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BACK FROM THE DEAD: HOW PRESIDENT REAGAN SAVED THE INCOME TAX

MARVIN A. CHIRELSTEIN*

Plato once observed that "when there is an income tax, the just man will pay more and the unjust less on the same amount of income." Today, the Congress is once again engaged in the timeless effort to craft an equitable, broadly based federal income tax without many of the "loopholes" that have spawned so much taxpayer cynicism. In this Article, Professor Chirelstein surveys the dramatic evolution of federal tax policy since Ronald Reagan became President. He argues that the President—an inveterate critic of the progressive income tax—is now leading the country through a tax policy crisis he helped to create. Professor Chirelstein concludes that the historic tax reform legislation of the 99th Congress should lay to rest the concept of a consumption tax and reinvigorate the progressive income tax that is the federal government’s fiscal cornerstone.

PRESIDENT Reagan has been an outspoken and consistent opponent of the progressive income tax throughout his political career. His criticism of big government, his enthusiasm for individual enterprise and initiative, and his anti-tax theme have been a constant element of the President's appeal to voters. In a 1961 speech to the Orange County, California, Press Club, Ronald Reagan commenting about the federal income tax system said:

Once we were told the income tax would never be greater than 2 per cent and that only from the rich. In our lifetime, this law has grown from 31 to more than 440,000 words. We have received this progressive tax direct from Karl Marx who designed it as the prime essential of a socialist state. . . .

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There can be no moral justification of the progressive tax. . . . Proportionate taxation we would gladly accept on the theory that those better able to pay should remove some of the burden from those least able to pay. The Bible explains this in its instruction on tithing. We are told that we should give the Lord one tenth and if the Lord prospers us ten times as much, we should give ten times as much. But under our progressive income tax, computing Caesar's share is a little different.¹

That was in 1961. In his television address on tax reform in May 1985, President Reagan said:

Death and taxes may be inevitable, but unjust taxes are not. The first American Revolution was sparked by an unshakable conviction: Taxation without representation is tyranny. Two centuries later a second American Revolution for hope and opportunity is gathering force again, a peaceful revolution but born of popular resentment against a tax system that is unwise, unwanted and unfair.

. . . So let's get started, let's change the tax code to make it fairer, and change tax rates so they are lower.

. . . [Changed in the ways that I propose, the tax law] would send one simple, straight-forward message to an entire nation: America, go for it.²

Though nearly twenty-five years apart, these two excerpts are quite consistent in content as well as in the choice of the exaggerated metaphor, "Go for it." This is fourth-down-short-yardage advice which a sensible coach always disregards unless the game is in the final minutes and the situation is desperate. Could we really be in that position today, so tyrannized by the income tax that any desperate move is justified?

Rhetoric aside, there have indeed been major developments in the tax field during the Reagan years. The purpose of this Article is to trace these developments, more in outline than detail. The quoted speeches make it clear that the President detests the idea of a progressive tax and prefers a flat, proportionate tax, the latter being authorized by the Bible itself. Reagan also prefers lower taxes to higher taxes, not only because he thinks that higher taxes

dampen incentives to work and save, but also because they fuel undesirable government programs. The question to be answered is where these views have led us. To be sure, the march of events in this field is far from over. At this writing, the House and the Senate have passed major tax legislation for which the President is largely responsible. There are approximately two years remaining of his second term, and there is the question, admittedly speculative, of how his successor might deal with the tax problems the President will leave behind. For various reasons, however, we may have reached and passed a sort of fever-crisis in the history of federal tax policy, and it is ironic that the man who led us through it is one whose view of the system has always been entirely hostile.

In this Article, the author summarizes present discontents: What is wrong with our structure as it stands? How did it reach its present condition? Next, recent history in the tax field will be surveyed: What reform alternatives lay before the President when he took office in 1981? Which did he choose and how did his tax program during his first years in office reflect his apparent ideals? Lastly, current legislative proposals will be examined: How responsive are these proposals to the system's faults, and what do they seem to show about the President's final (if it really is his final) resolution of policy issues in this field?

The observations made under these headings are more or less provable and a matter of record, and in general, well-known to tax specialists. On the other hand, taxation is not one of the natural sciences. The main issues in the field—shall we have a progressive income tax, and shall we have an income tax at all—are largely a matter of personal political and ethical judgment. Disagreement is both possible and inevitable. Indeed public controversy over tax policy has been as heated during the past half-dozen years as at any time in our history.

I. PRESENT DISCONTENTS

Many agree that the federal income tax has deteriorated to the point where it can no longer be defended as a fair and efficient system for generating revenue. The President has publicly, if not

very originally, described the present code as Swiss cheese, “big holes no matter how you slice it.” He is of course quite right. Tax preferences have grown phenomenally since World War II, and it is not possible today to regard our national tax system as anything but unfair and unequal in its application. The Internal Revenue Code contains a multitude of special interest provisions. Some are “industry specific” concessions to big businesses like extractive industries, defense contractors, and bank and insurance companies, while others benefit investors and high-salaried individuals through reduced tax rates on capital gains, and travel and entertainment expense deductions for executives and professionals. The ideal of a comprehensive tax base—a tax on “all income from whatever source derived”—now really applies only to middle- and lower-income taxpayers who have few opportunities to exploit the preferences which the Code affords to others.

All of this is too familiar to require more than a brief mention, but it is important to explore the special problems presented by tax shelters and tax arbitrage because these devices may represent the proverbial last straw. Nothing has had a more damaging effect on the attitude of ordinary taxpayers toward the tax system, and rightly so, than the increasing resort of high-bracket taxpayers to tax shelters and tax arbitrage. The two terms sound technical but actually stand for two related devices that are quite simple. Taken together, they generally permit people with high incomes to reduce their federal tax burdens to the level of an ordinary working person, if not below.

A tax shelter is an investment that is wholly or partially tax-exempt. Municipal bonds are a familiar example. To reduce the borrowing costs of states and cities, the tax law simply exempts the interest on municipal bonds from federal income tax. Anyone who might otherwise invest his savings in a fully taxable security, such as a corporate bond or a bank certificate of deposit, can instead shelter that investment income by switching to municipals.

5. E.g., I.R.C. § 263(c) (1985).
8. Id. § 1202.
9. Id. §§ 162, 274.
10. Id. § 61(a).
11. Id. § 103(a).
This advantage, however, is limited because the price of municipal bonds, to a considerable degree, already reflects the tax exemption: municipal bond yields are less than that of comparable taxable securities precisely because of their exempt status.\textsuperscript{12}

Another major class of investment is commercial property and residential real estate, which apparently offers significant opportunities for tax shelter advantages not fully capitalized by the market. Unlike municipal bond interest, rents received by real estate investors are fully taxable. However, by permitting real estate owners to depreciate their investments over much shorter periods than the true economic lives of the structures themselves, quite a similar effect is achieved.\textsuperscript{13} Accelerated depreciation enables the investor to defer the payment of current taxes to later years. This deferral is equivalent to an interest-free loan from the government, which is the same as exempting a substantial portion of the investment income from tax in the first place.\textsuperscript{14}

As a result, the investor class, whether by reason of the tax deferral permitted to real estate owners, or by reason of the capital gain preference allowed to security speculators, pays tax at much lower rates on investment income than do those who receive income from personal services. From the standpoint of income tax fairness, not the slightest justification can be offered.

The matter does not stop there however. With some restrictions, the Code permits taxpayers who borrow money in order to invest in tax-exempt assets, especially real estate, to deduct the interest they pay to the lender from their other taxable income, including salaries and fees. In effect, a fifty percent taxpayer now finds it worthwhile to pay more interest to a lender than he expects to earn on the investment he makes with the borrowed money. Thus, if the investment yields seven percent tax-free, the investor will be glad to pay interest at a rate of, say, ten percent for a loan. While it appears that the investor is paying three percent more for the money he borrows than he will earn on the related investment, the fact is that the ten percent interest outlay, being deductible from other taxable income, costs him only five percent after tax. Because the interest he receives is tax-free, he nets two percent from an arrangement that otherwise makes no economic sense. Presumably, the investor can continue this process until his taxable in-


\textsuperscript{14} Id.
come has been reduced to very low levels. It is precisely this phenomenon, sometimes called tax arbitrage,\(^5\) that is going on today, with the consequence that high-bracket people are avoiding tax not only on investment income by putting their savings into tax-exempt investments, but also on personal service income by engaging in tax arbitrage. Stated bluntly, anyone who these days allows his income to be taxed at the highest marginal rates is a fool. He should be looking for debt-financed tax shelters to invest in. Not surprisingly, a whole industry has sprung up and exists for the sole purpose of locating such opportunities and making them available for a fee.

Having pointed to all of these shortcomings in our present system, crowned by the tax arbitrage device, everyone would probably agree with the President in describing the income tax as porous. There is some irony here. The Reagan administration is responsible, to a degree, for the tax shelter problems mentioned. Responsibility to one side, however, the fact is that our venerable income tax structure is virtually in a state of collapse. High-income taxpayers can easily avoid the high rates that the law appears to impose, and perhaps as a consequence the general taxpayer morale is declining. Thus, many taxpayers are consciously underreporting their income—cheating, apparently with little risk of detection by an understaffed Internal Revenue Service (IRS). The rather humiliating proposal for a federal tax amnesty, in which tax evaders would be given a one-time chance to pay their back taxes without penalty, is an indication of how far away we are from the ideal of a practical, working income tax.

II. REFORM PROPOSALS

The income tax system is in worse condition today than it was before President Reagan took office, and some of the biggest holes in the cheese have been made by the President or by those he appointed to the Treasury. This is certainly not to say, however, that the President is solely, or even largely, responsible for the present situation. The erosion began long ago, and has spread with only a few periods of remission. In any case, there is as much (or more) reason to blame Congress, particularly the members of the House

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and Senate tax-writing committees, as there is to criticize the Treasury or the President.

During the 1950's and 1960's, the remedies attempted by those who feared that the tax structure was decaying were limited to patchwork; efforts were occasionally made by Treasury officials to persuade Congress to deal with egregious problems. On the whole, it was a losing battle. Proposals for substantive change were usually defeated by lobbyists, and the enforcement powers of the IRS diminished significantly.

The need for an overall solution to the problems of the income tax system had become apparent to the Treasury Department during the early and mid-1970's. In 1977, the Treasury produced *Blueprints for Basic Tax Reform.*\(^6\) *Blueprints* was largely the work of economists rather than tax lawyers, and perhaps for that reason it focused less on technical detail and interpretation and more on large-scale policy than most prior studies in the field. With this broader perspective, *Blueprints* set out two large-scale proposals for improvement of our national tax structure which helped considerably to clarify the issues.

### A. Comprehensive Tax Base

One of the proposals made in *Blueprints* was for a broader income tax base in exchange for a rate reduction. Within the limits of administrative feasibility, the tax base would be expanded to include all items of income from whatever source derived. With the revenues thus gained, tax rates would be brought down to lower levels benefiting most taxpayers. It was estimated that income subject to tax would be increased by one-third under a broadened base definition, and that rates could consequently be reduced to a top bracket of thirty-eight percent (from the present fifty percent) without a loss of revenue.\(^17\)

A decision to adopt an all-inclusive definition of "income" does not automatically resolve all issues of what to bring in and what to leave out of the tax base.\(^18\) Even so, a decision to eliminate preferences by taxing all measurable accretions to wealth without regard

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to source, to disallow deductions which quite plainly relate to personal rather than business activities, and to eliminate tax shelter and arbitrage activities, would go far to restore the integrity of the income tax system. Moreover, it would satisfy the general craving for structural equity and fairness.

The comprehensive tax base idea can easily stand by itself. However, rate reduction is almost always proposed as an accompanying feature, and this in turn raises the highly charged question of whether the rate structure that results should be progressive or proportionate. The term "modified flat tax" has been used in connection with many recent reform proposals, but since any schedule with more than one rate is by definition progressive, the question really is one of degree. In the end, the question of progressivity or proportionality probably cannot be answered through logic or analysis. The argument for progressive and against proportionate taxation usually is made on "equal sacrifice" grounds. That is, each additional dollar of income adds to one's sense of well-being, but not as much as the dollar that preceded it. Arguably then, equal sacrifice will be obtained only if wealthy people pay tax at a higher percentage rate than poor people. The difficulty with this argument, it is said, is that it obligates one to make interpersonal utility comparisons that are impossible to verify. To say that a rich man gets less pleasure from additional income than a poor man and to say at what rate the increase in the rich man's satisfaction declines is not possible. Because such determinations cannot be made, no justification can be made for any particular progressive tax schedule or indeed the idea of progression in general.19

Actually, the same critical argument can be made about proportionate taxation. If we cannot verify interpersonal utility comparisons, then we cannot say that the wealthy do not value additional income less than the poor, and there is no basis for asserting that a proportionate scheme is as fair or fairer than a progressive scheme. In short, the case for any rate schedule is uneasy because every schedule, whether flat or progressive, necessarily implies that the schedule-maker thinks it fairer than some other schedule, which in turn means that he has made assumptions about how the wealthy and the poor relate.20 The issue thus becomes entirely one of ethics

and politics. Logical analysis cuts neither way, adding to rather than detracting from its importance.

B. Consumption Tax Base

The second alternative reform proposal in Blueprints was to scrap the income tax entirely and substitute for it a national consumption tax. This idea was not a new one. It can be traced back to the great Yale economist Irving Fisher, who argued in the 1940’s that it was better to tax people on what they take out of the economy through consumption, rather than on what they put into the economy through saving.21

The consumption tax idea can be summarized quickly. In effect, the tax is imposed on consumption expenditures only; savings are excluded from the tax base.22 If, for example, an individual earns $50,000 at his job this year, spends $40,000 on living expenses, and invests $10,000 in the stock market, he will be taxed on $40,000 only—the $10,000 of savings is deducted. The same $10,000 will be taxed if it is ever withdrawn and spent on consumption, possibly during the individual’s retirement, but as long as it remains invested, no tax on that amount will be imposed. With a reduced base, the tax rate under a consumption tax would have to be higher than an income tax rate if the same revenue goals were to be met.

Reserving the ultimate question of “fairness” for a moment, it should be emphasized that a consumption tax would resolve and simplify some of the besetting complexities of the income tax, especially those that relate to the treatment of income from capital. Thus, there would be no further need to distinguish capital gains from ordinary income, because it is not the source of the individual’s income but how he disposes of it that matters. In addition, the vexatious question of asset depreciation would be entirely avoided. A business would simply be taxed on gross receipts less all expenditures, including purchases of plant and equipment, because the difference necessarily represents consumption.23 In effect, plant and equipment purchases would be deducted all at once rather than being recovered though periodic depreciation allowances, as is the case under an income tax. Tax shelters would presumably van-

22. BLUEPRINTS, supra note 17, at 12.
23. Id. at 121-22.
ish as a tax problem because income from capital investment would be free of tax to start with, and sheltering would be unnecessary. Finally, the separate tax on corporate income would be repealed. As long as a corporation retains and reinvests its earnings, such earnings are obviously not available for individual consumption. When dividends are paid a tax is imposed if the shareholder expends the dividend on consumption, but not if he saves it, as by reinvesting in additional corporate shares. In effect, we do not worry about the source or amount of income. What we do care about, and all we care about, is how much the individual spends on consumption during the period in question.

These and other advantages that attach to a consumption tax are undeniably considerable. By no means would all of the definitional problems afflicting the income tax be solved—we still, for example, would have to distinguish between personal and business entertaining—but surely many would be, because it is chiefly the difficulty of coping with capital income that has generated complexity in present law. That difficulty largely disappears under a consumption tax because the effect of allowing savings to be deducted is to remove capital income from the tax base altogether.  

The consumption tax is not without serious problems however. One such problem is how to treat gifts and bequests. Suppose a highly paid individual, having saved and invested a good part of his income during his working years, and perhaps having seen those investments appreciate, approaches the moment when his accumulated assets are to be handed down to his progeny. Should a gift or a bequest at death be treated as a taxable consumption expenditure by the donor or decedent as if giving were a form of consuming? Or should we treat the individual and his descendants as a single, extended unit with no tax imposed until at long last some spendthrift descendant decides to lavish the funds on consumption? Consumption tax proponents apparently differ on this issue; the more consistent view would be to tax nothing until, or unless, accumulations were finally consumed by descendants. The point is significant, at least conceptually. A decision not to tax gifts and bequests to the donors or descendants highlights a major consumption tax premise, namely, that wealth accumulations are not to be taken into account in measuring an individual's ability to pay taxes. Putting it differently, "ability to pay" in the conventional

income tax sense is simply not a relevant criterion of taxability under a consumption tax regime.

Those who support the consumption tax idea do so not because they favor the rich and prosperous, but because they believe it is a superior taxing system. Their reasons are twofold. The first is the claim that it is better to tax people on what they withdraw from the common pool through consumption rather than on what they contribute or add to the common pool through saving.\(^2\) Consumption generates pleasure and satisfaction; saving, by contrast, is an act of sacrifice and self-denial, or at least postponement. Is it not more appropriate, then, to treat consumption, rather than income, as the measure of taxability? The second fairness claim is one of neutrality. Under our income tax, it is argued, those who choose to save—to defer consumption to later periods—are taxed twice, while those who prefer to consume their income currently are taxed only once. The point can be illustrated easily. Assume \(C\) (consumer) and \(S\) (saver) each earn $1,000 and that the market rate of interest is ten percent. In a tax-free world, \(C\) can spend $1,000 on consumption this year while \(S\), who prefers to defer consumption, can spend $1,100 next year. The tradeoff between consumption and saving is obviously $1.00 to $1.10. If a forty percent income tax is enacted, \(C\)'s current consumption is reduced to $600 because he has to pay a $400 tax. \(S\), however, will be able to consume only $636 in the second year because the income tax is imposed on both his current income of $1,000 and the $60 of interest he earns on his savings. The after-tax tradeoff (i.e., $1.00 to $1.06) is thus less than the pre-tax tradeoff. Under a consumption tax, by contrast, \(S\) pays no tax in the current year and $440 ($1,100 x .40) in the second, leaving him with $660 to spend in the later period. The pre- and after-tax tradeoffs are the same (1.00 to 1.10) because "income" has been taxed only once. Arguably, then, consumers and savers are treated alike under a consumption tax, while the latter are penalized under an income tax.

While there is force to these arguments most Americans would have difficulty recognizing the consumption tax as superior in fairness and equity to a broad-based income tax. The reason for this is that people do not regard saving as an act of self-denial where high-income taxpayers are concerned, or as mere postponed consumption. In our day at least, saving generally appears to take

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place only after all reasonable consumption preferences have been fully satisfied, and hence sometimes appears to be the ultimate luxury. It is hard to believe that a taxpayer who finds himself at the year's end with residual income which he elects to invest in the stock market should thereby effectively reduce his obligation to pay taxes. This element would be redressed, and the two systems would become quite alike if gifts and bequests were treated as taxable consumption. However, Congress is unlikely ever to be persuaded to include gifts and bequests in the consumption tax base. In any event, inclusion is not consistent with the premise on which the consumption tax idea is founded.

III. THE PRESIDENT'S FIRST TERM PROPOSALS

The foregoing more or less provides a picture of the tax policy debate as it stood at the time President Reagan took office in 1981. The economic buzzword at that moment in history was "stagflation," meaning very low or even negative growth in real terms together with a high rate of inflation. To deal with this condition, Senator Roth and Representative Kemp, in 1978, proposed to reduce individual income tax rates very sharply over a three-year period. The principal effect, in their view and that of other believers in supply-side analysis, would be to increase materially the level of total economic activity. Both Roth and Kemp believed that existing marginal tax rates had greatly depressed incentives to work, save, and invest, with this consequence being magnified by an inflation which pushed taxpayers into higher tax brackets without increasing their real incomes. If tax rates were reduced, workers and savers would respond in a way that would lead to real growth. This growth would be sufficient perhaps to make the tax reduction self-financing, as well as to lessen inflation because of the favorable effect on aggregate supply.

Supporters of Kemp-Roth appeared to fall into two camps: first, those who felt that tax reduction was good but would have to be accompanied by some reductions in federal spending if further inflation or high interest rates were to be avoided; and second, those who felt that tax reduction was very good and that, given the an-

27. Repub., N.Y.
29. CONGRESSIONAL BUDGET OFFICE, supra note 28, at xiii.
ticipated increase in the supply of labor and investment, corresponding or even substantial cuts in federal spending were unnecessary.30 The latter group, of course, consisted of true believers, of whom Representative Kemp was a leading advocate.

Most economists, on the other hand, were nonbelievers, apparently convinced that labor response to changes in taxation was relatively small, well below that needed for the proposed tax cuts to be self-financing, and that the same was true with respect to rates of personal saving. These mainstream economists argued that large-scale tax reduction would quickly lead to high interest rates and recession. The Kemp-Roth idea in its pure form (with no commitment to spending constraints) was referred to by some of their number as the "economics of joy," and this, it seems was the general position of the profession.31

There was one economist who believed in the Kemp-Roth idea, and it was his view that finally carried the day. The Economic Recovery Tax Act of 1981 (ERTA) was proposed by President Reagan in February and passed in July with overwhelming congressional support. Its principal features included:

(1) a three-year twenty-three percent cut in individual tax rates, a reduction of the top tax bracket from seventy percent to fifty percent, and the indexing of brackets as a means of reducing the impact of inflation on the tax system;32

(2) a considerable list of special interest benefits for various groups that traditionally line up at the revenue trough;33 and

(3) an enormous reduction in the taxes paid by corporations and other businesses. This was achieved largely by adopting shortened depreciation schedules for equipment and real estate,34 and by inserting in the law a new procedure called safe-harbor leasing. This

30. Id. at x-xi.
32. Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options 238 (Feb. 1983) [hereinafter cited as Reducing the Deficit]. The Economic Recovery Tax Act of 1981 (ERTA) provided for reductions in the income tax rates as follows: 5% in October 1981, 10% in July 1982, and 10% in July 1983. The cumulative rate reduction was 23% because of compounding. Id. Bracket indexation, as reflected in I.R.C. § 1(f) (1985), was made applicable for 1985 and all subsequent taxable years.
34. I.R.C. § 168(b) (1985).
provision permits companies that cannot use their tax benefits to transfer them, for a price, to companies that can.\textsuperscript{35} From the standpoint of tax policy, ERTA reflected two major ideas: hostility toward a \textit{progressive} income tax and more broadly toward the income tax as a whole, and a preference for the old but newly risen idea of a tax on consumption. The antiprogressive element of the 1981 legislation was naturally and necessarily present in the concept of an across-the-board rate cut. A uniform percentage reduction in all rates necessarily resulted in a greater percentage difference between the after-tax income of a high-bracket and a low-bracket taxpayer than was present before the reduction. In effect, there was both an absolute rate reduction and a reduction of the degree of progression in the rate schedule. Put simply, there was a shift in the overall burden of the income tax from richer to poorer together with lower taxes for all. It would be possible, even easy, to reduce taxes without altering the after-tax relationships among different classes of taxpayers. Hence it is proper to infer—and it is consistent with the President’s often-expressed dislike of progression—that the 1981 rate reduction had both aims in view. In fact, the 1981 rate reduction meant little to lower-income families, because there was no increase in personal exemptions or the zero bracket amount, while for high-income families, the reductions were quite significant.\textsuperscript{36}

Movement in the direction of a consumption tax was assisted by the adoption of the Accelerated Cost Recovery System (ACRS). As noted, the central element of a consumption tax is the deduction from income of capital investment. Together with the Investment Tax Credit (ITC), ACRS had precisely that effect, so that many enormously profitable companies wound up owing no tax whatever, and overall the tax on corporate enterprises declined precipitously.\textsuperscript{37} The safe-harbor leasing device extended the benefits of ITC and ACRS even to companies with modest capital investment programs. Quite by accident, this also generated very handsome fees for the lawyers and investment bankers who put the leasing deals together.

The consequences of the 1981 tax legislation proved, within a short time, to be most disappointing both in economic and political

\textsuperscript{35} \textit{Id.} § 168(f)(8).

\textsuperscript{36} \textit{Congressional Budget Office, Reviewing the Individual Income Tax} 15 (July, 1983).

\textsuperscript{37} \textit{Id.} Thus, the estimated effect of ERTA was to reduce corporate tax revenues from $63 billion in 1979 to $37 billion in 1983. \textit{Id.}
terms. Recession, not growth, promptly ensued. Some critics of the Reagan tax program took this as proof that supply-siders had things upside down or at least wrong. Those critics argued that lower tax rates do not spur workers to greater effort and that the saving response to lower rates was far too small to make such rate cuts self-financing.\textsuperscript{38} Other commentators took a more moderate position: that the President had simply claimed too much for ERTA and that in fact personal tax levels do not play an overwhelmingly critical role in determining growth rates or the health of the American economy in general.\textsuperscript{39}

Political disenchantment arose for other reasons as well. First, the very sharp reduction in corporate taxes resulting from the accelerated depreciation provisions had an uneven impact on business in general. Some major companies found their liabilities reduced to (or below) zero, while others were still saddled with substantial tax obligations.\textsuperscript{40} Complaints were justifiably centered on the nonneutrality of the new depreciation schedules. Beyond this, the safe-harbor leasing provisions, which permitted tax deductions and credits to be sold in the marketplace, appeared to many to have a flavor of immorality about them, although they merely served to allow unprofitable companies to participate along with profitable ones in the general scheme of capital subsidies. Finally, and most acutely, the public as a whole became aware that debt-financed tax shelters, the value of which had been substantially enhanced by ERTA's depreciation rules, had become common practice among high-income taxpayers. The public realized that tax shelters were operating not only to eliminate tax on investment income, but also to reduce or eliminate tax on personal service income such as executive salaries and the earnings of top-bracket professionals. The latter phenomenon, more than anything else, is believed to have led to a public perception that the income tax system had deteriorated to a new low of corruption and chaos. How the President managed to escape blame and instead convert it into a cause and battle cry ("swiss cheese") of his own is one of the mysteries of our time.

Reaching beyond any of these considerations was the pervasive sense, in 1982 as in 1986, that the federal budget deficit had reached dangerous magnitudes and that steps must be taken at

\textsuperscript{38} Reducing the Deficit, supra note 30, at 16.
\textsuperscript{39} Id.
\textsuperscript{40} See id. at 3.
once to increase revenues. The result of this concern, which grew steadily in intensity, was the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).\textsuperscript{41} It aimed at raising nearly $100 billion in additional tax receipts over a three-year period. The guiding spirit for TEFRA was not the President but Senator Dole,\textsuperscript{42} and indeed the President is reported to have hesitated for a time before throwing his support behind it. The enactment of TEFRA in August 1982, was a great disappointment to supply-side supporters in and out of the Treasury. Representative Kemp opposed it to the end.\textsuperscript{43} Although enacted in response to a perceived fiscal emergency, TEFRA represented a significant if not conclusive retreat from consumption tax philosophy. While individual rates were not increased as some had proposed, the new enactment plainly reflected a shift in focus from supply-side incentives to tax equity and base-broadening.\textsuperscript{44} Corporate tax preferences were cut back,\textsuperscript{45} provisions in ERTA for the further acceleration of depreciation were repealed\textsuperscript{46} (a major step made easier by the moderation of inflation), ITC benefits were reduced,\textsuperscript{47} the safe-harbor leasing rules were substantially altered and confined,\textsuperscript{48} and new impetus was given to enforcement and compliance, including withholding on interest and dividends.\textsuperscript{49} To be sure, there were also excise tax increases,\textsuperscript{50} and the withholding provision just mentioned was repealed before it ever took effect.\textsuperscript{51} Yet, viewed overall, and in hindsight, the 1982 legislation may well have marked the end, or the beginning of the end, of one aspect of the Reagan revolution. Of course, this is not in reference to the movement toward rate reduction, for which the President continues to demonstrate great enthusiasm. What may have begun to reverse itself in TEFRA was the truly revolutionary

\textsuperscript{42} Repub., Kan.
\textsuperscript{44} See id.; Brown, President Wins on Tax Increase Gamble: A Loss for the Supply Side-Business Coalition, 16 Tax Notes 798 (Aug. 23, 1982).
\textsuperscript{46} Id. at 431.
\textsuperscript{47} Id. at 427, 429 (codified as amended at 26 U.S.C. § 48 (1982)).
\textsuperscript{48} Id. at 432-48 (codified as amended in scattered sections of 26 U.S.C. (1982)).
\textsuperscript{49} Id. at 576-79 (codified as amended at 26 U.S.C. §§ 3451-56 (1982)).
\textsuperscript{50} Id. at 563-68 (codified as amended in scattered sections of 26 U.S.C (1982)).
notion that consumption rather than income is the appropriate basis of our national tax system.

IV. THE PRESIDENT'S SECOND TERM PROPOSALS

If the latter assertion would have seemed premature or over bold in 1982, by 1984 it could be made with greater confidence. In his State of the Union Address in January 1984, the President directed the Treasury to develop a tax reform plan which would achieve fairness, simplicity, and incentives for economic growth. What he got in November 1984, was a very lengthy proposal, "Treasury I," which, together with substantial rate reduction, contained a set of base-broadening measures that went farther in the direction of academic purity than any practicing politician or academic commentator would ever have dreamed possible. It is not necessary to go through the proposal in detail, but, just to pick up a few high points, Treasury I would have:

1. Repealed the capital gain preference completely, but allowed the cost basis of investment property to be indexed for inflation;
2. Repealed accelerated depreciation in favor of economic depreciation, using true useful lives coupled with basis indexing;
3. Repealed a wide variety of special interest provisions, including those applicable to the oil business and the insurance and banking industries;
4. Substantially curtailed real estate tax shelters, disallowed consumer interest deductions other than for principal home mortgages, and materially decreased tax-free treatment for employee fringe benefits; and finally,
5. Compressed the rate structure to only three brackets (four if one includes the zero bracket) with the top rate being reduced from fifty percent to thirty-five percent.

55. Id. at 157.
56. Id. at 224-88.
57. Id. at 334-35.
58. Id. at 331-33.
59. Id. at 20-90.
60. Id. at 3.
It would be interesting to know whether the President really welcomed Treasury I or whether it took him by surprise. Although well aware that the President desired to reduce rates, this author believed that whatever happened President Reagan would never seek to solve the tax system dilemma by proposing a radical base-broadening measure. In any event, Treasury I implicitly rejected the consumption tax concept and instead (and with a vengeance) opted for the longstanding, but previously unattainable, ideal of the comprehensive income tax base. Treasury I gave way to "Treasury II" in May 1985, and in the process lost some, though by no means all, of its admirable reform features. The capital gain preference was restored for nondepreciable assets such as stocks and bonds, but depreciable assets such as buildings and equipment would still not qualify for the rate preference. The oil business, as perhaps one might expect, recaptured some of the advantages it would have lost under Treasury I, but other industries, including insurance and banking, were not so fortunate. Individual tax shelter opportunities, one of ERTA's outrages, continued to be curtailed. Purists would obviously find more to criticize in Treasury II than in Treasury I, but even they would have to concede that no other administration had ever moved so swiftly and on so many fronts toward achievement of the comprehensive tax base ideal.

Treasury II finally became a House Bill. With lobbyists working day and night in the corridors, the House gave up on a few important items: depreciable property again would qualify for capital gain treatment, and tax shelter opportunities would not be quite so sharply curtailed. Yet in other respects the House Bill accepts the proposals made in Treasury II and in some instances strengthens them. It is hard to see how or why the President would veto the Bill if passed intact. One can assume that his threat to do so when the Bill was being debated in the House was merely a sop to House Republicans and not seriously meant.

Viewed in overall terms, the House Bill in many respects amounts to a repeal of ERTA. There is a further reduction of individual rates, and the major compensating feature is the restoration

62. *Id.* at 164.
64. *See House Report,* supra note 6, at 186.
65. *Id.* at 292.
of tax on capital income, particularly income from business investment. For the period 1986-1990, individual rate reductions as provided in the House Bill would cost the Treasury about $140 billion. This would be financed by an increase in business taxes of about $139 billion, plus minor increases in excise and estate taxes. The idea of increasing business taxes through the medium of returning to economic depreciation essentially represents a rejection of consumption-based taxation, of which a major feature would have to be the expensing of depreciable property. To be sure, even the House Bill retains some consumption tax features, including the capital gain preference; however, the main elements of the Bill include individual base-broadening provisions and a large-scale restoration of tax on business income, which are major trends in the opposite direction.

Either the President moves in mysterious ways or this author has no talent for psycho-history. Probably both are true. Once again, there is nothing in Reagan's political background that would have encouraged the expectation that he would lead the fight for income tax reform; especially, at a moment when the income tax itself appeared to be emitting its death rattle. Yet that is just what has happened. Credit is certainly due and deserved to the House Ways and Means Committee, of course, but chiefly to the President for having pressed on with the matter despite a relatively tepid reaction from the public and outright opposition from some sections of the business community.

Has the story reached its happy ending? No confident answer can be given, unfortunately. Now that the Senate has passed its own version of tax reform, with the support of the President, we need only wait to see what the Conference Committee will do. The expected opposition to the Bill never materialized in the Senate. If one thinks, as this author does, that income rather than consumption is the better measure of taxable capacity, then the final version should be checked for consumption tax features. The place to look is in the area of capital cost allowances (depreciation). If accelerated depreciation and investment tax credits, together with unlimited interest deductibility and reduced capital gain rates, find their way back into the legislation, then it will be appropriate to conclude that the promise of income tax reform has not been kept.

V. Conclusion

There are two lessons to be learned about tax politics from observing the Reagan years to date. The first is that no one, not even this most popular President, can avoid generating resentment and public outcry if he attempts to move in the direction of a national consumption tax. The idea of treating savings as exempt from tax will seem to most voters to be class legislation. Whatever the logic of economics, most people do not intuitively accept the notion that investment constitutes an act of self-deprivation that deserves to be rewarded with a tax exemption. It is the command of resources to which people attach value and which appears to be the appropriate measure of ability to pay. Tax policy analysts would spend their time more fruitfully by working to improve the income tax than by continuing to promote the consumption tax as a substitute structure.

The second and equally important lesson may turn out to be that the American people actually favor the concept of progression and would view a flat-rate tax as inequitable. The President's rate reduction plan, which is perfectly consistent with his oft-stated dislike of the progressive rate schedule, was more advantageous for high income individuals than the House Bill. Under the President's proposals, the distribution of the individual tax cut was divided almost equally between individuals earning more than $75,000 and individuals earning less than that amount, although of course the great bulk of Americans fall in the under-$75,000 class. The House Bill divides the tax cut roughly one-quarter to the "overs" and three-quarters to the "unders" by altering the bracket levels and raising the top bracket rate from thirty-five percent to thirty-eight percent. An admittedly unprovable and self-serving hunch is that the rather spiritless public reaction to the President's tax proposals, despite the promise of lower rates, is traceable to this very factor. As noted, the President stumped the country for tax reform during the Spring of 1985, and the White House report of his grass-roots speech notes that applause was received from his listeners at many points. When, however, speaking at a rally in Oshkosh, Wisconsin, he triumphantly declared that under his plan nobody earning over $70,000 a year would have to pay more than thirty-five percent in tax, there appears to have been

67. Id. at 945.
dead silence. Very few of those present were anywhere near that level of income or ever expected to be.

Once again, people react with considerable skepticism to the image of the courageous entrepreneur—that hard-working risktaker who is finally rewarded with wealth and blessedness, and who is so much a part of the President’s political ideal. People like that image, but in the end rather doubt that the market operates at all times and in all circumstances as a just and accurate allocator of rewards and blessings. The very mild egalitarian counterforce that is contained in the idea of a progressive income tax may well seem logical to many Americans, rich and poor alike, on quiet reflection.

As of 1985, the gap between federal spending and federal revenues was running more than five percent of gross national product. Most economists seem to believe that the gap has to be narrowed in the near future, but it is doubtful that anyone really believes this can be done by cutting spending alone. Quite possibly, even probably, additional revenues will have to be found. The President has shown us where these revenues might come from, namely, the elimination of tax preferences. Reducing the capital gains exclusion to its historic level of fifty percent, for example, would add nearly $14 billion to revenues over the next five years. Limiting the deduction for consumer interest to, for example, $10,000, would add nearly $20 billion over the same period. All of this, of course, without increasing rates, but with a substantial increase in the equity and fairness of the tax system.

Authority for this position, to be sure, could be found in the Bible. Improving the income tax offers the best hope of restoring integrity to our tax system, and some hope of coping with our fiscal difficulties. Feeling this way about the matter, I can do no better, in the end, than to echo the Great Communicator and urge that we, “Go for it.”

68. See Oshkosh Speech, supra note 4, at 2.