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TAX REFORM PROPOSALS

by Allen Cheadle

"Flat tax," "fair tax," "simple tax" are the buzz-words in Washington these days. Behind the buzz-words lie three specific proposals to substantially change the U.S. tax code: Bradley-Gephardt, Kemp-Roth and the Treasury proposal. Behind the three proposals lie as many interest groups as there are sections in the tax code, all trying to shape the final outcome to retain their own special privilege. This article will provide an overview of the current code, summarize the three proposals, and speculate on the nature of the political debate and the final outcome.

Overview—The existing tax code is filled with provisions that allow certain expenses and types of income to be deducted before computing tax liability. Most of these deductions have specific economic rationales, and each alone may seem reasonable. Taken together, however, they mean that a taxpayer with a skilled accountant can pay far less in taxes than someone in an identical situation who is not aware of all the possible deductions. The sense that the law system is unfair is one factor contributing to the movement for reform.

Another factor creating a sense of urgency about tax reform is the growing federal deficit. Authors of tax reform legislation typically claim that their proposals will not increase taxes overall, but tax reform could (and probably will) provide a way of raising additional revenue. Many tax breaks result in huge losses of income to the Treasury. For individuals the major items are: exclusion of employer contributions to company pension plans—\$56 billion; deductions of home mortgage interest—\$25 billion; deduction of state and local taxes—\$21 billion. For corporations the major tax breaks are: the investment tax credit (10% of the value of new investment can be deducted from the tax bill)—\$32 billion; accelerated depreciation (the cost of new machinery is written off in a shorter time than its useful life)—\$27 billion. If the above individual and corporate tax breaks were eliminated, the deficit would be cut in half.

Bradley-Gephardt—Senator Bill Bradley (D-New Jersey) and Representative Richard Gephardt (D-Missouri) introduced the first reform proposal in 1982. The proposed law would replace the current system of 16 brackets (ranging from 11% to 50%) with three: 14%, 26% and 30%. The plan retains several major individual deductions: home mortgage deductions, charitable contributions, state and local taxes and payments to individual retirement accounts. It would eliminate the deduction of employer fringes (pensions and health benefits) and limit the deduction of medical expenses to above 10% of gross income (vs. 5% now). The plan would also eliminate the favorable treatment of capital gains, which would be taxed as regular income.

Bradley estimates that 70% of individual taxpayers would pay the same amount or less under his plan than under the current system. The losers would be wealthier taxpayers who receive large parts of their income in capital gains or fringe benefits. Wage earners, taxpayers who do not itemize, and low income groups would be the main beneficiaries of the plan. For corporations, under the Bradley-Gephardt plan the tax rate would be reduced from 46% to 30%, but most of the current special deductions (accelerated depreciation, investment tax credit) would be eliminated.

Kemp-Roth—A Republican tax reform proposal was introduced in April 1984, by Senator Bob Kasten of Wisconsin and Representative Jack Kemp of New York. The Kemp-Roth plan would be more "incentive oriented" than Bradley-Gephardt, treating investors and corporations more favorably. The Kemp-Roth plan imposes a single tax rate of 25% on all individuals with income above 130% of the poverty line (\$14,375). Those below that level would pay no tax. The standard deduction would be doubled from \$1,000 to \$2,000. The deductions for home mortgage interest, charitable contributions, education loans, property taxes, and fringe benefits are retained, but capital gains are taxed fully at the 25% rate. The corporate rate under the Kemp-Roth proposal is cut to 30% and most deductions are eliminated with the key exceptions of the accelerated depreciation and preference for income earned abroad.

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There are two important differences between Kemp Roth and Bradley Gephardt. First, Kemp-Roth eliminates progressive taxation, whereby those with a higher income pay a higher percentage in taxes. Under Kemp-Roth all taxpayers above 130% of the poverty line would be taxed at the 25% rate. Second, Kemp-Roth retains the accelerated depreciation allowance that is one of the most lucrative corporate tax breaks.

Treasury Proposal—Most observers felt that the Department of Treasury plan would be similar to Kemp-Roth, eliminating progressivity and giving a bigger break to business than the Democratic plan. Much to their surprise the version announced by then Treasury Secretary Donald Regan is closer in spirit to the Bradley-Gephardt plan and would result in a substantial shift in tax liability from individuals to corporations.

The Treasury plan follows Bradley-Gephardt by replacing the current system of brackets with three: 15%, 25% and 35%, thereby retaining a degree of progressivity. The standard deduction is doubled to \$2,000. The major deductions for individuals are retained as in Bradley-Gephardt, the exception being the deduction for state and local taxes. Entertainment expenses and business meals and travel would no longer be deductible. The net effect of the changes on individuals would be an estimated 8% reduction in total tax burden.

This loss in revenue would be offset by a 25% increase in corporate taxes. The rate would be cut to 33% but all major deductions including the accelerated depreciation allowance would be eliminated. Some particularly spectacular breaks for the oil and banking industries, including the oil depletion allowance and immediate expensing of intangible drilling costs, would also disappear.

Weighing the Proposals and the Political Prospects—In terms of fairness, balance and equal treatment, the Treasury proposal is the best plan of the three. First, it would reverse a long term decline in the share of taxes paid by corporations. The share of tax revenue paid by corporations declined from 25% in the 1950s to 12% in 1980. The Reagan tax changes cut that figure to 6% by 1984. The investment tax credit and accelerated depreciation result in whole industries (e.g., chemicals, wood and paper products) not paying a cent in federal taxes. Furthermore these breaks favor the older capital-intensive industries at the expense of service and high tech industries that have been the source of most recent employment growth. Second, for individuals, the Treasury proposal retains progressivity while at the same time broadening the tax base.

On the political front, all three tax proposals have avoided certain death by retaining the main deductions in particular. Bradley-Gephardt and the Treasury have taken on some cherished corporate deductions, including the accelerated depreciation allowance and breaks for the powerful oil and banking industries. In addition the Treasury proposal has angered high-tax states by eliminating the deduction for state and local taxes.

Few observers give any hope for reform without strong presidential support. President Reagan has been cool to his own Treasury's proposal, but his recent news conferences suggest that he has not read even the newspaper summaries of what is in the proposal. He expressed concern when someone told him that business taxes would be raised, and stated that those increased taxes would simply be passed on to consumers. His argument is incorrect (part of the tax will be paid by company shareholders) but it may be politically persuasive when combined with business lobbying. Business spokesmen are already warning of the dire consequences for capital formation if the accelerated depreciation allowance is repealed. Less publicly, oil and banking lobbyists are no doubt making their case to the administration. The likely outcome of these lobbying efforts is that some or all of the corporate deductions will be restored before a final administration proposal is made to Congress. To raise the same amount of revenue, individual rates must be raised or some major individual deductions will have to be eliminated.

It is easy to be pessimistic about the prospects for genuine tax reform. The response of business lobbyists to the Treasury proposal illustrates how various interest groups will mobilize to thwart changes in the tax code. On the brighter side, it may be possible to eliminate all but the most lucrative deductions, simplifying the code and reducing the possibility that two identical taxpayers will pay vastly different amounts in taxes. The distribution of the tax burden between rich and poor, corporations and individuals will depend on whether the final version is closer to Bradley-Gephardt/Treasury or to Kemp-Roth.

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