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**CARTER'S PROJECTED "ZERO-BASED" REVIEW
OF THE INTERNAL REVENUE CODE:
IS OUR TAX CODE TO BE
"BORN AGAIN"?**

L. Hart Wright†*

The evolution of today's Internal Revenue Code, which began with the mere embryo that Congress created in 1913, has absorbed over the ensuing sixty-four years more creative energy on the part of more co-authors than any other law in history. Despite this unstinted expenditure of "blood, sweat, and tears," the resulting document—were it possessed of human senses—would recognize that, for a foreseeable period, its life will be anything but serene. The plight in which it would find itself could even be compared to that early morning scene observed one hundred years ago by General Custer, when hostile forces were massed on every front and would shortly be placing his entire command under siege.

The Code's position differs from Custer's only in that its struggle began with preliminary skirmishes, confined to fairly limited fronts. The first of these took place last year (the Tax Reform Act of 1976) and from it emerged only one truly fundamental change: the structural alteration and integration of our estate and gift taxes which, in aggregate, never yield more than about \$5 billion in yearly revenue. That same amount was then lost by the Treasury in consequence of the single most important tax change generated by a second skirmish, from which emerged the Tax Reduction and Simplification Act of 1977. The standard deduction—available for a quarter of a century to those who would forgo itemizing their non-business deductions—was increased by that act to such a point (\$3,200 for married couples, \$2,200 for single persons) that only twenty-three per cent of our taxpayers now will have an immediate interest in itemizing. Potentially much more significant are the assaults yet to come, directed as they will be at the shape of the Code's other

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even more substantial components. During these attacks, one hostile force, whose exact make-up will change somewhat as the issues change, will be led by our newly elected President. During his pre-election campaign, President Carter was especially critical of our tax system, calling it a "disgrace" and asserting that the "President ought to assume the responsibility for complete tax reform."

While many of the Code's technical provisions will provide points of contact during the tax-policy battles now scheduled for President Carter's first term, those struggles will center around three central problems: (1) the competing roles, under federal revenue measures, of "price" concepts and "tax" criteria; (2) the possibly escalating role of the income tax as a welfare program for the *poor*; and (3) its current role, as President Carter puts it, as a "welfare program for the *rich*."¹ The overall result of these struggles is of exceptional importance. If the proponents of change prevail with respect to each of the three facets, and thus as to the whole, by the end of Mr. Carter's first term, our tax system also will have been "born again."

But to re-examine from "scratch" and substantially reshape the most complex law civilized man has created will be an awesome undertaking. And if the taxpaying public is to understand what is at stake and to be able to assess the relative merits of various proposals, politicians and the media—in dealing at least with the more important problems—must try to tailor their rhetoric to simple truths. This short essay, directed to law students, has the narrow objective of trying to assist that effort by identifying the general nature and dimensions of the three major issues, the different substantive contexts out of which each will emerge, the significant though sometimes obscured interrelationship of those issues, and the obstacles—now almost inherent—to *rational* wholesale reform responsive to the most complex of those issues.

I. FEDERAL RELIANCE ON "TAX" CRITERIA AND "PRICE" CONCEPTS

Most law students are only too keenly aware that states, with respect to a *part* of the revenue required for a traditional state function, completely ignore all "tax" criteria and utilize instead those "price" concepts typically employed by our private sector. The reference here is, of course, to tuition (often substantial, and sometimes greater yet at professional school levels), which many states require universities to impose to complement state-provided "tax"

1. Emphasis added.

funds. This general practice is not merely an anachronism. Even at the federal level where, as to traditional governmental functions, we have been committed since 1913 not just to tax support but to progressive taxation, there will be substantial controversy during President Carter's first term regarding the relative reliance on "price" concepts and "tax" criteria. Such an issue becomes peculiarly legitimate, whatever the individual response, whenever the government proposes to assume a function of according to individual recipients private benefits long provided (allegedly inadequately so) on a price basis by the private sector. An alleged or demonstrated need for the government to allocate some tax resources to a given societal problem does not give rise automatically to the corollary that previously used price concepts should be completely displaced.

The Carter administration will encounter the price-versus-tax issue when it asks Congress to adopt a National Health Insurance plan, which amounts to nationalization on a more extensive basis of another part of the \$130 billion spent on health care in 1976 by the public and private sectors combined. Here, in contrast to another situation to be discussed later in this essay, the price-or-tax issue may arise in a context propitious for its rational consideration since, in the health care area, the public can both recognize the issue and comprehend its dimensions. Illustratively, the tax side of the issue will be clearly exemplified by the Kennedy-Corman bill, which provides that benefits per person would bear no correlation to the cost each would bear. Identical benefits (insurance coverage) would be provided to each family regardless of its size, but half of the total cost (estimated at \$24.8 billion by 1980) would be covered by general revenues from the progressive income tax, with the other half coming from payroll taxes divided in such a way that employers would pay the larger share. In contrast, several other plans backed by well-entrenched sponsors would be less costly to the Treasury, partially because they would complement tax support with one or more price components. These proposed price components would require the insured to pay a specified annual minimum before triggering benefits, or a modest co-payment-per-item (for example, \$X per office visit), or self-or-co-insurance costs, borne by the insured, which would cover a stated proportion of the total medical costs otherwise paid by the plan itself.

Consideration of the health care issue *may* be so timed as to contribute to rational deliberation. At one point, the opposite appeared to be true, since the House Ways and Means Committee Chairman had indicated last January that his committee would not deal with National Health Insurance until *after* it had dealt with

proposed reforms of our income tax law and of its stated and effective rate structures. In February, however, President Carter announced that he had accelerated his scheduled introduction of a health plan; now it *and* his proposed income tax reform may be submitted at approximately the same time. This would be a wholesome coincidence since the cumulative impact of *all* federal taxes should be taken into account when Congress fixes the degree of progressivity to be reflected in the income tax's rate structure, as its ultimate aim at that point should be to fix each income class' appropriate share of the total federal tax burden. Burdens in the nature of a mere price should and, here, could be ignored.

Hopefully, an equally rational approach will be taken in resolving yet another price-versus-tax issue which Congress now must face. This issue—the separate, but now inadequate, funding arrangement which raises about \$80 billion annually for Social Security—is currently being re-examined by Congress.

Appearing in the press with some frequency are statements from politicians and commentators alike that are usually predicated on the assumption that the Social Security levy is a tax *qua* tax. On the basis of this assumption, the levy's regressiveness and the resulting inequity are criticized sharply. The critics also often include the regressive Social Security levy in their definition of the total *tax* package to help demonstrate that the total package is, in their opinion, insufficiently progressive.

I have analyzed elsewhere the argument that this exaction has some of the earmarks of a tax, and of a regressive tax at that.² In a nutshell, while it is imposed on wages at a *flat* or proportional rate of 11.7 per cent (shared equally by employer and employee), it permits no deduction for necessities and excludes from the base amount not only all income a covered employee might derive from capital but also that portion of his salary or wage exceeding \$16,500.

The exaction, however, possesses one important price characteristic. It is paid during one's working years for, *inter alia*, a statutory right (depending on survival) later to receive personal retirement benefits; and, as a given individual's wages increase (within the covered range) during his working years, so too do his tax liability *and* his anticipated future benefits.

But the resemblance of this latter characteristic to a price is not intended to suggest that the levy is only a price. While for a given

2. See Wright, *Crisis Ahead: Challenges to America's Tax System*, 29 OKLA. L. REV. 911, 932 (1976).

individual a correlation exists between the amount of tax paid and the amount of anticipated benefits, that correlation is designedly imperfect. It is subject to a variety of deviations that depend on a variety of factors, including a built-in minimum welfare-type benefit.³ Thus, in overall effect, the Social Security tax is actually a hybrid, possessing in varying proportions both price and tax characteristics.

The existing balance between these two components is under challenge before a Congress which must deal with the Social Security fund's annually recurring deficit and must act to increase the system's annual intake. Some persons will view the problem as one of price, arguing for a rate increase on the ground that such a measure will tend to preserve among participants (and future Congresses) the self-respecting impression that—in contrast to welfare programs—participants *earned* their scheduled benefits. Others, in opposition, tend to classify as ordinary government expenditures either all of the relatively modest benefits now provided by the plan or that portion of any benefit not responsive to a price concept. Not surprisingly, these persons will view the deficit problem as a "tax" problem and will argue that the requisite revenue increase should be extracted by more progressive means. By one device or another, they either would tap our general fund, for which the progressive income tax is the mainstay, or further increase previously scheduled increments in the Social Security tax *base* (as distinguished from its rate).

Modified versions of both these latter courses were proposed by the President on May 9, 1977, when he dealt specifically with Social Security's financial problems. Under the plan he proposed, the general fund would pay for shortfalls in Social Security revenue, but only to the extent a given shortfall is attributable to excessive unemployment during a recession—such shortfalls being deemed a general cost of our economic system, not a specific cost of our retirement arrangement, and hence properly borne by progressive taxes. Also, over a transition period, the President's plan would raise the now-statutorily-scheduled ceilings on the Social Security tax base. Ultimately that base would include the entire wages of all covered employees. But the very fact that this enlarged base would be used

3. To say that there is even an imperfect correlation is not to suggest that, in terms of *absolute* dollar amounts, a given individual's anticipated benefits are *actuarially* responsive to the amount of tax earlier paid in with respect to his wages. For one thing, benefits escalate automatically with inflation. Also, even on a *relative* basis, while a given individual's scheduled benefits are larger than average if his covered wages (and the tax paid thereon) were larger than average, the benefits do not rise in direct proportion to the covered wages.

only in calculating the employers' share of the Social Security tax stresses further, with devastating clarity and in three separate ways, the tax side of the price-versus-tax controversy.

First, where the employer is engaged in business for profit, the deduction of his Social Security tax for income tax purposes obviously will pass part of his increased *gross* cost to the Treasury's general fund. Of course, institutional employers not subject to the federal income tax—states, municipalities, and exempt private charitable or educational institutions—cannot so shift these increased costs. But second, whether the employer is subject to or exempt from the federal tax, our inability to determine precisely the ultimate incidence of the employer's own *net* share of that increased cost also tends, from any given employee's perspective, to reduce relatively the "price" underpinning of Social Security. We simply do not know whether any given employer's net increased cost will be passed on to the consumers of his products (through increased prices) or, in the case of state and local governments, to their respective taxpayers, or to all or only some of the employer's employees (whose future wages may be smaller than otherwise would be the case). We know only that the proposed enlargement of the wage base will tend, one way or another, to prejudice particularly those employers whose activities require them to employ an above-average proportion of well-paid employees. Third, to limit the enlarged base to the employer's tax also relatively reduces the price component by not providing for increases in future retirement benefits which would have followed only for *higher* bracket employees *if* ceilings on the base, when raised sufficiently to meet the deficit problem, had been spread so as to apply also to their allocated and withheld share of the tax.

Unfortunately, there is great risk that, on three pivotal occasions, the public may not actually realize the true dimensions and significance of Social Security's price-versus-tax issue. The first such occasion may emerge because Mr. Ullman, the Chairman of the House's tax-writing committee, has indicated, most recently on August 22, 1977, that Congress' immediate response to the President should be to buy time, using patchwork hikes in the nature of minor adjustments within the payroll structure itself to solve the immediate Social Security deficit problem. The aim would be to provide Congress, in a later session, with a greater "opportunity to fully and carefully consider basic, long-term changes that will have far-reaching effects." Such a delay would mean that the in-depth price-versus-tax debate would not actually take place until after Congress has refashioned the principal device we use to achieve progressivity, the in-

come tax law and its rate structure. Thus, in reshaping that *principal* device, Congress and the public will be wearing blinders; both will be ignorant of—and thus forced to disregard—an important fact (potential changes in Social Security funding) germane to the ultimate goal of proper overall tax progressivity.

Further, a risk exists that the income tax debates may completely mislead the public because they will not be predicated on the public's full understanding of the relevant issues, which could have been assured by a thorough complementary debate on the Social Security tax. For example, if the past is any indication of the future, some politicians and commentators, who will disseminate through the press data or conclusions regarding the impact of our *total* tax package on various income classes, are certain to proceed on an unarticulated assumption—that the *whole* Social Security levy is a tax *qua* tax and, thus, a part of that package. That a portion of that levy, and thus a portion of the total package, more nearly resembles a price will have been ignored, and the public will have been misled.

Finally, should Congress override Chairman Ullman's effort to postpone a more comprehensive revision of Social Security's financing arrangement and go on to address itself without scrupulous care to the merits of the President's plan, from *that* debate the public may not fully recognize a highly significant relationship between that plan and yet another proposed shortly thereafter by the President. Specifically, his formal May 9th *Social Security* proposal was followed on August 6, 1977, by an equally formal plan to revise the *Welfare* system that if enacted would in fact, though so disguised as not to do so *pro forma*, by itself permanently convert the Social Security tax into a *progressive* levy. This aspect of the matter is discussed below.

II. THE INCOME TAX: A WELFARE PROGRAM FOR THE POOR?

Although this country remains committed to the free enterprise system, our substantial regulation of it to prevent abuse long has been complemented by devices designed to alter the income distribution generated by the marketplace. The most important such device grew out of our desire early in this century to gear each individual's share of the federal tax load to his ability to pay. To this end, we adopted in 1913 an income tax system under which, by hypothesis, one's share of the tax load would be affected by the amount of his income. Also included in our tax system was a specific bias, in the form of

progressive rates, against larger incomes. That rate structure, which in 1913 began at one per cent and reached a marginal stated rate of six per cent on income exceeding \$500,000 ultimately evolved over the years into the current rate pattern that begins at fourteen per cent and climbs to a marginal seventy per cent on income exceeding \$200,000 in the case of a married couple filing a joint return.

This rate structure will become a major issue in early 1978 when Congress deals with the administration's plan for income tax reform. One aspect of that issue will be the degree to which our current rate spread should be compressed, with the ceiling rate being reduced as a tradeoff for removing from the Code a variety of narrowly conceived tax preferences, such as special exclusions and certain deductions, that have been added in piecemeal fashion over the years. The prospects for such an endeavor will be evaluated later in this essay. However, before this Congress tries to reach a consensus on any given ceiling, it will be faced with—and perhaps will have resolved—a related structural issue located at the opposite end of the income spectrum.

As mentioned earlier, our first modern income tax act was deliberately shaped to include a bias against larger incomes in the form of a progressive rate structure. That same act simultaneously contained a preference in favor of lower incomes in the form of a substantial exemption deduction, designed primarily to shelter from the federal income tax all except those who were moderately well-to-do. Of an approximate population of 97 million, no more than 425,000 persons were expected to suffer any tax liability; and that estimate proved high, for fewer than 325,000 persons actually paid an income tax for the year 1913.

A substantial preference of the foregoing type remained more or less intact for a quarter of a century. For example, in 1939 (the year Hitler launched World War II by invading Poland) only 4 million Americans, out of an estimated population of 130 million, had to pay a federal income tax. But when this country became involved in World War II, the need to raise additional revenue and to curtail the demand for consumer goods led to a sharp reduction in the exemption deduction. As a consequence, between 1939 and 1944 the number of income taxpayers increased tenfold. And from that now distant point in time through 1976, not even all those living below the poverty line were completely sheltered from income tax liability, despite congressional use of a variety of sheltering devices, such as the exemption deduction, standard deduction, and earned income credit. However, the administration-supported Tax Reduction and Simplifi-

cation Act of 1977 did finally increase the standard deduction sufficiently to reestablish a complete shelter at the poverty line.

The 1977 act also extended for an additional year (through 1978) an earlier recession-inspired *temporary* income tax change designed to shelter the poor from the adverse effects of yet another tax. In making the large 1975 tax cut, Congress included a temporary refundable ten per cent earned-income-tax credit applicable to the first \$4,000 of wages, the maximum \$400 benefit decreasing by \$1 for each \$10 (ten per cent) of wages above \$4,000, with \$8,000 in wages being the credit-termination point. The credit was allowed to working families with a child in the household, and a refund if no income tax was otherwise owing, for the purpose was to return to such families an amount roughly equal to the aggregate *Social Security tax* on their wages. Since the refunds were achieved under the income tax statute and were financed by general funds, not by Social Security taxes, the individual recipients continued to build up their Social Security rights. In effect, during that recession such families were not to suffer any "price" for their future anticipated pensions.

Apart from the *tax* sheltering effect of the foregoing devices, governmental concern for the poor's welfare has otherwise shown up only on the *expenditure* side of the federal budget. But this may be altered during President Carter's second year in office. Both the administration and the House Ways and Means Committee announced that before either begins to deal publicly with general income tax reform, each would take on that cluster of programs described by the President as the "welfare mess." Out of that total cluster, five major welfare programs account for spending of almost \$40 billion annually by our various levels of government. While the structure and thrust even of these five programs are well beyond the intended scope of this essay, criticisms abound and a brief recapitulation of these criticisms is essential to an understanding of the aims of the President's proposed solution and, more relevant here, the role *tax* ideas are to play to the end of altering further the income-distribution effects of our economy—in this case, to favor not only the poor but now also the "modest income working people hard hit by payroll tax increases [principally Social Security]."

Administrative problems alone have proved troublesome to our welfare effort. For example, concern is expressed over the number of so-called welfare cheaters and also the number of bureaucrats required to administer, albeit unsuccessfully, these categorical and

often overlapping programs geared to different eligibility requirements.

Yet other criticisms focus on program substance. Now, except for the federally funded \$5 billion annual food stamp program, each state unilaterally fixes and pays for the primary level of benefits these programs accord its residents, with the benefit levels varying widely in amount from state to state. Critics object that federal matching grants exacerbate these variations; as a result, average monthly benefits per family under the Aid to Families with Dependent Children (AFDC) program varied in 1976 from \$380.51 in New York to \$47.93 in Mississippi. Aside from these state-determined variations, other criticisms point simply to the general inadequacy of the payments themselves, to the consequent impact in the viability of affected family units, and to the effect of both of these factors on the estimated three million minor children living in AFDC homes. In short, total funding is said to be inadequate, causing millions to live below an acceptable poverty line. Others charge that the programs, by focusing so significantly on unemployed AFDC mothers, tend to overlook the plight of the underemployed and even discourage their interest in part-time or low-paying employment. Some, moreover, are troubled by the psychological consequences of stigmatizing individuals as "welfare" recipients. Finally, yet others are bothered because several programs provide only benefits in kind (for example, food stamps and housing), thus depriving recipients of that freedom of choice now enjoyed by those of us fortunate enough to earn cash incomes.

The President's proposed substitute—unveiled as recently as August 6, 1977, and labeled a "Program for Better Jobs and Income"—sprang from an integrated perspective of how our tax and expenditure programs affect the economically disadvantaged. It includes features which provide additional though revised benefits for the poor as well as new benefits to those not poor but having only a "modest income."

As to the poor, the program would consolidate three of the five major welfare programs (Aid to Families of Dependent Children, Supplemental Security Income, and Food Stamp programs) into a single cash-assistance program somewhat in the nature of a negative income tax. National minimum standards would be established for both cash payments (which states could supplement) and more exacting work requirements. Payments henceforth would be formally characterized either as a "Work Benefit" or as "Income Support," depending on the degree to which work (hopefully private employ-

ment, but public service jobs if need be) was required in a given case. Program administration otherwise would be further streamlined in keeping with a strengthened federal role and with annually declining financial roles for state and local governments.

According to this *welfare-revision* proposal, our positive-income-tax law's present *temporary* refundable ten per cent credit on wages up to \$4,000 would become a permanent feature for families having, as before, at least one child in the household. To this benefit, the President would add a further five per cent credit, allowable on earnings ranging from \$4,000 up to the point where a family, depending on its size, would become liable for federal income taxes (the so-called tax entry point). The administration apparently expects that its own later submitted income-tax reform proposals will fix this entry point, for a family of four, at around \$9,000. Thus, for that size of family, the maximum credit would exceed \$600. However, at around \$9,000, that family would begin to suffer a phaseout of \$1 for each \$10 (ten per cent) of earnings in excess of that figure—the declining credit thereafter terminating completely when wages reach \$15,600.

Since the original and also the currently asserted purpose of this credit was to cushion the impact of our "payroll tax" (Social Security tax) on working families having relatively low incomes, the proposed declining income tax credit is simply a *device*, and welfare revision is simply the *occasion*, for establishing what becomes tantamount to a progressive *Social Security* tax, the rate varying depending on the amount of income. Progressivity in the Social Security tax results from the fact that this refundable credit declines proportionately as income rises and is denied to the more economically advantaged members of the work force. Proportionately, the greatest benefit will be derived by the working poor having wages of \$4,000 or less; they will enjoy what is the equivalent of an almost complete refund of Social Security taxes (10 percentage points of the aggregate 11.7 percentage points paid by employers and employees), for otherwise they have no income tax liability. In all cases, however, future Social Security benefits would remain unaffected.

In terms of replacing the three existing welfare programs which the President proposes to eliminate, the enlarged tax-credit arrangement, though involving an additional annual cost of \$3.3 billion (total cost, \$4.8 billion) and benefiting 12 million additional families having relatively low or modest incomes, would still play only a relatively minor role. Complementing it, at a total additional annual cost of \$2.8 billion, would be a separately administered and much

larger cash assistance program (\$20.7 billion in federal funds, plus state or local supplements). To assure feasibility of the latter's "work" requirements, a program of guaranteed public service jobs (full- and part-time, 1.4 million in number) and occupational training also has been budgeted, at a projected cost of \$8.8 billion in federal funds.

The cash assistance program would not be a *pure* negative income tax. It includes other components, such as a work requirement keyed to variable standards. But otherwise, this proposed statutory *right* to receive a minimum cash income, with the level being affected by family size *and* adjusted further by an implicit rate applied to any wages received, does include the major features of a negative-income-tax preference. Thus, to that extent, it raises issues strikingly similar to those which emerge when tax preferences are proposed for the positive side of the income tax ledger.

Any consideration of tax preferences on *either* side of that ledger should commence by answering three fundamental and cumulative questions: first, whether there is actually a societal problem; if so, second, whether the government should involve itself directly in trying to solve it; and, if so, third, whether the government's contribution to resolving that problem can be made more equitably and efficiently through a tax preference or through some other means.

That the poor do have a problem, and that the government should involve itself, are matters that were decided long ago—and correctly—during Franklin Roosevelt's presidency. President Carter, on trying to think through the third question—*i.e.*, whether a guaranteed cash assistance program (coupled with a work requirement applicable where feasible but determined by variable standards) would be both more efficient and equitable than three of our existing categorical programs—may well have been influenced by findings growing out of the government's own rather long-term experiments with negative-income-tax plans. Several thousand families, residing in six different geographical regions, have lived for several years under diverse negative-income-tax arrangements, all to the end of providing data on their behavior. While some findings have been released, no doubt more will be disclosed during the coming debate. In any case, in the course of making a choice, the President necessarily had to deal with the almost inherent conflict which, in the setting of tax preferences, tends to exist between the twin goals of efficiency and equity.

Equity might seem to require that the program treat persons in like economic and family circumstances alike. Efficiency, by hy-

pothesis, mandates that the nation's largess not be wasted by payments in mere substitution for other potential income. Further, equity and efficiency together require that persons in different economic and family circumstances receive different amounts from the government. In other words, at some point and in some manner, it is necessary for the plan to take into account an otherwise eligible family's outside earnings.

Should this not be done the plan would be inequitable and could waste the nation's resources. For example, to ignore completely all outside earnings would mean that, if the minimum amount guaranteed by the government is to be \$4,200 for a family of four, such a family would have a right to receive the entire \$4,200 even if it had outside earnings of \$4,199. On the other hand, to pay that family only the difference (one dollar) would be tantamount to imposing a one-hundred per cent tax rate on the \$4,199 earned in the private sector.

In responding to a roughly comparable problem when fixing our ordinary progressive rate pattern on positive income, conservatives are not alone in acknowledging that the imposition of a one-hundred per cent marginal ceiling rate on earned income in excess of \$50,000 would discourage a taxpayer from inconveniencing himself in any way to earn more than that \$50,000. In short, given such a rate, the potential productivity of a taxpayer, and of America, might well suffer. Such a concern apparently prompted a supposedly liberal President, John F. Kennedy, to propose that our marginal ceiling rate of ninety-one per cent be reduced to its present seventy per cent. Subsequently, during former President Nixon's first term, this was reduced to fifty per cent in the case of personal service income.

For similar reasons, President Carter, in shaping his financial assistance program for persons economically disadvantaged, was disinclined to rely on psychological satisfaction alone to inspire the program's beneficiaries to work and to try to climb out of the poverty class. In addition both to basic work requirements (imposed where deemed feasible, sometimes full-time, sometimes part-time) and to guaranteed accommodation of those requirements by public service jobs if need be, he provided positive economic incentives to work, in the private sector if possible, for *all* such persons.

To provide such economic incentives, he concluded that cash grants should not be reduced by the entire amount of a beneficiary's other earned income. In other words, such outside earnings were *not* to be subject to the equivalent of an implicit positive one-hundred per cent tax rate. Even now under the AFDC program, a moth-

er's benefit payment is reduced only by sixty-seven per cent of each dollar earned in the private sector in excess of the first thirty dollars earned each month. However, a negative income tax does present a dilemma. If a sixty-seven per cent implicit rate (which allows the taxpayer to retain thirty-three per cent of his earnings plus the full guaranteed payment) will provide some inducement to work, even greater inducement and, thus, greater efficiency would be provided by imposing a lower implicit rate of fifty per cent. But to decrease the rate from sixty-seven to fifty per cent does intensify the conflict between efficiency and equity, in that identical amounts of aid would be paid to two families who otherwise have increasingly different gross income levels, and this could increase that share of the nation's allocated poverty funds paid to persons able, because of the plan itself, to live *above* the poverty line. In short, the plan could generate another type of inefficiency.

To illustrate the foregoing, three assumptions are necessary: (1) that the elimination of poverty is the sole objective; (2) that the poverty line exists at \$6,000 for a family of four; and (3) that a guaranteed minimum income has been fixed at \$4,200 for such a family. Assuming that a family is able to earn \$5,600 in the private sector, imposition of a fifty per cent implicit rate would leave it with a net of \$7,000 ($\$4,200 + \$5,600 - [50\% \text{ of } \$5,600]$), \$1,000 of which would be in excess of the \$6,000 poverty line.⁴ If, in fact, the plan's overall efficiency does require a *built-in* incentive to work, it would be self-defeating by hypothesis to correct the previously illustrated inefficient deployment of \$1,000 by substituting for the *flat* implicit rate on outside earnings a *progressive* implicit rate of the type used in our positive income tax. For example, suppose we triggered a second tier implicit rate of one hundred per cent with respect to the \$1,000 excess, would this not violate the original hypothesis by depriving the individual of any built-in incentive to crawl out of the poverty class and by encouraging him to continue to receive at least a net \$400 guaranteed minimum payment?

The point here is that, with a fifty per cent implicit rate, the excess \$1,000 payment problem can be avoided altogether only by reducing the guaranteed minimum to \$3,000 (exactly fifty per cent of the assumed poverty line). But such a plan would also fall far short of eliminating poverty in the case of those *without* outside earnings.

4. Indeed, such a family, under a 50 percent implicit rate, could earn \$8,200 in the private sector and still be entitled to receive \$100 in negative income taxes.

The President, in that part of his program providing "Income Support" payments for the aged, the blind or disabled, and single parents of children under age fourteen, opted for a fifty per cent implicit rate and a basic federal benefit for four-member families of \$4,200 (calculated as follows: \$1,900, plus \$1,100 for the first child, and \$600 for each additional child). In consequence, the basic benefit would not phase out completely until such a family's earnings reached \$8,400—a figure well above the poverty line.

Before and after the presidential election, Mr. Carter stated that the federal government simply could not afford to assume the total cost of the entire welfare effort. In keeping with this admonition, his proposal would require states to pay ten per cent of the basic benefits paid to their residents (except where this figure exceeds ninety per cent of a state's previous welfare costs). States also could supplement that basic benefit. And in our example, the federal government would pay seventy-five per cent of the first \$500 of any such supplemental benefit and twenty-five per cent of any additional amount up to the poverty line.

But a state which provides supplements to "Income Support" recipients also must supplement proportionally another class of federal cash payments called "Work Benefits." This type of benefit is to be paid to various persons—two-parent families, single people, childless couples, and single parents with no child under age fourteen—who, although satisfying a full-time work requirement, still have income deemed insufficient to support their families. Here the basic benefit for a family of four would be fixed at \$2,300. A zero implicit tax rate would be applied to the first \$3,800 of outside earnings, with a fifty per cent implicit rate applicable to any excess up to \$8,400 of outside earnings. At this point, once again, the benefit would phase out completely.

Designing both types of aid payments to meet the goals of equity and efficiency (by providing, simultaneously, existence-level support and *also* economically oriented work incentives) inescapably led to another controversy generating conflict between, and an impingement on, those same goals of equity and efficiency. While many unable to work will receive only bare subsistence-level "Income Support" payments, many others will receive some aid ("Work Benefit") even though that assistance, plus their own earnings, enables them to live well above the poverty line.

To accomplish a hierarchy among incentives, so as to provide a greater incentive for beneficiaries to seek work in the private sector rather than be content with public service jobs, the President would

further integrate his aid or negative tax program with our positive tax law. To this end he proposed that income earned in public service jobs be ineligible for the enlarged earned income tax credit.

Finally, equity alone theoretically might seem to require adjustments from place to place in the dollar amount of the guaranteed minimum federal payments to take account of geographically caused disparities in the consumer price index. This effort, however, would be very complex, for an analysis of the consumer price index probably would show that substantial differences exist not just between New York and Mississippi, but also between urban and rural Mississippi. In fact, the effort is so complex that, with respect to the positive income tax, successive Congresses have avoided a comparable political "hot potato" of mind-boggling complexity: neither the exemption deduction nor the income brackets used in the progressive rate pattern have been adjusted to reflect their real worth in different geographical regions. However, the President's program may in fact, albeit not in form, at least roughly handle the underlying problem indirectly through the plan governing state supplements. States having a high cost of living are likely to provide the larger supplements, and the cost of these supplements will be borne in part by federal funds.

III. THE INCOME TAX:

A "WELFARE PROGRAM FOR THE RICH"?

The President, in concluding that our tax system was a "disgrace," reserved his sharpest criticism for the Code's large array of narrowly focused tax preferences in the form of special exclusions, deductions, credits, or rates. A 1976 study for the Senate Budget Committee, prepared chiefly by staff personnel working in the Congressional Budget Office, estimated that the seventy-seven most widely recognized tax-preference provisions cost the Treasury, in the abstract, nearly \$100 billion annually in lost revenue.⁵ Approximately three-fourths of that amount represents a reduction in the tax load of individuals, with the balance serving to reduce corporate taxes.

With respect to individuals, except where the preference took the form of a credit, the effect was to shelter from a given taxpayer's *highest* marginal tax rate the amount of income that benefited from the preference. This helps explain why individual taxpayers with

5. This figure assumes that, if each such preference were eliminated, taxpayer behavior would remain the same.

adjusted gross incomes of \$50,000 or more are said to have saved, as a result of tax preferences, approximately twenty-three per cent of the \$71 billion saved by all individual taxpayers, even though they represented only about 1.2 per cent of those filing a taxable return. No doubt these were among the considerations that prompted the President to describe the income tax law as a "welfare program for the rich."

Much has been published, pro and con, about the rationale or substantive merits of these various preferences, viewed separately or together. The aim here is less substantive and merely provides an overview of the circumstances that brought us to this point, of the President's apparent aim to press for a major structural change that would eliminate the tax-preference approach to problem-solving, and of the obstacles he will face as he tries to undo the past.

A. *The Original Conception: To Tax Only the Rich*

The framers of our first income tax act, and most notably Representative Cordell Hull, had no intention of creating what the President now describes as a "welfare program for the rich." Their intention was precisely the opposite. It was, in general, to apply progressive rates to an income base that, except for a *very large* exemption deduction, was to include all "gains, profits, and income . . . of whatever kind and in whatever form paid . . . derived from any source whatever. . . ." In other words, as noted earlier, they intended to establish "ability-to-pay" as the criterion *and* to protect completely from this tax not only the poor but also those not at least moderately well-off. Taxable returns were expected from less than 0.5 per cent of the population.

Within that small segment of the population, the framers did create tax preferences for certain limited types of economic activity. Having made the decision to allow a large standardized exemption deduction fixed as to amount to accommodate ordinary family expenses, they logically decided to prohibit taxpayers from taking further account of "personal, living, or family expenses." As to a few circumstances, however, they were willing to make exceptions to this blanket prohibition. Two such exceptions, the deductions for non-business taxes and for interest payments, then had the primary effect of encouraging home ownership. But, in contrast to their effective operation today, those provisions did not then discriminate against the poor or even against those moderately well off. Because of the large exemption deduction, these income groups were immunized completely from that tax. A third preference presumably rested on

equitable considerations. It allowed a deduction, in the case of non-business property, for losses caused by "fire, storm, shipwreck or other casualty. . . ." Most such property was then, as is true now, acquired by using previously taxed income (after-tax savings). Involuntary conversion of such property means that, to the extent of his loss, the taxpayer-owner would never actually enjoy income on which previously he had paid a tax. Hence, a deduction was thought necessary "to square" matters. A fourth and final preference excluded interest derived from state and local bonds, apparently as a result of a widely held belief that such immunity was required by the Constitution.

*B. From Then to Now: Escalating Reliance on a
Tax-Preference Approach to Problem Solving*

When referring to tax preferences, some politicians and commentators, particularly when speaking through the popular press, often use the term "loopholes" and, by their manner and in the context of their remarks, imply that the origin of these can always be traced to influences that are at best tainted and at worst nefariously sinister. In fact, however, such inferences appear to be true in only a few instances, and even these have involved preferences of relatively little consequence—amounting almost to private bills. Some apparently were deliberately so well-disguised by deceptive language that their sponsors literally were able to slip them into the tax law without having to explain their real purpose to the taxpaying public.

But not one of our major preferences has been so slipped into the statute. All of them can be traced, roughly speaking, to one of four other general sets of circumstances, only three of which are described here; the fourth is considered later. The most unusual of the four is illustrated in the origins of several Code provisions that, in combination, clearly defer tax on the undistributed profits of our now more than 30,000 controlled foreign subsidiaries. Given the Code's otherwise worldwide reach, the deferral in question accords a tax preference to American parent corporations that control those subsidiaries, with an annual revenue loss now exceeding \$500 million. The legislative history of this statutorily created preference suggests that it is the completely unanticipated product of several otherwise fully justified tax provisions. That this actually could occur is, in context, quite understandable. The preference originated in our first income tax act (1913), whose congressional authors were neophytes in income tax affairs. And at that time this country, then a debtor nation,

did not possess our now highly publicized \$130 billion in foreign direct industrial and commercial investments that would have dramatized for those early authors the tax consequence inadvertently concealed by language primarily concerned with other factual circumstances.

Exemplifying the second set of originating circumstances is an almost equally expensive preference that allows oil companies to deduct currently all intangible costs (such as wages, as distinguished from derricks and pipes) incurred in drilling a well even where it turns out to be a "wet" well that may produce profitably for many years. The distinctive nature of this second set of underlying circumstances is that Congress itself did not anticipate this specific factual problem; the preference resulted from a *technical interpretation*, in this instance by the *Treasury*, of undeniably sensible general statutory language, used deliberately by Congress to avoid having to deal specifically with every imaginable situation. Knowing what we do today, no doubt a contrary result would be reached by both the Treasury and the judiciary were that same precise technical or interpretative question now to arise for the first time. But back in 1917, we did not know nearly as much as we do today about the useful lives of oil and gas wells. And in that now fairly distant past, the Treasury's published regulations permitted intangible costs to be subsumed under general statutory language allowing a full and immediate deduction for "all the ordinary and necessary expenses incurred in carrying on any trade or business," instead of requiring that such costs be treated as capital expenditures and depreciated over the estimated useful life of the well (as we do in the case of buildings).

In the third situation, at the point a major preference began to wind its way through Congress, outside interested observers, as well as members of congressional tax-writing committees, knew very well that it was a preference that was being sponsored allegedly in the public interest. Because each such preference typically was ultimately sponsored by one or both of the tax-writing committees, rather than by the appropriations committees, an earlier Chairman of the House Ways and Means Committee, while avoiding the term "loophole," acknowledged that they did represent a type of "back-door spending." More recently, Congress itself, in developing new approaches to the total budgeting process, opted for the expression "tax expenditures."

After enactment of the 1913 income tax act, the next use of the foregoing approach to societal problem solving involved the preferential deduction for contributions to charitable, educational, or religious

organizations. This idea originated in an editorial published in the *New York Times* shortly after our entry into World War I, at a time when Congress, to meet the then extraordinary high costs associated with that war, had just hiked the top marginal ceiling rate from six to sixty-seven per cent. The editorial expressed a fear that, because our people were not accustomed to such high progressive rates, the increased load would tend to discourage taxpayers from continuing their generous financial support of private nonprofit organizations carrying on extremely important societal tasks. (Harvard University was singled out as an illustration of such an organization.) No doubt major institutions of that type and their supporters, who simultaneously were potential contributors *and* taxpayers, did what they could to assist the congressman who had the editorial published in the *Congressional Record* and who successfully sponsored the enabling legislation that authorized a charitable-contributions deduction.

Three subsequent developments have contributed significantly to today's widespread and intense criticism of this tax-preference approach to societal problem solving.

First, each administration and Congress has seen our nation encounter *new* societal problems and, beginning particularly with the administration of Franklin Roosevelt, has sought to provide a governmental response. While new tax preferences were not the only weapons available, typically a taxpayer-group (often well-organized or at least well-represented in legislative halls) either *was* itself the societal problem or expressed interest in helping to attack the problem, but in either case such a group argued that it could not "go it alone" and that it required the aid of a new tax preference. The assistance also provided by every such group in facilitating congressional enactment was no doubt also a factor in tempting each succeeding administration—down to and including the administration of President Carter—to respond to problems by turning to just such a tax measure. It is hoped that a few examples, out of the many that might be cited, will emphasize the magnitude and seemingly inevitable character of this development.

Franklin Roosevelt, concerned with the Great Depression, sought to improve the nation's economic health by increasing consumer purchasing power. To this end, he induced Congress *inter alia* to extend a tax preference to corporations but only as to *distributed* profits, intending a significantly higher corporate rate for *undistributed* profits. It was also during his administration that the government addressed itself to the nation's health problems by adding to the tax code a special deduction for extraordinary medical expenses.

The Truman administration was marked, illustratively, by concern over the impact of the postwar era's skyrocketing prices on older persons who had retired or were about to retire from the labor force. Out of this concern emerged a tax preference doubling the personal exemption deduction for taxpayers or their spouses who had reached sixty-five years of age.

President Eisenhower was in office when, to spur investment and invigorate a slow-moving economy, a provision for double-declining balance depreciation was added to the Code.

But over the long haul, that apparently was not enough. By the time John F. Kennedy campaigned for office, our economy was again in the doldrums—a fact that led him to promise that he would take the steps necessary to “get America going again.” To this end, his administration later pressed successfully for the adoption of an investment tax credit.

President Johnson will be remembered, perhaps not only for our role in the Vietnam War, but also for his “Great Society” programs directed at the problems of the underprivileged. Not surprisingly, a special tax preference was granted employers during his administration to encourage them to hire and train welfare recipients. The preference took the form of a tax credit for part of the wages paid such persons.

After Richard Nixon assumed office, the nation again suffered an economic slowdown and also a serious balance-of-payments problem. He responded in part by successfully urging Congress to adopt two new tax preferences: (1) the ADR system (asset-depreciation-range system) to encourage business modernization and expansion; and (2) the DISC (domestic-international-sales-corporations) arrangement to spur exports.

Gerald Ford had just assumed the presidency when America suffered its most severe recession since the Great Depression of the 1930s. He and Congress responded with the Tax Reduction Act of 1975. To assist the sorely depressed housing industry, *inter alia*, it included a substantial tax credit for any taxpayer acquiring a new home.

Finally, Jimmy Carter, though earlier quite generally critical of tax preferences, turned for help to such a preference soon after he took office, by urging Congress to increase the investment credit. Later, as the economy improved and after other features of his anti-recession program had encountered widespread criticism in Congress, he abandoned this proposed increase in the investment credit. However, Congress responded by tacking on a job credit for employers adding new employees.

The foregoing examples are *only* illustrations of the important proposition stated earlier: each administration and each Congress faced with societal problems has turned to tax preferences for assistance. This important proposition must be kept before us during the ensuing discussion.

Equally important to understanding the intense criticism directed at tax preferences, and closely related to the development just discussed, is the fact that each administration and each Congress has been almost consumed by the particular societal problems *it* encountered. As a consequence, no administration or Congress has expended much effort trying to determine whether previously adopted tax preferences should be retained. Thus, each such preference tended to remain a part of the Code regardless of whether the societal problem it originally addressed was still a significant problem, and if it were, whether that tax preference represented the most equitable, efficient, and feasible solution. It is true that the Tax Reform Act of 1976 did eliminate the fifty-year-old tax preference for China Trade Act corporations, but by 1976 only three taxpayers had any interest in its continued existence. The preference had certainly outlasted its usefulness.

A final factor contributing to our dissatisfaction with tax preferences is that typically the annual revenue loss resulting from any given preference increases enormously in the years following its enactment. For example, disregarding the constitutional issue, in the case of individuals the exclusion of interest from state and local bonds was relatively unimportant back in 1913 when tax rates ranged only from one to six per cent. Today, however, the top marginal rate is seventy per cent, and it should surprise no one that eighty-eight per cent of the resulting \$1.3 billion annual revenue loss is attributable to individuals in high tax brackets having adjusted gross incomes of more than \$50,000. In the case of corporations, given the almost flat forty-eight per cent stated rate imposed on most banks, the estimated revenue loss of \$2.8 billion is even greater.

Similarly, in the first year following the 1921 enactment of the tax preferences now associated with private pension trusts, there were relatively few such trusts. But those provisions, designed to encourage the private sector to involve itself in the nation's retirement problems, have proved their effectiveness. Such trusts now hold over \$200 billion in assets. But this tremendous growth also helps explain why the relevant tax preferences now result in an annual revenue loss of \$6.5 billion. Finally, there probably was little employer-sponsored group life insurance in 1921 when the Internal Revenue Service first

ruled that the annual benefit was excludible by covered employees. But today, group plans account for more than forty per cent of all life insurance.

Taking into account literally dozens of comparable illustrations, tax preferences are now responsible for an estimated revenue loss of almost \$100 billion, about three quarters of which is lost individual income tax revenue.

*C. President Carter Responds:
Wholesale Attack on Preferences*

The foregoing developments on the tax side of the ledger have been matched, according to President Carter, by almost identical developments on the appropriations side. Congressional committees, concerned with appropriations, are said to have devoted almost all their time to questions involving *increases* requested by the various agencies, leaving scant time to examine whether any justification existed for previous funding levels. To reverse this trend and to force reexamination of the *entire* budget by reference to relative priorities, the President hopes to institute, with respect to all appropriations, a system of "zero-based budgeting."

On the tax side, his stated intentions are identical. To say, as he has, that the nation must have "comprehensive, total tax reform," that we must "start from scratch rather than simply revise today's system," is simply another way of calling for "zero-based" review of the Internal Revenue Code.

His proposed guideline, substantively speaking, is to assure progressivity by taxing all income in the same way, but none of it more than once. Quite obviously, this is tantamount to a frontal attack on tax preferences. This accounts for his belief that, as a tactical matter, real reform will be possible only if the entire income tax law is "taken on" at one time, as a single package, "so that people [can] see a balance of where they might have to pay more in one area and get benefits [such as lower rates] in a different area."

1. Obstacles in Carter's Path

The qualities that made possible Mr. Carter's extraordinarily quick elevation from political obscurity to the oval office will be sorely tested when he seeks to overcome the six formidable obstacles that stand in the way of his proposed tax reform.

The first difficulty results from the possibility that his "shotgun" may have too broad a gauge. Politicians and commentators who

refer to tax preferences as “loopholes” tend to create an impression that *all* tax preferences are equally devoid of merit. But on the day of reckoning (that is, when the votes are counted) they may discover that the impression they helped create has also entrapped them. Specifically, their failure to make distinctions and to concentrate their attack on the least meritorious may lead them to “take on” entirely too much. Meaningful differences do exist in at least the relative merits of the diverse preferences. For example, in respect to tax preferences associated with private pension trusts, the societal problem warranting concern (the provision of retirement income for the aged) relates exclusively to the very taxpayer group advantaged by the preference. They are *one and the same*. But it is otherwise in the case of deductions for gifts to ordinary charities. The basic aim here is to encourage preferenced taxpayers to donate substantially more than the value of their tax preference to organizations in which they possess no economic interest but which, according to congressionally mandated standards, are performing important societal functions for *others*.

That there *is* a meaningful difference between these cases has even been acknowledged by the President. But his first problem goes beyond the fact that differences exist in the relative merits of tax preferences. More crucial is the fact that taxpayers and congressmen *perceive* important differences among the various preferences. Those varying perceptions no doubt are influenced by otherwise formulated ideological tastes; some persons, more readily than others, would use the income tax as a social tool to revise the income allocation patterns of the marketplace. As a consequence, a person of the former persuasion, while prepared to preserve the *exclusion* for *Medicaid* benefits (however substantial) received by a poor person, may nonetheless argue for elimination of the *deduction* for extraordinary medical expenses on the ground that it also benefits individuals in high rate brackets. In contrast, a second person less interested in politicizing the income tax may equate the two tax preferences. He could argue that both are warranted, since neither actually constitutes a “preference.” He views “income”—the “base” or “subject” of the tax—as something potentially enjoyable. With respect to our two so-called preferences, it is obvious that neither afflicted person really will “enjoy” the amounts in question; each case is roughly analogous to an involuntary conversion generating a casualty loss. Our second observer, wishing to treat this loss according to his own conception of income, may be regarded by yet others as actually having done nothing more than identify our fourth category of preferences, which

Congress justified by reference to *equitable* considerations. But the pivotal point—and one not to be thrust aside—is that, in the battle to eliminate preferences, it will not be easy to overcome previously conceived dispositions that led many persons (including congressmen) to subscribe to the *rhetoric* housing those substantive arguments supporting the original enactment of many preferences.

A second obstacle, compounding the significance of entrenched, favorable perceptions, is the existence of vested interests. Enormously powerful, sometimes different, sometimes overlapping, yet invariably articulate, taxpayer groups now benefit from one or more of our substantial preferences. For *illustrative* purposes only, consider the following data:

(1) 90 million individual insurance policies now are included in the group life insurance policies taken out by employers for employees;

(2) 32 million individuals, most of whom still are in the work force, are covered by preferentially treated private pension plans with total assets of more than \$200 billion;

(3) a comparable number, most of whom now have left the work force, currently benefit from the income tax exclusion for social security benefits;

(4) 9 million individuals, sixty-five years of age or older, file income tax returns claiming the second or additional exemption deduction granted exclusively to this age group;

(5) since sixty-four per cent of all housing units are owner-occupied, it is not surprising that in one recent year 19.4 million returns listing itemized deductions included one for interest;

(6) about 750,000 profitable corporations are sufficiently small to benefit substantially from the current \$50,000 surtax exemption.

Given the reality that vested interests in preferences are so widely spread across economic and age spectrums, and given the aggregate dollar amount involved in such preferences (individual and corporate preferences account for almost \$100 billion annually), a successful campaign to eliminate them obviously requires that, as a *quid pro quo*, something be offered in exchange, even if our government immediately could effectively use (which it could not) all of the otherwise resulting revenue gain. The President in effect offered such a trade-off when he explained his reason for undertaking total tax reform in one package: “[I]f they only hear about the part that they’ll pay more and don’t hear about the compensating element of reduction in tax rates, that just creates consternation and concern, and it’s a bad political thing to do.”

But from this "compensating" offer will emerge a third and quite complex obstacle to his success, an obstacle that concerns the *degree* to which our current rate spread would be compressed, with the ceiling rate reduced. The complexity and formidable character of this problem result from the cumulative impact of several considerations. The potential value of many such preferences (and thus the current tax saving) to specific individuals or income classes increases as their respective incomes and marginal rates increase. But to try to account for this in a compensating rate-reduction scheme would run headlong into the fact that there is no uniformity in the degree to which taxpayers *within* any given income class now avail themselves of these preferences. In short, no rate reduction, at least within limits tolerable to the treasury,⁶ ever could satisfy all of any given income class.

A fourth obstacle greatly intensifying the power struggle will emerge if there is an attempt to use the rate revision as an occasion to make—as the President has suggested—a *relative* change in the *effective* rates paid by the various income classes (to achieve greater effective progressivity than presently exists). To refer to this problem first in terms of a *power* struggle is not to question the theoretically rational proposition that marginal rates for higher income brackets must be higher than rates applied to lower income brackets even to achieve, in substance, a proportionate-rate tax (as distinguished from a progressive-rate tax). The utility value of a dollar to any given individual does decrease, perhaps even measurably, as the number of dollars available to him increases. But there probably is even more vitality in the iconoclastic view of the late Louis Eisenstein to the effect that, in congressional corridors, theoretically oriented rhetoric of this type can, at best, hope to play a role only *after* a pure power struggle has produced an agreed upon top marginal rate. Until that point is reached, the issue, in his view, is solely political, with its ultimate resolution a compromise—one that in effect has been forced on the diverse competing interests and that modifies through taxation the income distribution patterns otherwise generated by our economic system.

It will be difficult enough to reach a compromise on a new ceiling rate (simply in a trade-off for preferences) even if there is no intention to change the relative effective rates of the various income classes. In part, this will be due to a complementary proposal which

6. To cut deeply enough to "buy off" everyone could either postpone some of Mr. Carter's planned programmatic changes or neutralize his efforts to balance the budget by the end of his first term.

probably will be submitted by the President, to eliminate the so-called double tax on distributed corporate profits. I have analyzed elsewhere the purposes and ramifications of this proposal,⁷ which former President Ford's treasury secretary had first proposed to interested congressional committees. Relevant for our purposes, however, is this question: if the enactment of such a proposal is assumed to constitute a benefit primarily for higher income classes, should this assumed benefit affect (that is, reduce) the amount of *individual* rate reduction that otherwise would be offered in exchange for various preferences; or should it be used in exchange for the elimination of existing preferences at the *corporate* level (such as the investment credit that alone saved corporations almost \$7 billion in 1976); or should it be deemed warranted without exacting for it any pound of flesh, the theory being—as the President once said—that it simply is not “right” to tax income twice?

The formidable character of the complexities presented in just choosing among these three alternatives can be demonstrated by one example. Should it be decided to eliminate entirely the preferential investment credit in a trade-off for President Carter's proposed elimination of the “double taxation” of corporate profits, what is to be done to pacify those among our 11 million single proprietors who do not own shares, and thus will not benefit from Mr. Carter's complementary proposal, but who would lose their share of the \$1.5 billion in investment credits that *individuals* claimed in 1976?

The foregoing difficulty will be encountered even if the overall compromise is intended generally to maintain the existing relative effective tax loads borne by the various income classes. But should the President seek, as he has implied, to change the relative effective burdens of the diverse classes, the justifying consideration to which he points is certain to be challenged. The President's attitude and the reason for his proposed change was indicated by the following statement: “The present tax structure is a disgrace to this country. *It's just a welfare program for the rich.* As a matter of fact, 25 per cent of the total tax deductions go for only one per cent of the richest people in the country.”⁸ The data used by the President were roughly correct. But his conclusion, that the tax is a “welfare program for the rich,” is at least questionable. He did not mention that, even with all the preferences, the 1.2 per cent of our taxpayers having adjusted gross incomes exceeding \$50,000 (presumably the

7. See Wright, *supra* note 2, at 914.

8. Emphasis added.

one per cent class to which he referred) did, nevertheless, pay approximately eighteen per cent of all individual income taxes.⁹

A fifth and distinctively different obstacle facing any wholesale attack on preferences grows out of the substantial degree to which our economy *and* various preferences of long duration have become inextricably interwoven, *together* shaping not only economic relationships but our economic life, so that pulling out the preference threads could unravel much of the fabric. For example, labor unions and management long have bargained collectively over the merits of diverse types of fringe benefits as substitutes for take-home pay. The bargaining process took account not only of business purposes and family needs but also of the existing relative after-tax cost of the two to both employers and employees. The end result, set out in thousands of labor contracts, has become an accepted part of our economic life. To unravel this existing pattern, accepted by labor as well as management, would not be easy. By the same token, loss (or curtailment) of the preferential interest deduction obviously would pre-

9. Also, looking only at preferences extended directly to individuals, the resulting tax savings to them appear to be spread across the various income classes in a manner more proportionate to each income class' actual proportion of the total income *tax* load than might be supposed on reading only comments in the popular press.

The following schedule includes in each column the relevant date most recently available to this writer.

Estimated Percentage Of

Adjusted gross income class (AGI) (dollars)	Total taxable returns (1974)	Total dollar value of preferences (1976)	Total individual income taxes paid (1973)
0— 7,000	29.7%	9.37%	5.64%
7,000—15,000	40.9%	22.07%	28.36%
15,000—50,000	28.2%	41.77%	48.05%
50,000 and over	1.2%	23.07%	17.96%

While the above figures show the percentages of the four adjusted gross income classes falling under the three listed categories—total taxable returns, total dollar value of tax preferences, and total income taxes paid (the use of differing years being forced by the absence of complete data)—each such percentage is less than totally accurate.

The inaccuracy results from the fact that AGI does not include all of the items which would be included under a fully comprehensive definition of income. Illustratively, long-term capital gains typically are reduced by one-half before their inclusion in AGI. Further, in 1976, some United States citizens living or working abroad were able to exclude up to \$25,000 in overseas earnings from AGI, causing them to fall in a lower AGI class although their salaries tended to range upward from \$20,000. Again, a man aged 65 or over and with a spouse aged 65 or over, retiring in 1976 and entitled to the maximum benefits then payable under Social Security, would have been able to exclude from his AGI \$6,552 of those benefits. Should this retired worker also have been receiving a noncontributory pension and/or any income from past savings, he would have had an AGI of \$6,552 less than would have been the case were Social Security benefits includible.

Obviously further illustrations can be cited. For a general, albeit brief, discussion, see SEN. COMM. ON THE BUDGET, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 4 (March 17, 1976).

clude homeowners from using it to cut their tax and housing costs. And there would be a further side effect since the increased cost of owning a home would reduce its market value vis-à-vis that of a bond. Further, homeowners would not be alone in valuing the preferential deductions for nonbusiness interest and taxes; their opinion of this "subsidy" is no doubt shared by the hundreds of thousands of persons associated with the troubled housing industry. Indeed, aid to that industry was the precise reason why, in 1975, Congress granted a new one-shot tax preference—a substantial credit—to individuals purchasing new homes.

The point, more generally stated, is this: if Congress contemplates eliminating a preference that indirectly also benefits important interests *other than* those preferenced taxpayers, must it—both as a tactical matter and in order to handle a potential societal problem—be prepared to present simultaneously an alternative nontax program to accommodate the concerns of those other important interests? For example, will hospitals, in addition to directly affected taxpayers, require assurance that there will be a National Health Insurance program before they abandon their support for the existing tax preferences individuals enjoy with respect to health insurance (whether employer sponsored or otherwise)?

An affirmative answer to this general question would exacerbate beyond all reason a sixth obstacle that, even if it were standing alone, would constitute a sufficiently formidable obstacle to comprehensive tax reform. This sixth obstacle concerns the method and the time frame by which such reform is to be pushed through Congress. A senior White House aide has stated that the President's comprehensive reform bill will be submitted in late 1977, about one year after the President's assumption of office. The mere possibility that he then might expect Congress to be equally prompt in processing that proposal and in enacting a new Code (for instance, by late 1978) is alone sufficient to dramatize the awesome impact of method and time frame on attempts to achieve "comprehensive" tax reform.

Generally speaking, there are only two possible approaches in Congress, though each can be compromised to one degree or another. The first, buttressed by the Carter imprimatur, is the single-package approach. The other is a staggered approach, proposed several years ago by Wilbur Mills, former Chairman of the Ways and Means Committee. Under the latter, all tax-preference provisions would be divided into groups, with final action on each group (termination, revision, or reenactment) taking place intermittently in succeeding years according to a predetermined time schedule calling for completion of the entire task in a fixed number of years.

With respect to the President's plan to submit a single package in late 1977, assume that otherwise fairly knowledgeable but busy policymakers within the executive branch are able during Mr. Carter's first year to absorb intelligently not only the essential economic data, but also the social and political nuances unavoidably relevant in choosing from among competing substantive alternatives that, taken as a whole, must coincide at least with the boundaries of the present income tax. Assume also that within the same year, lawyers experienced in tax affairs will be able to produce a sufficiently understandable draft at least to warrant its submission to the tax-writing congressional committees. At this point, the first of three serious difficulties will begin to emerge. Is it realistically possible for those committees, to which many new members have recently been assigned, to respond *intelligently and responsibly to a single package* having such enormously complex, interdependent, and wide-ranging ramifications and dimensions? Consideration of this question identifies the first problem, which is exacerbated by the fact that each committee will have before it not just the President's proposal but also alternative plans.

And what about the Congress itself, once the committees file their majority and minority reports? To understand the plight of individual congressmen and senators, it is necessary to make just two points. If the reader is wearied by this short essay (which merely raises questions without answering them and which illustrates each with a single example, ignoring a multitude of others equally troublesome), how can a congressman or senator be expected within a relatively short time to "get on top of the whole subject" to the extent required for him to respond intelligently and responsibly to a *single* package embracing *total* tax reform?

But political life being what it is, many congressmen and senators will no doubt conclude that the foregoing difficulty is the least of their problems. Many will feel that, whatever pressures are exerted in Washington, they simply cannot vote until after their own constituencies—to whom they are ultimately responsible—have developed the type of understanding essential to providing intelligent "feedback" (voter reaction).

The mind-boggling difficulties encountered in trying simultaneously to educate sufficiently both the public and Congress concerning the potential effects of any *total* tax reform proposal (on each of them individually and on the nation as a whole) would, it is true, be minimized by Mr. Mills' *staggered* approach to the problem. But it raises another difficulty, at least equally awesome, which the President understandably is most anxious to avoid.

The principal difficulty with the staggered approach becomes self-evident upon examining the ill-fated Tax Policy Review Bill of 1972 in which Mr. Mills embodied his proposal. Its aim was to assure that all preferential provisions would be reexamined carefully *and* manageably—with one-third coming up for review each year. This approach would insure that all relevant arguments would still be fresh in the minds of congressmen and the public at the time Congress acted on any given set of preferences. One corollary to this approach necessitates the division of all preferential provisions into three groups. But Mills'—or anyone else's—groupings would have an inherent defect. If Congress did legislate following its study of the first group, it would find itself buying a "pig in a poke," and, as Mr. Carter so clearly recognizes, this will be true however the various provisions are grouped. This is the inescapable consequence of the exceptionally pluralistic and complex character of our society. The tax affairs of individuals or business enterprises have become intertwined in diverse ways and degrees with many Code provisions including those according various types of preferences. As a consequence, under the staggered approach, regardless of how the preferential provisions are grouped, there is great risk that congressmen (and the public) will conclude that, because of the overriding importance of the tax reform's *total* effect, they simply must not vote affirmatively on changes proposed for the first group without knowing precisely what will be done to the provisions included in the other two groups, on which work and action have been deferred. Thus, under this method, there may be even less assurance than under the President's single-package approach that any total tax reform can be achieved, though both methods would be encumbered by the first five previously described obstacles.

Mr. Mills' earlier bill, to assure that Congress in fact would carefully reexamine all preferences according to the predetermined time schedule (over a three-year period), would have applied automatic repealers—staggered over the three-year period—to each item in each group. The underlying supposition was that Congress, with this gun at its head, was certain to act, one way or another. Predictably, the business community argued that the consequent threat, because of its unsettling effect, would *immediately* adversely affect business confidence regarding the future business (including tax) climate.¹⁰

10. Representative Ullman, now the Ways and Means Committee Chairman, responded to this criticism at that time by proposing that the automatic repealer be eliminated, accompanied by a congressional directive to the tax-writing committees to complete their study in a two-stage approach (rather than three) over a two-year period.

For reasons cited elsewhere, the President has now opted for the single-package approach to reform. But whatever Congress now does in connection with that effort, the Senate Operations Committee proposes that thereafter, through its "Sunset Bill," all "*tax expenditure*" provisions be subjected to termination dates selected to coincide with the scheduled periodic reexamination of their functional counterpart programs on the "*direct expenditure*" side of the ledger.

IV. CONCLUSION

Within just one term, President Carter proposes to move from the greatest annual deficit in history to a balanced budget, to reorganize the entire government, to institute National Health Insurance, to revamp the entire welfare program, to deal with the energy problem, and to "zero base" not only all appropriations, but also the Internal Revenue Code. Obviously, he is not a timid man (to whom "everything is impossible").

It also is true that each of those things needs to be done.

But contemplating *only* his proposed wholesale revision of the tax code and understanding the formidable obstacles to *intelligent total* tax reform, some of his critics no doubt will conclude that, precisely because he opted for the "impossible," for the "pie in the sky," Congress may well wind up having to follow the advice of the late Rudyard Kipling: "stick to the Devil you know."

But his critics may be wrong. His unusual rise from relative obscurity to the Presidency—against "impossible" odds—demonstrates, does it not, that, in addition to lacking timidity, he clearly is no fool (one who rushes "in where angels fear to tread").