

THE ECONOMICS AND POLITICS OF TAX REFORM

Richard Gephardt

Introduction

Politicians have talked about tax reform forever. Everybody is for it, but most also have this or that little exception—the little deduction that they do not want you to touch. While there is a lot of interest in talking about tax reform, I am not sure how much interest there is in actually doing something. When you do something, there must be a specific proposal that actually says, “these deductions are in and those are out, and this is the rate structure.”

It all really reminds me of a story I recently heard about a fellow in a particular town who was having great luck fishing. He was coming home with garbage buckets full of fish. It became an item of discussion throughout the county and much of the state. There were newspaper articles about it. Finally people talked about it to the point that the local game commissioner decided he had better investigate how in the world this person could be so lucky. So the commissioner began to investigate, to talk to people, trying to find out what kind of lures the fisherman was using. When the commissioner was walking down Main Street of the fisherman’s home town, this fellow came up to him, hit him on the shoulder, and said, “I know why you’re here and I have nothing to hide. In fact, the best way for you to find out how I do it is to go fishing with me.”

The commissioner thought, “Well, this is the fastest way to find out.” So they got in this fellow’s car, went out to the local lake, jumped in the fisherman’s boat, and raced out to the middle of the lake. The fisherman shut off the motor, reached under his seat, pulled out a stick of dynamite, lit it and threw it into the water. A huge explosion

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took place and a host of dead fish came up to the top of the water. The fisherman pulled out the garbage can and started throwing the fish into the can. The commissioner could not talk for about five minutes. Finally he regained his composure and he said, "Sir, do you realize you've broken every law and every regulation in the county and state game code? When we get back to shore I am going to take you in front of the magistrate and have you indicted."

The fisherman disgustedly dropped his bucket, reached under his seat and grabbed another stick of dynamite. After lighting the dynamite, he handed it to the game commissioner, and said, "Commissioner, are you gonna talk or are you gonna fish?"

I think this is exactly where we are with tax reform. We have about talked it to death and now it is time to get on with the really hard part—putting together the legislation and trying to pass a good bill. Before I discuss the mechanics of how this can be done and offer a political overview of where we are (which probably is the thing I am best qualified to discuss), I would like to present the basic rationale for tax reform.

The Rationale for Tax Reform

About eight years ago I was appointed to the House Ways and Means Committee, and I quickly learned how the tax game in Washington works. By 1977, for a variety of reasons, there were a significant number of entitlement programs in place. Defense, as you know, was increasing 4–5 percent a year above inflation. The only place we politicians could find to spend money was the place that nobody noticed—the tax code. In addition, we had inflation driving people into higher and higher tax brackets. Thus, with each passing year we had a little more revenue coming in. The percentage of the GNP the government was taking was rising. Deficits were not too bad at the time. So a favored activity was to get into the Ways and Means Committee and erode the base on which taxes were paid. Different groups of individuals were handed tax breaks, tax goodies, loopholes, incentives, or whatever you want to call them. In essence, what was taking place was a forgiveness of taxation in return for a change in some kind of behavior. As time passed, what started as a fairly isolated activity became a very popular political game. And as it increased in magnitude, more and more groups figured out how the process worked. The thinking was, if it was good enough for this and that industry, then surely we can work out a little something in the tax code for other favored groups.

Many times these tax breaks were not major or highly publicized. One word in section 642Q was changed and nobody knew what happened, except some tax lawyer or member of the Joint Committee on Taxation. All of a sudden somebody or some industry picked up a couple million dollars or more because of some perverse, arcane change in a couple of paragraphs or a comma that provided yet more relaxation to the tax code—and another erosion of the base. As a result, each tax bill got bigger and bigger, in terms of complexity and in terms of forgiven revenue. I am told that about 20 years ago we had almost \$37 billion worth of tax expenditures while today it is up to around \$350–\$360 billion.

The biggest program in the government is not defense or social security; it is a program called “tax breaks” or “tax incentives” and it is administered by the Internal Revenue Service (IRS) through voluminous regulations—written by the IRS, tested by the tax courts, and then rearranged and redone by Congress.

Having watched this process both from a tax policy standpoint and from a political standpoint, a number of us in the Congress became convinced that we had to have substantial change. We could not allow this process to continue—not just because of the economic effect or the complexity effect, but because people’s faith in the tax code and in the government itself was being eroded. Thus, we began to investigate how these problems could be addressed—how substantial reform in our tax laws could be accomplished.

The Bradley-Gephardt Plan

In 1977, William E. Simon, then secretary of the Treasury, put out a thick new book called *Blueprint for Basic Tax Reform*, which basically called for a consumption-type income tax. The plan received considerable attention in Washington and generated significant debate, but it never resulted in a bill. When Jimmy Carter came to Washington in 1977, he came with his version of tax reform, which was basically the \$50 rebate, prohibition of the three-martini lunch, and a few other odds and ends. It was an exercise in which he was trying to restore the tax base without any change in tax rates. It was not until after the 1981 tax legislation, which lowered the rates but failed to restore the base, that people seriously began to look at far-reaching income tax reform.

When I started my investigation, I actually began with a consumption-based income tax. Although attracted to the economics of the idea, after looking at it, talking to people about it, and working with the Joint Committee on Taxation, I came to the conclusion that it

was both too complicated in terms of transition and too questionable in terms of its actual economic impact. I finally returned to the usual investigation of how we can take what we have, try to simplify it, and restore the base while lowering the rates. It was against that background that I came to know Senator Bill Bradley, who was engaged in the same activity. So we joined forces and came up with the Bradley-Gephardt "Fair Tax" bill.¹

The Bradley-Gephardt bill has three basic objectives, the most important of which is to stimulate the growth of our economy. This is probably the most difficult goal to communicate. It is the one that people quickly want you to have eight econometric models to support. I do not have any econometric models, and I do not believe they would actually prove anything anyway. However, my gut feeling, common sense, and experience tell me that the American economy would work better if we had greater efficiency in our tax code—if we paid greater attention to the economic consequences of taxes for all kinds of capital and business decisions, rather than driving everything by an overwhelming and consuming interest in how the intricacies of the tax code treat specific activities. I cannot prove that to you—there is no way to prove it without trying it and seeing what happens—but I am convinced it is true.

The Argument for Efficiency

The main argument for tax reform, I believe, is to achieve greater efficiency in the way the tax code works. When Congress gets into the business of figuring out \$370 billion of tax breaks a year, the House Ways and Means Committee and the Senate Finance Committee really are put in the business of trying, at least partially, to plan the American economy. We in Congress take pride in the free market system and do not want the government in the business of planning economic decisions. Nevertheless, the places we most often do that is in the House Ways and Means Committee and the Senate Finance Committee. I confess that I am not qualified to act as a central planner and I do not know anybody on either committee who is. They are all wonderful people, great Americans. They all mean well. But the fact of the matter is that when the details are all put together, I am convinced that we do not have the foggiest notion of what we are doing in terms of the total economic outcome.

The Congress has put provisions in the tax code that have deterred Americans from saving. As a result, our net private savings are relatively small. When government is borrowing 70 percent of those

¹See Bradley (1984), Bradley and Gephardt (1985), and Gephardt and Wessel (1985).

savings, as it is today and probably will be for the foreseeable future, the question arises, "Are we allocating the capital that is left in the private sector in the best way?" In my judgment we will have the best chance to do that if we get out of the business of trying to direct those decisions through tax laws.

The Argument for Fairness

The second objective of Bradley-Gephardt is to establish a fair tax system—to restore the tax base and to lower tax rates. Some people are worried that a flat rate tax will help people at the top of the income pyramid and that with fewer exemptions, the middle class will be disadvantaged. Senator Bradley and I are very concerned about the fairness issue. There are studies that indicate our bill would increase tax collections from people at the top end. There are others that disagree with this view. I think probably this disagreement results from different assumptions about how individuals adjust their consumption and investment decisions in response to lower tax rates. We asked the people who wrote our bill to try to make as sure as is humanly possible that we would not increase the tax liability of any income group. We believe that even with a static measurement of income, this has been accomplished.

I believe that our plan promotes fairness by the very fact that it increases the base and lowers the rates. Under our plan, people will be brought back into the tax system. I do not see how any of us can justify people's avoiding taxation—even with the minimum tax law that is now in place—because they are able to use all kinds of different shelters and mechanisms to get their effective tax rates down to very low levels.

On the corporate side, I really do not believe that we can argue that some corporations should be paying the top rate while other corporations should get a check from the government every year to stay in business. Yet this is essentially what we are now doing. We do not want to change the mix between the amount of tax corporations are paying and the amount individuals are paying. There are some people who believe that corporations, which now generate 6 percent of federal tax revenue, should be back to 15 percent. Others would like to take them to 25 percent of income. There are obviously others who believe that the corporate tax is an anachronism—that the economy would work better if we got rid of it. They say that even 6 percent is too much.

I have heard the corporate tax debate for eight years and we will hear it for the rest of our lives. I do not really think we ought to lower the corporate tax because people who believe corporations ought to

pay some taxes are really going to get offended. However, we will all benefit if we can get corporations to pay more evenly in terms of what they earn. Thus, rather than trying to figure out exactly what percentage corporations should pay, we should attempt to achieve greater equity by treating corporations earning roughly the same income equally under the tax code.

If we are going to pass a tax reform bill, we desperately need to avoid the distributional debate. Some people want taxes on individuals to be more progressive. Some want them to be less progressive. The Bradley-Gephardt plan takes the position that if you keep progressivity about where it is with a static model, knowing that we are never going to agree on a dynamic model, then we will be okay. People can live with that and understand that it is a good outcome.

The fairness issue is an awfully important issue. Every poll shows us and every conversation with John Q. Public tells us that the American people, whether right or wrong, believe that the current tax system is unfair. There is a whole variety of reasons for that perception. However, the long and short of it is, if substantial tax reform is to occur it must achieve greater tax equity.

The Argument for Tax Simplification

There are all kinds of arguments about the tax simplification objective, and I admit that the transition rules will be something to behold if tax reform is actually implemented. The IRS and others will be kept busy for a very long time. But even admitting all the transition problems, we will strike a blow for simplicity by enacting any one of the plans that are currently on the table. There are two major reasons this is so. First, even with the transition rules, tax simplification will stop the constant meddling with the tax code, itself an important objective. Of course, nobody can guarantee that future Congresses will not tamper with a flat rate tax system that achieves the simplicity sought by the Bradley-Gephardt plan and other tax reform proposals. A new Congress convenes every two years. We send new members. Some of us get retired without wanting that to happen. New people show up and they come with new ideas and they want to change laws. There is no way we are going to stop or should we stop new Congresses from being able to change the law. However, I believe that if we can lower marginal tax rates and simplify the present system, the American people will be sensitive to any future attempt by Congress to erode the base and raise rates. Also, with two or three rates rather than with fourteen, inflation will have less of an impact. It will not drive people forever into the higher brackets, a phenomenon that encourages Congress to give goodies

away by eroding the tax base. I really believe our plan will stop the constant churning and changing of the tax laws.

Second, if we can achieve tax simplification, many of the special exemptions and deductions can be abolished. The last tax bill Congress passed—the Deficit Reduction Act of 1984—was 1,300 pages long. It was a so-called loophole closing bill designed to raise revenue. When the regulations are completed, if they ever are—five or ten years from now—they will be another three or four or five thousand pages. It looks like what we are really trying to do is write a code for each person in the country. It is called mix and match—put together your own code. And when we get done writing provisions that we think apply to everybody in the country, we find out some people are slipping through the provisions. We go through the tax courts for 10 years and then we write some new regulations. Then we write a new statute and before we are done with one section that started out to be very simple, it turns out to be an absolute labyrinth of new tax rules and regulations. If we take out a lot of these deductions and we keep them out, and if we keep rates down, over time there will be a marked increase in the simplicity of tax law application. The IRS now audits less than 1 percent of all returns. It used to audit 2 percent. Part of the reason it cannot do better is the incredible amount of complexity involved in an audit of any return today.

In sum, the Bradley-Gephardt bill promises significant tax reform. If enacted, it would produce a tax system that is fairer, simpler, and more efficient than the current system.

The Political Landscape

Any discussion of tax reform must consider the political landscape: where we are, how we can achieve meaningful reform, and what the post-reform system is going to be like. This is somewhat like describing World War III because that is what it is going to be like to pass significant tax legislation. I have been through five tax bills and I have seen the lobbying pressures that have been brought to bear over little things that you would not expect anyone to quarrel over. Everyone remembers the fight over withholding on dividends and interest a couple of years ago. Every year we have looked at the tax law there has been an entry from the Joint Committee on Taxation and the treasury saying we ought to begin withholding on dividends and interest. Everybody got a good belly laugh out of it and then we went on to the next thing. I shall never forget when the withholding recommendation finally came up on the list of ways to raise revenue or to lose revenue. In 1982 Senator Dole and Congressman Conable

and others decided that withholding on dividends and interest should be included in a tax bill. They argued that we had been talking about withholding for 20 years and that it made eminently good sense. Hence, they included it in the bill, which was signed by the president.

The banking industry said: "We know the president wants this bill, we have to do something about the deficit, and we will look the other way while you put it in. But we are making no commitment that we will leave it alone after it gets in." At the time I thought, "Boy, they made a terrible mistake because once it gets in they'll never get it out."

About a month after it was signed into law we started to see a few letters coming in—a sprinkling of letters from around our districts. Most were form letters, although they appeared to be individually written. All the sender had to do was sign it to send the message, "I want you to repeal the changes on the withholding of dividends and interest because I think it is unfair to tax my dividends"—something to that effect. What started as a sprinkling of letters became a heavy snowstorm and then a blizzard. In that year the number of pieces of mail to Congress went from two million to four million. At least two million were the prearranged mailings—mailings through savings and loan associations and banks. Every time they sent a statement to anyone, they would enclose a form letter and ask the recipient to mail it to his or her congressional representative. Some of them even included the 20-cent stamp to send it.

I remember saying, "You know, this is ridiculous, the people just do not understand this thing. We can educate people. We must stand behind this. The worst thing in the system is that people are not paying their taxes. This withholding thing is an absolute hemorrhage in taxes that are not being collected."

Then I remember going to town hall meetings and seeing attendance increase. We used to have 30 to 40 people wander in. Now I would go to a meeting and there would be 200 to 300 people there. Most of them were senior citizens. They would stand up and tell me how angry they were. I clearly remember one meeting when a woman stood up and said, "Why do you want to tax my dividends by 10 percent? Why do you want to raise the taxes on my dividends and interest?" I said, "Ma'am, I appreciate your concern, but this is not a new tax. It is simply a different way of collecting the tax. There is a big exemption provision and you probably will not be subject to withholding in any event." After I got through with the explanation, she stood up and said, "I appreciate what you said, but you did not answer my question. Why are you increasing taxes?" Everybody

clapped and people stood on their chairs. I finally gave up, realizing that I could not get the point through.

This story illustrates the political impact of the tax law. There is no place where the intersection between the people and the government is as important as in the area of taxation. This is where the people meet their government. This is where everybody is involved with the government on an annual basis, sometimes on a quarterly basis—when they fill out their tax forms and send in their money. So if you are talking about substantial tax reform, you are talking about a political explosion the likes of which none of us has ever seen. There is not a lobbyist in Washington today who has not been hired by at least one group or organization to fight this tax bill. There are planes coming in and out of Washington with increasing frequency. The battle lines are drawn. It will be the political battle of the century if not the country's history. If it is to be won for tax reform, it will happen only if there is a genuine uprising by the people—something like the Boston Tea Party. People must say “I want it to change. I want you, my representative or senator, to vote against all of this clamor of special interests in favor of the general interest.” It has to be put that starkly and it has to be put that bluntly in order to make it happen in Washington.

There are some good signs that make me believe it can happen. First, we appear to have a president who believes in tax reform, who wants it to happen and who will support it strongly. Second, we have bipartisan support in both the House and the Senate. Right now people favor different plans, but in essence the plans are very much the same. Third, I think the Congress in general understands the need for tax reform. There are many people who have debated tax reform measures and talked about changing the system for two or three years now and who have taken strong positions for tax reform. If we get something on the floor, I think we are going to have to confront it and vote up or down. Are you for it or are you against it? It is going to be a very important vote. So I am optimistic about what can be accomplished.

Concluding Remarks

Tax reform is really a choice about ourselves. It is a choice about our country. It is a choice about what kind of a tax system we deserve. And it is a choice that we ought to go ahead and make in 1985. If this debate goes on into 1986 or 1987, it will dissipate. It will drive business people crazy because they will not know what is going to happen; there will be no certainty, no predictability. It will wear

people out, dismay them, and cause them to lose interest. We really ought to go ahead in 1985 and do it. Further, if we put it off to 1986, that will be an election year. You will have 22 Republican senators up for election. You will have about half that number of Democrats. There will be a huge fight for control of the Senate and control of the House. In such an environment, tax reform will come to a complete halt. It has to move in 1985 or it is not going to move. This is the year of decision.

The struggle for tax reform is really a test of whether self-government works. The whole idea of trying to run this country in part by a committee of 535 people is audacious when you really step back and look at it. With a population of 250 million people, we have a committee of 535 people trying to decide how something as complicated as a tax system should work. I really think it works only if, from time to time, we arrive at a consensus in our democracy that says, "What we have got here is not working. We need to return to something that will be more effective."

When Ben Franklin was leaving the building where they were writing the Constitution, he was asked by a group if we had decided to have a monarchy or a republic. It was an important question. He was happy to report to the group that we had decided to have a republic. However, as he walked on, he stopped and said, "My friends, we have a republic if we can keep it." That statement has been true every day since then and it is true today.

I believe part of "keeping it" is being willing to accept the challenge as Americans of debating and deciding what kind of tax system we want. It is the most important way Americans approach their government and have to deal with their government. Indeed, I believe that if our republican form of government is to survive and prosper, we must institute a tax system that is simpler, fairer, and more efficient than the present system.

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THE ROUTE TO A PROGRESSIVE FLAT TAX

Robert E. Hall and Alvin Rabushka

Introduction

The tax-reform movement, in its current phase, came to life in 1982. Our role in the movement began with an article we wrote for the *Wall Street Journal* on December 10, 1981, in which we first proposed our flat rate tax. The public, media, and politicians latched onto the idea of radical simplification and reform of the federal income tax, making it the most widely discussed national economic issue of 1982. Members of Congress rushed to introduce more than a dozen flat tax proposals. Some were pure, tithe-like, 10 percent flat tax rates on all income, with no deductions of any sort permitted. Others were so-called modified flat taxes with two, three, or four tax-rate brackets and sharply diminished deductions, but retaining the more popular ones such as home-mortgage interest and charitable contributions.

Today there are four main contenders, which have received the bulk of publicity and analysis and are likely to remain the chief alternatives to the current tax system. The most publicized plan is that of the U.S. Treasury, put forward in November 1984. Democratic Senator Bill Bradley of New Jersey and Congressman Richard Gephardt of Missouri are sponsors of another well-known proposal. They call their plan "the fair tax," which is also the title of Bradley's recent book. The chief congressional rival to Bradley-Gephardt has been proposed by Republican Congressman Jack Kemp of New York and Senator Bob Kasten of Wisconsin. Its acronym, FAST, stands for "fair and simple tax." It has the semiofficial blessing of the Republican establishment.

Our own plan continues to draw attention, though it is offered as an ideal, rather than as a politically practical compromise. It is

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