TAX POLICY REVISION — IMPLICATIONS FOR FAMILIES

Edward J. Metzen
University of Missouri-Columbia

Proposals for federal income tax reform center around the themes of fairness, simplicity, and economic growth. There seems to be widespread consensus that the tax system is in need of reform, although the public mind is currently (and appropriately) very much on the federal deficits — a matter not unrelated to tax policy. In fact, if tax reform is achieved, it may be as a result of public concern over the national debt; there may be public unwillingness to pay higher taxes without reform. My remarks focus on a few key aspects of proposals under consideration, primarily those of the administration; they include assessments, implications for families, and some alternative proposals, organized around the concepts of fairness, simplicity, and economic growth.

Fairness

Consumption Tax as an Alternative to Income Tax. A tax on consumption — whether sales, value added, transactions, or other type — is not an acceptable alternative from the standpoint of fairness. Such taxes are regressive; they have their relatively heaviest impact during hard times when people draw down savings or go into debt to maintain consumption levels; they would contribute to increasing maldistribution of wealth and income; and they would exempt high income persons to a substantial degree from contributing their full share of support for the society that enables them to gain the prestige and benefits they are able to enjoy through the acquisition of high income and wealth. Surely persons of wealth have relatively more at stake in the existence of our costly military establishment than do those of modest or no economic means; dollars diverted into savings to accrue that wealth should not be exempt from providing their share of the cost of our collective well-being.

Share of the Tax Burden. The administration voices — unwisely — a commitment to a tax reform bill that is "revenue neutral." The share of total income tax paid by households in various ranges of the income spectrum would remain essentially intact. Families below the poverty line would pay no income tax, although low income single persons would still face a tax burden. The president's proposal moves substantially in the direction of granting greatest relief to those with high incomes. While low income households would receive the largest percentage reduction in their income taxes, families above $200,000 income would get bigger percentage reductions in taxes than those with incomes between $20,000 and $200,000. And the Center on Budget and Policy Priorities has calculated that under the president's plan, the advantage would accrue heavily to higher income persons in terms of both absolute dollar amount and as a percentage of income. The reductions for those below $200,000 income would range from .4 percent to .7 percent of income — about $100 for those below $10,000 income, about $250 for those between $50,000 and $100,000. By contrast, for those above $200,000, the average reduction would be about 2.3 percent or $9,250 per year (based on 1983 income data) [7]. The effect of the president's plan, then, would be to contribute to the increasing maldistribution of income and wealth that has been developing in recent years. The proposed relief for the poor, while significant in relative terms, would simply enable them to regain some of the ground they have lost to the tax system in recent years, and would still leave some working poor facing a harsher total income and payroll (Social Security) tax bite than they were in 1978. (We must begin to factor Social Security taxes into the assessment of tax burdens, for that payroll tax underwrites a major social support component of the federal budget. The Social Security tax is regressive in its formula, and totally exempts property income from support of elderly, disabled, and dependent persons who receive Old Age Survivors' Disability and Health Insurance (OASDHI) benefits.

If the tax-favored elements proposed for elimination constitute inequity, then the end result of reform should be a shift in the total tax burden toward those who have been benefitting from such inequities — primarily those at the upper end of the income distribution. Such a result would require steeper progressivity — in particular, a higher top rate — than that proposed by the administration. But under the president's proposal, the reduced rates on high incomes would more than offset the proposed base-broadening through elimination of elements of favored treatment.

Capital Gains Treatment. The favored treatment accorded capital gains should be eliminated. To the benefit of everyone, a source of inflationary bias would be reduced because the price structure for assets which formerly benefitted from favored treatment would decline; and inflation-created gains will be less attractive than they currently are. President Reagan's proposal to further reduce tax rates on capital gains would increase inequity in the tax structure and contribute to the further maldistribution of wealth and income; the benefits would accrue almost entirely to persons in the top 5 percent of the income distribution.

Corporate Tax. The corporate income tax should be fully integrated with the individual tax so that individuals would each pay tax on their share of corporate earnings at their own marginal rates. The corporate structure enables high income persons to avoid high marginal rates on retained earnings, and then enjoy the benefits of the lower capital gains rates when they profit from those retained earnings through increased share prices. Further, the corporate tax is to some unknown — but certainly very high — degree spread to consumers in the form of higher prices, and to that extent has the effect of being a regressive consumption tax. In absence of integration, the corporate income tax should be retained and strengthened.

Taxation of Benefits. Taxation of employee benefits, unemployment compensation, worker's compensation, veterans' disability benefits, and a portion of Social Security benefits is appropriate since they are part of income. If a portion of benefits is to be free from taxation, it should be a basic, initial amount; President Reagan's proposal that a basic amount of employer-provided health insurance coverage be taxed and coverage above that amount be tax-free is regressive and makes a mockery of egalitarian rhetoric.

Deductible Items. Personal deductions should be eliminated, including those for consumer credit charges, home mortgage interest, state and local taxes, charitable contributions, and other items, with the exception of involuntary expenditures for health care and casualty losses. Deductibility is regressive under a progressive rate structure. Favored tax treatment for expenditures creates inequities and inefficiencies by subsidizing individual choices and raises the price structure and self-indulgence relative to favored items. Where allowances are to be made, they should be provided as credits to create progressivity and reflect the higher marginal utility of money for those with lower incomes. The favored treatment accorded the untaxed, but tax-deductible, appraised appreciation of property contributions particularly cries out for reform. While credits for health care costs can be justified, there is need for a national health care financing program to safeguard people against the ravages of health care costs, rather than merely providing some relief through the tax system.

Exemptions and Credits. Maintaining zero-bracket amount, exemption allowance, earned income credit, and child care credit is desirable. They are relatively more important to families at the low end of the income spectrum; proposed increases for the first three are desirable. The child care allowance, to be equitable, should remain a credit rather than be changed to a deduction as proposed. Further, if we are a nation that truly believes in equality of opportunity for individuals, the exemption allowance should be changed to a credit. The current system, which gives persons who safeguard income from high marginal rates a larger tax reduction than persons with low marginal rates, constitutes a regressive personal allowance.

Two-Earner Allowance. The two-earner allowance should be retained as a reflection of greater expenses and reduced leisure and household production time available to two-earner couples. While treating the individual, rather than the family, as the taxable unit would have a number of desirable consequences, and be particularly desirable in light of today's living patterns, so long as the family is a tax unit, the two-earner allowance should not be eliminated. While tax policy should perhaps not be utilized to encourage the traditional family structure, surely tax policy should not penalize marriage.

Dividend Exclusion. It is equitable to eliminate this exclusion, as proposed, and treat dividends as if they were additional earned income.

Indexation. While indexation is in a sense appropriate in its intent and effect, in the context of indexation of other factors (Social Security, some labor contracts) it serves to help institutionalize and sustain the rate of inflation. It would be better if appropriate legislative adjustments could be made in timely fashion in light of circumstances.

Tax-Deferred Saving. President Reagan's proposal to eliminate the 401-K provision for tax sheltering retirement programs is desirable in its nature, but inequitable. This avenue has been adopted by a substantial and increasing percentage of middle income earners, particularly those working for modest size businesses, and the proposal would remove it while leaving other similar avenues untouched. A desirable and equitable reform would be to eliminate all avenues of tax deferral, including IRAs, Keoghs, company pension plans, and tax-deferred annuities. They shift the tax burden or increase the federal deficit (and thus create inflationary pressures in the short run). They all favor those who can shelter the most dollars and who avoid the highest marginal rates, and thus constitute a source of inequity. They contribute mightily to the long-run maldistribution of wealth and income, and thus speed us down the road toward a have versus have-not society in which those with huge stocks of accumulated wealth can live in luxury and bid up the prices of goods and services, and an increasing percentage of the population inevitably must be supported via transfer programs or live in serious relative deprivation. When sheltering increases the national debt, the net effect of the policy is to enable individuals — particularly high income persons — to avoid paying their share of the national bill, and instead to purchase a portion of the resultant debt with their tax-avoidance savings and then charge the rest of society interest on it. The accompanying table illustrates how dramatic this effect can be over an extended time; the potential for shifting the tax burden to others (including people of lesser means) and/or for increasing the national debt is not only inequitable but alarming.

Further equity calls for elimination of favored treatment for selected saving media such as life insurance.

Tax Treatment of Business. Elimination of every loophole and in-

TABLE 1

FUTURE VALUE OF $2,000 (IRA) AND $30,000 (KEOGH) ANNUITIES DUE COMPOUNDED AT 10% ANNUALLY IN TAX-DEFERRED AND NON TAX-DEFERRED SAVINGS VEHICLE

Yrs	Annuity	Marginal Tax Rate	Non-Tax Deferred	Tax-Deferred	Shifted Burden
10	2,000	15%	$27,363	$35,062	$7,699
	30,000	35%	$280,245	$525,935	245,690
40	2,000	15%	$545,386	$973,704	$428,318
	30,000	35%	$3,647,436	$14,605,554	$10,958,118

equity in the personal income tax structure will not leave the public feeling that the tax system is fair unless reforms are also undertaken regarding business taxes. A public that reads and hears regularly about subsidies to business via tax expenditures, and about ostentatious personal consumption under the guise of business expense, will continue to be appropriately restive about the system and increasingly grudging about paying its fair share. The subterranean economy will be further stimulated if such circumstances continue. Elimination of favored treatment in this arena will contribute somewhat to the federal revenue side. It will contribute to efficient business practice, and remove a source of inflationary price pressure. Most importantly, it will contribute to a sense of fairness in the tax system among the populace.

Other Needed Reform. Fairness in the overall tax structure can be achieved only if there is also equity regarding taxes on the transfer of assets by gift or at death. Policy in that area has been toward allowing increased accumulations of assets to go untaxed.

Simplicity

While proposed reforms would greatly simplify the tax code, significant simplification will come only for those who currently utilize the maze of tax provisions to reduce their taxes. Tax return filing will not be affected for the vast numbers of taxpayers who file short forms. The information required on those is minimal, and the process almost as simple as it can be. The proposal to provide a return-free billing system would enable many to avoid even that step. For most people, the sense of complexity grows not out of their own actual tax returns, but out of the sense that others are gaining advantage through the myriad provisions for favored tax treatment. This is an all-too-accurate perception that leads many to dig through records and ponder their circumstances to try to gain similar advantage, before finally completing their basically simple, straightforward returns. Flat rate or modified flat rate structures are bally-hooed as contributing to simplicity, but the claim is much overdone. The progressive, multiple rate category structure is certainly not one of the more challenging aspects of tax return filing. Multiplying and adding numbers is a relatively simple exercise, once one has determined what the correct applicable number — taxable income — actually is. A structure with only a few rates loses incremental progressivity and creates disjunctions in tax treatment at levels of change in marginal rates.

Economic Growth

Economic growth will be enhanced by elimination of tax provisions that currently distort economic decisions and lead to inefficiency in resource allocation and utilization. Creation of a climate in which such decisions are made on the basis of economic factors alone, rather than harkening to the siren song of favored tax treatment, will accrue in varying degree to everyone in the society.

Gainers, Losers, and Hazards

Everyone will be affected to some degree by tax reform, even if his/her tax bill is unchanged. Among those who stand to lose are persons whose livelihoods are garnered from guiding others to their greatest personal advantage through the labyrinth of our current complex revenue code, and those who have taken advantage of a host of provisions to reduce their tax bills, some of whom have come to depend in substantial measure upon favored tax treatment to provide their incomes. Those with a financial interest in selected industries and in tax-shelter devices built on excessive depreciation, as well as nongovernment beneficiaries of tax-exempt bonds from which favored treatment may be removed, would pay a higher, more equitable share of taxes. Of course, those who would gain relatively most from tax reform are those who have benefitted little, or not at all, from favored treatment on either the income or the expenditure side. In terms of desirable objectives of tax reform, the initial treasury proposal is much preferable to the president's proposals, which show signs of retrogression toward (and beyond) the shortcomings of the current code.

True reform will require political courage and public vigilance and support lest reform be prostituted by powerful self-interest groups. The masses of citizens must not be bamboozled into accepting reduced rates and rhetoric as a substitute for attainment of equity. We must not allow ourselves as a nation to buy a program of "trickle-down tax reform" under the guise of enhancement of fairness, simplicity, and growth. Not only would such a result be inequitable, but unhealthy societal discontent would set in when the reality became clear. The masses must be willing to give up their modest breaks under current law as a bargain price for achieving elimination of the huge breaks enjoyed by others, and adoption of equitably reduced rates for everyone. Beyond that, improved enforcement is essential to assure compliance.

The Context

Reform is being considered in the context of several factors that erode our egalitarian self-image and offend our sense of fairness. We have over the past few years endured an incidence of poverty higher than at any time since the late 1960s. Many citizens have been completely untouched by any benefits of the economic recovery; indeed, policy during this period has worsened their condition. Inequality in the distribution of income in 1984 was greater than it has been since the late 1940s. The gap between the rich and the poor widens [2]. Meanwhile, the Treasury Department reports the following for 1983: While the average American family paid a federal income tax of 13 percent, 5,395 people with income above $1 million paid less than 10 percent, and 2,225 paid less than 5 percent; 30,000 households with income above $250,000 paid less than 5 percent; 1,900 households with $250,000 or more income, including 300 with income over $1 million, paid zero tax! [3]. Given the combination of exemption of savings and capital income from the income tax via various forms of favored treatment; the Social Security tax on payroll, sales and other direct consumption taxes; and the fact that the corporate tax is in substantial measure passed along as a consumption tax, we have in total moved strongly in the direction of taxing labor and consumption, while freeing capital income from an equivalent share of the tax burden. Our tax structure enables some corporations, owned primarily by people of substantial means, to enjoy a negative income tax — something we have been unwilling to adopt as a means of directly sustaining human beings with inadequate incomes.

Portents

We may be approaching a Waterloo for effective participatory democracy. Our federal deficits indicate that we are not rich enough to afford everything we insist on having as a nation, while our tax code suggests that many are too greedy to pay their fair share of the tab. The economic and social implications are ominous.

President Reagan has identified tax reform as "the second American revolution." My prediction is that if we do not attain equity through tax reform in the near future, the inequities will lead to increased fragmentation, divisiveness, and eventually true revolution in this country; for revolutions are born not of shared deprivation, but of perceived inequity. The equity issue has been increasingly sensed by the citizenry; it must be resolved if our societal fabric is to remain intact.

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