and driven our balance of trade to record deficits. These deficits easily could provoke events that would abort the current expansion.

So the projected deficits *are* harmful, and they will not solve themselves. They are large enough that spending cuts alone cannot bring the budget close enough to balance. Doing nothing on the tax side (or on the spending side) is not an option.

II. *The Short Term Shortcuts*

The quickest approach to deficit reduction is simply to increase tax rates under the existing income tax. Such a course was recommended by President Reagan as part of his contingency tax package in the fiscal 1984 Budget. Because the logic of a separate surtax seems questionable in light of the long-term structural nature of the

4. In the last 15 years the deficit has risen astronomically. In 1970, the total deficit, including off-budget federal entities, was \$2.8 billion. Ten years later it had risen to \$73.8 billion. By 1983, just three years later, the deficit had grown to \$207.8 billion. See, OFF. OF MGT. AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT FY 1985, 9-60 (1984)[hereinafter cited as 1985 BUDGET]. According to the FY 1985 Budget figures, the estimated deficit for 1985, including off-budget entities, is \$195.2 billion. The Congressional Budget Office estimated even higher figures. See *infra* note 5 and accompanying text.

5. These figures do not include off-budget federal entities and are, correspondingly, less than the figures that account for these entities. CONGRESSIONAL BUDGET OFFICE THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE 55 (1984).

6. *Id.*

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deficit, it might be argued that tax rates could be increased in a permanent fashion instead.

However, raising income tax rates may be one of the worst ways to deal with the deficit. A rate hike, arguably, is unfair because the higher rates only increase the burden on those who already pay a fair share of tax while the most successful tax avoiders continue to escape taxation. Raising tax rates rewards and promotes tax sheltering and evasion, and penalizes the return to productive activity. While we must reduce the deficits, increasing tax rates would be a step backward in many respects.

III. *Muddling Through*

Other than raising rates or imposing a surcharge to reduce the deficit, we could continue to follow the pattern of the past few years and implement semi-annual "cats and dogs" tax reform bills that chip away at the deficit by picking up small increments of revenue.

It would be wrong to belittle the work of the tax-writing committees in 1982 and 1984. Although confronted with trying political circumstances, these committees produced two genuine tax reform bills that made the system fairer and attempted to lower the deficit. However, these efforts were not enough because every provision required a fight with a special interest group. This process is politically very painful and, moreover, the easiest targets have already been chosen for the first two rounds. The work of the 1982 and 1984 tax committees, therefore, is not likely to be repeated.

Furthermore, the 1982 and 1984 tax bills did not lead us toward a simpler, more rational tax law; on the contrary, they complicated things. Loopholes in the tax law were compromised rather than eliminated, and therefore are now half open and half shut. An example is the corporate alternative minimum tax in the 1982 law.⁷ Corporations are left wondering whether they will have to pay a partial tax on their tax preference items. Bizarre forms of business planning are encouraged in order to avoid or minimize the alternative minimum tax. This approach is hardly conducive to sound tax policy or sound business policy.

On all counts, "muddling through" has a low probability of suc-

7. I.R.C. § 56 (Prentice-Hall 1984) [hereinafter cited as I.R.C.]. For a brief overview of the legislative activity leading to enactment of the alternative minimum tax (which replaced the "add-on" minimum tax), see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶5.01 (4th ed., Cum. Supp. No. 2)(1984).

cess in dealing with the deficit and advancing our economic interests.

IV. *Consumption Tax Proposals*

In large part because the "muddling through" approach has left us with income tax preferences and exceptions that are both unfair and economically inefficient,⁸ there have been numerous proposals advanced over the past two years for an entirely different approach to raising basic federal revenue. These proposals are oriented toward taxing consumption, rather than income.

One alternative involves replacing the income tax with a personal expenditure tax. The personal expenditure tax is like an income tax except that all savings are tax-deductible and all borrowing and withdrawals from savings are taxable. An expenditure tax could be designed to have a greater revenue yield than the current income tax, but only if it retained high marginal rates.

Another approach to taxing consumption in order to narrow the deficit gap involves adding a transactions tax to the existing system. Such a transactions tax might be a "value-added" tax (VAT) or a national sales tax (NST) which, for all practical purposes, are equivalent. The VAT, already in use in the European Economic Community nations, and the NST would impose a sales tax on goods and services at each stage as they move through the production and distribution process. The primary difference between the present retail sales tax and both the VAT and NST is that the latter taxes are imposed in increments of value whereas the former is not imposed until the final transaction of consumption.

Perhaps the most popular argument for taxing consumption is that it would increase saving and investment because the return to saving would not be taxed directly, as it is under the present income tax. This argument is far from proven. The 1981 income tax cuts substantially reduced the tax burden on income from capital, just as

8. The questions of equity (fairness), efficiency and simplicity are the core issues presently discussed in terms of comprehensively restructuring the income tax. "Horizontal equity" means that taxpayers with equal abilities to pay taxes should pay equal amounts and that those with greater abilities to pay should pay more. "Vertical equity" stands for the actual amount by which the taxes paid by the taxpayer with the greater ability exceeds the tax liability of the other taxpayer. The goal of "economic efficiency" is that "taxes should interfere as little as possible with the incentives to engage in specific types of economic activity except to the extent that Congress intends such effects." "Simplicity," of course, is the attempt to make the system less complicated. See M. GRAETZ, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* (forthcoming, Foundation Press, 1985).

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a shift to consumption taxation would, but there has been no detectable increase in saving.⁹ Investment has increased, but no more so than in any typical economic recovery.¹⁰

Either a personal expenditure tax *or* a VAT would raise serious practical problems. The expenditure tax would involve a massive and difficult transition and a virtual reeducation of taxpayers from the income tax principles of seventy years' standing. A VAT would be an additional tax, requiring a new bureaucracy and an entirely new paperwork load. Finally, either proposal would tend to place the heaviest burden on average taxpayers who are forced to consume most of their income just to feed, clothe and house their families.

V. *Fixing the Income Tax*

Instead of approaches that are overly ambitious, like the personal expenditure tax, or others that are not ambitious enough, like the VAT or the piecemeal reform bills, we can take the income tax we have now and improve it to its full potential—reducing the deficit and helping the economy at the same time.

This strategy has two essential parts. First, income that now escapes taxation through legal but unjustified exclusions, deductions and credits must be brought back into the tax base. This increases fairness by treating taxpayers with similar incomes more alike and increases economic efficiency by eliminating distorting incentives to alter economic arrangements purely to reduce taxes. Moreover, it reduces the budget deficit by subjecting more income to tax.

The second part of the strategy is to reduce tax rates. The additional revenue raised by broadening the base will allow a reduction in rates without hampering efforts to reduce the deficit. Lower tax rates encourage work and investment, because the return on work is higher; they discourage tax sheltering and avoidance because the return on shelters is lower.

The Fair Tax was the first fully articulated approach to compre-

9. Personal savings declined to a 33-year low following the 1981 legislation. Norman Ture, who was Undersecretary of the Treasury for Tax and Economic Affairs at the time, stated that the decline was "not only a disturbing result. It [was] very surprising." Kilborn, *Americans Saving Less Now Than Before the '81 Tax Act*, N.Y. Times, Sept. 6, 1983, at A1, col. 2.

10. A number of economists have studied the effects of taxation on incentives to invest. In particular, they have studied the effects of corporate income tax provisions on business investment decisions. See, e.g., Auerbach, *Taxation, Corporate Financial Policy and The Cost of Capital*, 21 J. ECON. LITERATURE 905 (1983); A. AUERBACH, *THE TAXATION OF CAPITAL INCOME* (1983); M. FELDSTEIN, *CAPITAL TAXATION* (1983).

hensively restructuring the income tax along these lines. The Fair Tax alterations produce a fairer, simpler and more economically efficient income tax; the bill and its expected results show just how much we can accomplish—both for the economy and for tax policy—within the framework of our existing income tax.

VI. *How the Fair Tax Works*

The Fair Tax Act¹¹ is a coordinated effort to restructure both the individual and the corporate income taxes. It is designed to improve the income tax system on several fronts at the same time.

The goals of the Fair Tax are:

—To broaden the income tax base to include many of the *presently* excluded or sheltered sources of income, and to treat income more uniformly;

—To reduce income tax rates, thereby increasing incentives and reducing economic distortions;

—To maintain, for the most part, the current proportional distribution of the tax burden among household income groups and between households and corporations; and

—To retain the tax preferences that are generally available to most taxpayers and that are needed to avoid genuine hardship, and thereby increase the prospects for its enactment.

Achieving all of these goals requires a balance, with every part of the package dependent upon every other. Furthermore, the choice of tax rates is critical.

A. *Broadening the Tax Base*

Broadening the tax base is the price of lowering tax rates. Recent experience proves that cutting tax rates without repealing loopholes leads to fiscal disaster.¹² To pay for its rate reductions, the Fair Tax repeals more than forty tax preferences and modifies more than 100 sections of the tax Code. Many of the current Code provisions may have noble purposes, but as a group they tend to complicate the tax law and force tax rates up for those taxpayers to whom they do not apply.

One means of broadening the tax base involves bringing presently excluded items into the income base. Current law excludes

11. H.R. 800, 99th Cong., 1st Sess. (1985).

12. The 1981 tax cuts were the largest in peacetime American history. The federal budget deficit, however, has risen substantially since that year. See *supra* text accompanying note 4.

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items of income received by people occupying all levels of the income scale. The Fair Tax repeals many of these exclusions. Tax rates are then reduced and adjusted, to avoid shifting the tax burden to any particular income group. Some of the most important tax exclusions are discussed here.

(1) *Fringe benefits*. Employer-provided fringe benefits are one of the most costly and fastest-growing tax preferences. Tax exemption of employer-paid health insurance premiums will cost about \$28 billion in fiscal 1985,¹³ and life insurance premiums will cost another \$3.2 billion.¹⁴ The projected revenue loss for fiscal 1989 from employer-paid health insurance and life insurance premiums is \$34.1 billion and \$3.6 billion respectively.¹⁵ Recent expansions of fringe benefits into dental and legal insurance and day care reduce revenues still more.

These preferences feed on themselves. Employees prefer fringe benefits to cash because fringes are not taxed at high marginal tax rates. The more fringe benefits are used, the narrower the tax base and the higher the tax rates must be; these higher tax rates then make fringe benefits even more attractive. The growth of fringe benefits and the deterioration of the income tax system have gone hand in hand.

The Fair Tax repeals the exclusions for employer-paid health, life, dental and legal insurance, and employer-subsidized day care. Because these benefits are, in substance, employee compensation, they also become taxable under the social security payroll tax. The Fair Tax also reduces by one-third the maximum for tax-exempt employer contributions to pension plans, which can be used by highly compensated professionals as vehicles for accumulating large amounts of tax-exempt savings. These modifications allow rates to be substantially reduced under the Fair Tax.

(2) *Capital gains*. Current law allows an exclusion of 60 percent of all long-term capital gains (that is, gains on capital assets held longer than six months), at the cost of about \$27 billion of revenue in fiscal 1985.¹⁶ This exclusion is intended as an incentive for investment and a compensation for inflation. However, the percentage exclusion is an accurate compensation for inflation only in rare

13. 1985 BUDGET, *supra* note 4, at 5-113.

14. *Id.* at 5-134.

15. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., OVERVIEW OF THE TAX TREATMENT OF FRINGE BENEFITS 18 (Comm. Print 1984).

16. 1985 BUDGET, *supra* note 4, at 5-72.

instances and only by coincidence;¹⁷ a better incentive for investment is to tax profits uniformly and at the lowest possible rate. There is little evidence that a large exclusion for capital gains is a greater incentive for overall investment than would be low uniform tax rates for all forms of investment income. This exclusion is one of the most important elements of many tax shelters, producing conspicuous unfairness and considerable economic waste and misallocation of resources. The capital gains exclusion enormously complicates tax law and administration, tax forms and instructions, and business planning. The large exclusion motivates considerable effort to convert income that would be taxed at ordinary rates into income that will be taxed at the more favorable capital gains rates. Another effect of the capital gains rule is that there is a large effort made to convert capital losses to ordinary losses.

The Fair Tax repeals the capital gains exclusion. The resultant increase in revenue will finance substantial tax rate cuts, especially at the upper end of the income scale where much income consists of capital gains. The lower rates should encourage saving and investment, and the more neutral treatment of different forms of capital income should reduce distortions and abuse.

(3) *Oil and gas subsidies.* Other prominent tax preferences subsidize the oil and gas industries.¹⁸ The expensing (i.e., immediate write-off) of intangible drilling costs allows immediate tax deductions for development costs that, in other industries, would have to be capitalized and deducted over the lifetime of a project. "Percentage depletion" allows independent oil firms to claim annual deductions for the wasting of an oil-producing property even if the deductions eventually come to more than the total cost. These two provisions will cost the Treasury about \$3 billion in 1985.¹⁹ They were intended to encourage domestic oil production, but with prices decontrolled the market provides adequate incentives. Expensing of intangibles and percentage depletion are frequently combined to produce highly lucrative tax shelters. The Fair Tax repeals these two tax subsidies and places oil and gas investments on a par with investments in other industries.

(4) *Depreciation.* The 1981 Reagan tax cuts greatly accelerated depreciation allowances for investments in plant and equipment

17. See M. GRAETZ, *supra* note 8, at ch. 5 (the capital gains exclusion is a "rough and ready" means of accounting for inflation).

18. I.R.C. §§ 263(c), 611-17. Section 613 concerns "percentage depletion," and § 263(c) allows for the immediate expensing of "intangible drilling costs."

19. 1985 BUDGET, *supra* note 4, at 5-46.

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through the Accelerated Cost Recovery System (ACRS).²⁰ ACRS lumps most equipment investments into a class depreciated over five years, with a few assets written off over three to ten years. The bunching of many assets with differing lifetimes into a single class makes the tax system favor some assets over others, introducing distortions. The investment tax credit (ITC)²¹ can magnify these distortions.

ACRS, coupled with the ITC, is so generous that some investments actually receive net subsidies from the tax system; the effective rate of tax over the lifetime of the asset is *negative*. This applies to some structures, as well as equipment, where they are written off over unrealistically short periods. Tax shelter experts were quick to see the possibilities, and have combined ACRS, the ITC, and some creative accounting to produce some highly profitable shelters. Since ACRS was enacted, tax shelter investments have been growing at increasingly faster rates.²²

The Fair Tax repeals the ITC and replaces ACRS with a new “open accounts” depreciation system that does not distort investors’ choices among different assets. The new system attempts to mirror the actual wearing-out of investments—called “economic depreciation”—and thus does not allow the overgenerous acceleration that encourages tax shelters. Furthermore, the Fair Tax system simplifies tax accounting for business.

(5) *Tax-exempt financing*. States and localities recently have taken increasing advantage of their authority to issue tax-exempt securities for private, rather than public, purposes. Industrial revenue bonds and industrial development bonds have been used to raise money for below-market mortgages; pollution control bonds have been issued to pay for capital expenditures for pollution control by businesses. These bonds have admirable purposes, but they have flooded the market for tax-exempts and thereby increased the interest rates that all states and localities have to pay even for public pur-

20. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 203 (codified at I.R.C. § 168).

21. I.R.C. §§ 38-52.

22. “As of September 30, 1982, 284,828 returns with tax shelter issues were in the I.R.S. examination process, an increase of 36,000 returns over the prior year. . . . [T]axpayers invested \$8 billion in ‘tax-advantaged investments’ (excluding IRAs and municipal bonds) in 1981 and \$9 billion in 1982, and will invest an estimated \$11 billion in 1983. . . . [I]nvestments in public tax shelters . . . for the first quarter of 1983 were 53 percent higher than they were one year [earlier].” STAFF OF JOINT COMM. ON TAXATION, 98th Cong., 1st Sess., BACKGROUND OF TAX SHELTERS 5 (Comm. Print 1983).

poses. Attempts to cap the use of these bonds have proven extremely difficult due to political forces.

The Fair Tax retains the exemption for general obligation bonds but repeals the tax exemption for all new private-purpose bonds issued by states and localities. This plugs a growing leak in the tax base, and helps state and local governments by cutting back on the supply of tax-exempt instruments in an already crowded market.

B. *Itemized Deductions*

In addition to augmenting the income base by bringing presently excluded items back in, the Fair Tax also cuts back on itemized deductions from taxable income.

(1) *Medical expenses.* Medical care costs in excess of 5 percent of adjusted gross income (AGI) are deductible under the current tax law.²³ The purpose of the deduction is to provide relief to taxpayers with extraordinary medical bills. But with medical costs now running at closer to 10 percent of total consumption in the economy, the 5 percent threshold really does not screen out all routine medical care costs.

The Fair Tax raises the AGI threshold for the medical cost deduction to 10 percent. This allows lower tax rates for all taxpayers, and maintains relief for those with extraordinary medical expenses.

(2) *State and local sales taxes and miscellaneous taxes.* Current law allows a deduction for state and local sales taxes. This deduction is a small and predictable fraction of income—about one percent on average—making it an unlikely candidate for relief as an itemized deduction. Even so, it can be the subject of considerable paperwork, because some taxpayers actually add up all of their sales tax payments for the year (instead of using the tables that the IRS provides, which tend to understate the tax). Other state and local taxes, including personal property taxes, are also typically quite small. To lower rates further, the Fair Tax repeals all of these deductions, leaving only the deductions for income and real property taxes. This broadens the tax base, and simplifies and reduces paperwork.

(3) *Consumer interest charges.* The current law's deduction for consumer interest acts as a subsidy for consumption-oriented borrowing, and therefore discourages saving. Consumer interest deductions also violate the tax principle that interest should be deductible only when it is a cost of earning income. This objection

23. I.R.C. § 213.

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applies to all forms of non-business, non-investment borrowing, including home mortgages. Cutting back on the deduction for mortgage interest would be extremely painful, however, because many existing mortgages were written for a long term in the expectation of a mortgage interest deduction. In addition, the deduction for mortgage interest plays a considerable role in determining the value of existing homes.

Another complication in dealing with the interest deduction is the fungibility of money. For example, a taxpayer can finance an investment by buying a car on time instead of paying cash, implicitly making the auto loan an investment loan. Repealing the deduction for interest on auto loans would deny this investor a legitimate offset for a cost of making his or her investment.

The Fair Tax deals with these problems in a pragmatic but structurally sound way. The mortgage interest deduction is retained. Other consumer interest deductions may be claimed in amounts not to exceed investment income. Thus, interest expenses are assumed to be costs of earning income to the extent that the taxpayer has investment income—the most reasonable rule.

Thus, the Fair Tax makes selective repeals and cutbacks of itemized deductions in order to reduce tax rates as much as possible for everyone. But the value of *all* itemized deductions is cut back, in that the tax rates against which those deductions apply are lowered.

C. Protecting the Low-Income Taxpayer

The 1981 tax rate cuts left the personal exemption and the zero-bracket amounts (ZBAs) (i.e., the standard deduction) unchanged. Because there has been considerable inflation since the last time these amounts were increased, low-income taxpayers have faced considerable tax increases in real terms, even with the rate cuts. In particular, poverty-level incomes that have merely kept up with inflation are now unable to claim the exemption and ZBA and therefore have incurred increasing tax liabilities. One essential task of tax legislation in 1985 is to remedy this oversight in the 1981 law.

Even taxpayers who do not itemize their deductions may claim deductions equal to the zero-bracket amount. The ZBAs for married couples and single persons have been \$3,400 and \$2,300 respectively since 1978.²⁴ Increasing the ZBA increases the maximum amount of income that low-income people can earn without paying

24. I.R.C. §§ 1,3, 63(d).

tax. It also reduces mostly the taxes of low- and middle-income people, because upper-income people tend to itemize their deductions. The ZBA simplifies tax filing for some people who now itemize marginal amounts of deductions; it allows these taxpayers to claim the standard deduction instead of completing the work necessary to file for itemized deductions.

The Fair Tax increases the ZBAs substantially, to \$6,000 and \$3,000 for married couples and single persons respectively. The 2 to 1 ratio eliminates one structural cause of the marriage penalty, which arises when two working people marry and their new ZBA is less than the combined ZBAs that they used to claim when they were single.

The personal exemptions claimed by taxpayer, spouse and dependents have been \$1,000 each since 1978.²⁵ (Taking into account the personal exemption credit repealed in 1978, the exemptions in effect have not been changed since 1976.) Extra exemptions for the elderly and blind are \$1,000 each as well. The value of these exemptions has been eroded substantially by inflation.

Like the ZBAs, the exemptions increase the amount of income that people can earn before paying tax. But unlike the ZBAs, the exemptions cut taxes for people all the way up the income scale, and increasing them does not simplify the tax filing process.

For these reasons, the Fair Tax concentrates its relief on increasing the ZBAs, but it also increases some personal exemptions to keep them in reasonable proportion to the ZBAs. The exemptions for taxpayer and spouse are increased from \$1,000 to \$1,600, but the other exemptions (dependents, elderly and blind) remain at \$1,000.

With all these changes, families of four can earn up to \$11,200 (a \$6,000 ZBA, two \$1,600 taxpayer exemptions, and two \$1,000 dependent exemptions) and pay no tax. This will raise the tax-free income level above the officially determined "poverty line."

D. *Reducing and Simplifying Tax Rates*

Given the Fair Tax changes in the tax base and the low-income relief provisions, it is essential to adjust the tax *rates* to prevent unintended shifting of the tax burden. By holding the distribution of the tax burden approximately unchanged by income group, the Fair Tax minimizes the chance that several tax-base-broadening steps

25. I.R.C. § 151(b)(e).

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will compound each other and leave some groups with substantially higher taxes.

Because of its particular tax base and low-income relief steps, the Fair Tax can hold the tax burden unchanged with a new two-part rate schedule. The first part is a flat 14-percent tax on taxable income. This simple tax, called the “basic tax,” will be *the only tax for about 80 percent of all taxpayers*. This eliminates much of the complexity of graduated rate schedules in terms of computation, income averaging (which the Fair Tax repeals for this reason), and the marriage penalty (the Fair Tax has no marriage penalty for taxpayers subject only to the basic tax). It is also easier for taxpayers to understand.

Most of the population is subject only to the 14 percent basic tax rate. However, if the low basic rate were the only tax imposed on upper-income taxpayers, the government would lose a significant amount of revenue and these taxpayers would gain an enormous windfall. The Fair Tax, therefore, maintains progressive taxation through an additional tax, or surtax. The surtax has two brackets: Married couples pay a surtax of 12 percent on adjusted gross income (AGI) (not taxable income) from \$40,000 to \$65,000, and 16 percent on AGI above \$65,000. For single people, the boundaries are \$25,000 and \$37,500. The combined maximum tax rate (basic plus surtax) is 30 percent, substantially below the current law’s maximum of 50 percent, but the 30 percent raises the same revenue because the tax base is broader.

One reason the upper bracket rates can be reduced is that the surtax applies to AGI instead of taxable income and, therefore, itemized deductions do not reduce the surtax. The only exception to this restriction involves mortgage interest and other consumer interest expense which may be deducted to the extent of the investment income. As with the deduction for non-mortgage interest under the basic tax, this provision allows an offset for what are implicitly costs of earning investment income.

The Fair Tax repeals indexation of tax rate brackets, exemptions and ZBAs. This is done because the Fair Tax already increases the personal exemptions and the ZBAs far more than would indexation. Second, since the Fair Tax has only three tax rate brackets (and 80 percent of all taxpayers are in the lowest bracket), the problem of bracket creep is largely eliminated by the basic structure of the tax. Third, Congress has always cut taxes at its own discretion to compensate for inflation, and probably would continue to do so under

the Fair Tax. However, if high inflation again becomes a serious problem, indexing can be added.

Corporate tax rates, now designed as a graduated system ranging from 16 to 46 percent, are simplified to a flat rate of 30 percent. This raises the same revenue as the current law because of the broader base that primarily results from the repeal of the ITC and the reform of the ACRS. The equality of the corporate rate and the highest individual rate will prevent manipulation of personal service corporations to avoid individual income taxes. The Subchapter S provisions, continued from the current law, allow small corporations to avoid higher taxes that otherwise would result from the elimination of the graduated corporate rates.

VII. *The Effects of Adopting the Fair Tax*

A. *Impact on Individual Taxpayers*

Because individual tax returns today vary in almost infinite detail, it is impossible to show precisely how every taxpayer would be affected by the passage of the Fair Tax without literally recomputing every return. In general, however, the average taxpayer at any given income level would receive a small tax cut. This is because the average taxpayer gains little from the tax preferences that would be repealed but would benefit from the tax rate cuts. In contrast, those who now use tax preferences to pay little or no tax would pay more.

To illustrate this pattern, the Congressional Joint Tax Committee computed the tax liabilities of taxpayers claiming average amounts of deductions and exclusions under the current 1985 law and under the Fair Tax. Their results are reproduced in the table below.

Examples of Tax Liabilities Under Current Law and the Fair Tax			
	Adjusted Gross Income	1985 Combined Income and FICA* Tax	Fair Tax Combined Income and FICA* Tax
Two-Earner Married	\$ 15,000	\$ 1,897	\$ 1,874
Couple with Two	30,000	5,145	4,783
Dependents	40,000	7,151	6,919
	50,000	10,060	9,991
	60,000	13,144	12,873
	120,000	31,170	26,975
One-Earner Married Couple	10,000	956	811
with Two Dependents	20,000	3,087	2,937

*Federal Insurance Contribution Act (i.e., the federal tax imposed on employee compensation).

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B. *Impact on States and Localities*

For the states, the most pertinent change in the federal tax system will be the availability of a reformed revenue-raising instrument. Many states try to keep their income taxes similar to the federal tax system for the convenience of their taxpayers. When they want to increase revenues, states face a dilemma: They can increase their tax rates on what is basically an unfair and inefficient federal income tax base, or they can broaden their own tax bases at the expense of greater complexity and confusion for their taxpayers. The Fair Tax will give the states a broader, fairer and more solid income tax base from which to raise their revenue. If the states must increase their tax rates, they can do so with the knowledge that the additional revenue would be raised from a more structurally equal perspective.

State and local governments will be affected to some degree by the Fair Tax's repeal of the deductibility of sales and personal property taxes. However, these deductions are not the same as subsidies to the states in that they do not increase state revenues. To the extent they reduce the pain of imposing and paying these taxes, the effect is marginal at best and does nothing to compensate the majority of taxpayers who do not itemize.

Similarly, the Fair Tax's repeal of the exclusion of interest on private-purpose tax-exempt bonds will inflict a minimum of pain. This tax exemption has often forced localities into a bidding war with one another for the dubious purpose of providing cheap financing for private businesses. In the meantime, the rising tide of tax-exempt bonds has increased the interest costs of public-purpose borrowing. Even with a maximum 30 percent tax rate, states and localities will be no worse off in floating their own debt for traditional purposes.

C. *The Result*

In comparison to an additional tax, like a VAT, or a totally new tax, like a personal consumption tax, the Fair Tax is a collection of relatively small, manageable steps. But the whole is more than the sum of its parts, and the result is a substantial step forward in tax policy.

First, the tax base is made substantially broader and more neutral. Different investments are treated more equally, thereby eliminating an unwanted tax influence in business decision-making.

Second, because of the broader tax base, tax rates can be reduced substantially. This increases incentives for work, saving and investment, and decreases the rewards of tax avoidance.

Third, the repeal of many preferential tax provisions greatly simplifies the tax law and its forms and instructions. With so many opportunities for tax minimization and sheltering eliminated, business planning will revolve around making the highest profit in the marketplace without regard to the tax consequences—which is as it should be. The simplified rate structure, with its large first bracket, gives lower- and middle-income taxpayers a much clearer and simpler picture of how their tax liabilities are determined. The lower rates reduce the general intrusiveness of the tax.

Finally, with fewer opportunities for abuse and with more income subject to tax at progressive rates, the Fair Tax is more fair than the current law. With the repeal of the numerous shelter-enabling tax loopholes, the lower rates, and the more generous low-income relief, taxpayers will see and appreciate this greater fairness and simplicity.

It is the careful balance among its provisions that makes those improvements administratively workable and politically feasible.

D. *The Deficit*

The Fair Tax was designed to replace, in its first year, precisely the same revenue raised by the current tax system. The reason for this choice was to allow an “apples-and-apples” comparison between the Fair Tax and the current law; any alternative that raises more revenue will seem less attractive by any but a highly sophisticated comparison. Furthermore, any program to reduce the deficit will be multifaceted and income tax reform will be only one part. Any isolated judgment on how much of that burden should be placed on the income tax would be premature. Nonetheless, the Fair Tax as it stands would make a substantial contribution to reducing the budget deficit. In future years, the Fair Tax would raise increasingly more revenue than the current law. By 1989, it alone would raise \$30 billion more. Whatever the ultimate choice for a comprehensive tax and spending program to reduce the deficit, the Fair Tax is an essential part. We cannot build such a program on a tax system whose most important part—the income tax—is unfair, economically distorting, and overly complex. We cannot ask families who are now disproportionately taxed to pay more. The Fair Tax puts our revenue base on a sound footing from which we can launch our attack on the deficit and prevail.

Fixing Income Tax with Fair Tax

VIII. *Conclusion*

Like any meaningful reform of a long-standing and complex system, enacting the Fair Tax will take a lot of effort. Average taxpayers will lose some tax preferences, but in exchange for lower tax rates. And taxpayers must be shown that they will be better off in the bargain. Special interests that win big from the current system will oppose the Fair Tax, as they have opposed narrower reforms in the past. Despite the Fair Tax's generous transition provisions, some investors, particularly those with tax shelter investments, will be hurt and will protest vehemently.

But a major problem with the income tax is that the bulk of taxpayers pay too much while others pay too little. To solve that problem, the latter group will have to pay more. To the extent that taxes have been avoided through manipulation of investments, the values of those investments will fall. This is a transition problem that can be lessened with transition rules such as those provided by the Fair Tax, but it cannot be avoided entirely.

If we realize what is at stake, and put the general interest first, we can have a tax system that will allow us to grow and prosper. The Fair Tax can bring us closer than we have ever been before to the goal of being united in a fair and cooperative partnership rather than being divided by a complicated, inefficient and unfair income tax system.