

POLICY ESSAY

DEJÀ VU ALL OVER AGAIN: REEXAMINING FUNDAMENTAL TAX REFORM AND EVALUATING THE FEASIBILITY OF A TRANSACTION TAX IN THE 111TH CONGRESS

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Few issues have been the subject of more conversation, debate, and frustration than the Internal Revenue Code. Since the enactment of the original tax code, legislators have tried to balance the objectives of simplicity, efficiency, and fairness in writing and administering the federal tax system. Until now, however, Congress has not been able to author a comprehensive system that works well for all taxpayers. The complexity of the tax code confuses and frustrates individuals while causing increased costs for businesses. Through the proliferation of credits and exemptions the tax code changes how resources would be allocated in an open market. Moreover, the current system of taxation fails in its attempt to be fully progressive, enabling wealthy individuals and corporations to avoid their full tax liability through professional tax planning, tax shelters, and even tax evasion. Thus, the system remains inequitable, imposing a disproportionate tax burden on the middle and lower classes. This Essay suggests a new framework for Congress to consider: the Debt Free America Act, introduced by the author in the 111th Congress in 2010. If passed and signed into law, the Act would replace the current income tax with a one percent transaction tax on all financial transactions in the United States. The Essay explores how such a system would, in light of the history and principles of tax reform, better meet the ideals of tax policy and the needs of a changing global marketplace.

I. INTRODUCTION

Few issues in American public policy have elicited such longstanding and acrimonious debate as the structure of the U.S. tax system.¹ To a large degree, tax policy requires confronting questions that are foundational to the American system of government and the sorts of public policy it should enact²: What is government meant to do? Whom is it meant to serve? How

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¹ See, e.g., LANDMARK DEBATES IN CONGRESS: FROM THE DECLARATION OF INDEPENDENCE TO THE WAR IN IRAQ 223, 270, 437 (Stephen W. Stathis ed., 2009) (describing congressional debates from 1894 to 1981 regarding the U.S. income tax); William Gorham, *Foreword* to C. EUGENE STEUERLE, THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA xix (1992) (“The tax policy debate . . . will necessarily be with us as long as we have government. . . . Attaining a balance between the benefits and costs of taxes is a delicate and often acrimonious affair.”).

² See, e.g., MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 1–2 (6th ed. 2009) (“The most fundamental issues of public policy

much can the government ask its citizens to contribute? What sorts of obligations do citizens have to one another?

The answers to these questions are essential to establishing national priorities and determining the size and scope of the federal government. As such, the fact that these questions are embedded within tax policy imbues the U.S. tax code with great political and philosophical significance.³ Moreover, from a philosophical standpoint, unjust taxation has been anathema to the American system of government since its inception. To be sure, the American Revolution was itself sparked by the colonists' rejection of what they believed to be arbitrary and capricious imperial taxes imposed by a distant Parliament in which the colonists had no representation.⁴

With the exception of the District of Columbia,⁵ current concerns over taxation tend not to focus on the issue of adequate representation in the legislature. Instead, modern critics of the U.S. tax code question the fundamental fairness of the level of taxation imposed⁶ and the distribution of tax burdens among the tax-paying public.⁷ Taxation can be a means of effectuating important public goals by providing funding for government initiatives. For instance, during the 2008 presidential campaign, then-vice presidential

sometimes are raised when Congress enacts tax laws, and the Internal Revenue Code is laden with legislative judgments about social policy. . . . Issues of equity in taxation raise issues of justice generally. . . . [Additionally, t]axation long has been a primary link between the people and their government.”)

³ See *id.*; DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE 11–12 (2003); Kevin D. Hoover & Mark V. Siegler, *Taxing and Spending in the Long View: The Causal Structure of US Fiscal Policy, 1791–1913*, 52 OXFORD ECON. PAPERS 745, 745 (2000) (discussing the relationship between taxes, spending, and political goals).

⁴ See THE DECLARATION OF INDEPENDENCE (U.S. 1776) (listing “the imposing of taxes . . . without consent” as a grievance against King George III); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 3 (2d ed. 2007) (characterizing the Declaration of Independence as “a bill of particulars against British taxation”); Scott A. Schumacher, *Macniven v. Westmoreland and Tax Advice: Using “Purposive Textualism” to Deal With Tax Shelters and Promote Legitimate Tax Advice*, 92 MARQ. L. REV. 33, 43 (2008) (noting that “[t]he battle cry of the American Revolution was not ‘liberté, égalité, fraternité,’ but rather, ‘no taxation without representation’”). Indeed, antipathy toward taxation—even when not couched in terms of a fight against injustice—is a popular American sentiment. GRAETZ & SCHENK, *supra* note 2, at 2 (“Resistance to taxes is as American as apple pie and can be traced back to the nation’s birth. We have always been a tax-hating people.”); see also MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 35–42 (2008) (detailing the Republican Party’s successful cultivation of anti-tax sentiment among the public).

⁵ See No Taxation Without Representation Act of 2006, H.R. 5410, 109th Cong. (2006) (proposing that the District of Columbia be treated as a state for several purposes, including taxation).

⁶ See, e.g., BOB DOLE & JACK KEMP, TRUSTING THE PEOPLE: THE DOLE-KEMP PLAN TO FREE THE ECONOMY AND CREATE A BETTER AMERICA 3, 6–16 (1996).

⁷ See, e.g., Nancy C. Staudt, *The Hidden Costs of the Progressivity Debate*, 50 VAND. L. REV. 919, 919–21 & nn.1–9 (1997) (outlining the contours of the debate on progressivity in the tax system, including several critiques of progressive income taxation); see also HALL & RABUSHKA, *supra* note 4, at 36 (“No aspect of federal income tax policy has been more controversial, or caused more misery, than allegations that some individuals and income groups don’t pay their fair share.”).

candidate Joe Biden urged wealthy individuals to accept greater economic responsibility for the financial hardships faced by an expanding number of Americans by paying more taxes.⁸ Such notions of collective responsibility are compelling, but whether the imposition of taxes is the method by which these common social goals should be realized is an altogether contentious issue.⁹

Equally important, and more central to the arguments in this Essay, are the structural problems with the present system of federal taxation. The current tax code is exceedingly complex and difficult to administer.¹⁰ Furthermore, the current system is not sufficiently neutral, which results in economic inefficiency.¹¹ Many proponents of tax reform assert that the current system of taxation discourages saving, reduces economic growth, causes economic distortions, and worsens the nation's balance of trade.¹² Given the need for fundamental reform of the tax code, this Essay explores several important issues: (1) who should be subject to taxation; (2) what system of taxation should be adopted; and (3) how that system of taxation should be administered.

Although the current tax structure is primarily based on the taxation of income, it actually contains elements of both income-based and consumption-based taxation.¹³ The current system taxes wages, interest, dividends,¹⁴

⁸ Associated Press, *Biden Calls Paying Higher Taxes a Patriotic Act*, MSNBC, Sept. 18, 2008, <http://msnbc.msn.com/id/26771716> (discussing comments made by Joe Biden indicating that "paying more in taxes is the patriotic thing to do for wealthier Americans").

⁹ See, e.g., Staudt, *supra* note 7, at 919–21 & nn.1–9. Compare James A. Dorn, *Introduction: The Principles and Politics of Tax Reform*, 5 CATO J. 361, 367–68 (1985) (arguing that a progressive system of taxation is inherently flawed, impermissibly substituting "end-state (or distributive) justice" for "the liberal rule of law tradition with its emphasis on procedural (or process) justice and private property rights"), with Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 14–21 (2006) (contending that the tax system should be concerned with redistributing wealth).

¹⁰ GRAETZ, *supra* note 4, at 14 (finding that it costs the government and taxpayers \$150 billion to calculate taxes and administer the tax system each year due to the complexity and confusion inherent in the system).

¹¹ See *id.* at 5–10. Graetz argues that fundamental tax reform is necessary to change the federal government's unsustainable practice of spending more than it receives in revenues. *Id.* at 6–7. According to Graetz, "[w]e must stop pretending that we can continue to live with a tax system inadequate to finance what we are spending." *Id.* at 7. Similarly, by some estimates, the current system of taxation imposes total compliance costs of \$100 billion on individuals and business. HALL & RABUSHKA, *supra* note 4, at 16. Hall and Rabushka also claim that the federal tax regime costs the U.S. economy \$100 billion in lost outputs from the pursuit of tax-favored investments, \$50 billion directly attributable to lobbyists lured to Washington in the hopes of obtaining tax incentives for clients, and \$35 billion attributable to consultation with tax-planning professionals. *Id.* at 28. Moreover, the difference between what taxpayers actually owe and what they pay is estimated as a staggering \$345 billion. Susan Cleary Morse et al., *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 37 (2009).

¹² See GRAETZ, *supra* note 4, at 5–10; HALL & RABUSHKA, *supra* note 4, at 127–36.

¹³ JAMES M. BICKLEY, CONG. RESEARCH SERV., NO. R40414, TAX REFORM: AN OVERVIEW OF PROPOSALS IN THE 111TH CONGRESS 1–2 (2009). Income is generally defined as the sum of consumption and savings. *Id.* at 2. Accordingly, an income tax applies to the amount an individual or business consumes and saves. *Id.* As its name would suggest, a consumption tax is only levied on the amount a taxpayer consumes. *Id.*

and capital gains,¹⁵ all of which are consistent with an income tax.¹⁶ At the same time, however, the current tax system excludes from taxation certain types of savings, such as pension and Individual Retirement Account (“IRA”) contributions, which is consistent with a tax using a consumption base.¹⁷ In revising the tax code, Congress should determine which of these forms of taxation better satisfies the goals of simplicity, fairness, and efficiency—the three criteria by which tax systems are generally assessed¹⁸—and adjust the tax base accordingly. Ultimately, this Essay articulates a rationale for adopting a consumption-based system of taxation.

Part II of this Essay briefly outlines some of the fundamental problems posed by the complexity and opacity of the current tax system. Part III then provides background on the prior tax reform efforts that led to the passage of the Tax Reform Act of 1986,¹⁹ the last major piece of tax legislation. Part IV compares the tax reform efforts in 1986 with the legislative proposals under consideration by the 111th Congress. Part V then discusses the Debt Free America Act, as introduced by this author, which proposes to replace the current system of federal taxation with a small fee of up to one percent to be imposed on financial and economic transactions. Part VI discusses both the prospect for successful congressional passage of the Debt Free America Act and the possibility that such a fundamental change to the current system of taxation will be signed into law.

II. STATEMENT OF THE PROBLEM

One of the primary reasons for public dissatisfaction with the current tax system is the inability of many taxpayers, including the most sophisticated, to determine whether the taxes they are required to pay are fairly assessed. Taxpayers face thousands of pages of tax statutes and regulations.²⁰ The sheer volume of these federal tax documents, let alone their complexity, infuses a great deal of uncertainty into the process of paying taxes. For example, Michael Graetz estimates that two million Americans pay a combined one billion dollars in excess taxes every year because of confusion over whether to choose the standard deduction or itemize their individual deductions.²¹

¹⁴ *Id.*; see I.R.C. § 61(a) (2006) (defining taxable “gross income” as “income from whatever source derived,” and specifically including compensation, interest, and dividends).

¹⁵ I.R.C. § 1222 (describing the various forms of capital gains and losses for tax purposes).

¹⁶ BICKLEY, *supra* note 13, at 1.

¹⁷ *Id.*

¹⁸ GRAETZ & SCHENK, *supra* note 2, at 28–31.

¹⁹ Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.).

²⁰ HALL & RABUSHKA, *supra* note 4, at 6–7.

²¹ GRAETZ, *supra* note 4, at 14–15.

Moreover, identifying the proper forms used to pay taxes to the federal government can itself be extremely complicated and often requires the specialized knowledge and skill of professional accountants or tax attorneys.²² The Internal Revenue Service (“IRS”) issues nearly 480 tax forms and over 280 additional forms simply explaining how to fill out the first set.²³ The more than fifteen thousand changes that have been made to the tax code since 1986 also add even more instability and unpredictability to the unwieldy federal system of taxation.²⁴ According to Graetz, Americans and their professional advisors spend a total of approximately 3.5 billion hours sifting through these documents and preparing and filing their annual taxes.²⁵

Furthermore, a form that is appropriate for one taxpayer, depending on a vast array of circumstances, may not be suitable for another. For instance, an individual who claims no dependents may only be required to submit Form 1040EZ²⁶; however, she may be required to submit the longer standard Form 1040 if certain credits are claimed.²⁷ Similarly, a taxpayer who wishes to itemize deductions in order to minimize her tax obligation to the federal government may be required to submit the Schedule A form in addition to Form 1040.²⁸ Additionally, a taxpayer claiming income from interest or dividends may be required to submit the Schedule B form as well as the Schedule A and 1040 forms.²⁹ Taxpayers seeking to claim the first-time homebuyer tax credit must also submit Form 5405 in addition to the Form 1040 or Form 1040EZ.³⁰ Thus, to the average taxpayer, the incredible number of forms, despite any instructions provided by the IRS,³¹ can often lead to confusion, uncertainty, and profound frustration with the entire process.³²

For businesses, the resources required to properly remit taxes to the federal government can be even more extensive. This is especially true for large, multinational corporations, which often must hire large teams of tax

²² See William H. Miller, *The Coming Tax Battle: Will Business Unite on a ‘Doable’ Strategy?*, *INDUSTRY WK.*, Oct. 1, 1984, at 70, 71 (noting that the increasing complexity of the tax code caused the percentage of taxpayers seeking advice from professional tax preparers to rise from eighteen percent in 1954 to fifty-two percent in 1984).

²³ HALL & RABUSHKA, *supra* note 4, at 7.

²⁴ GRAETZ, *supra* note 4, at 11.

²⁵ *Id.* at 14.

²⁶ IRS, FORM 1040EZ (2009), available at <http://www.irs.gov/pub/irs-pdf/f1040ez.pdf>.

²⁷ IRS, FORM 1040 (2009), available at <http://www.irs.gov/pub/irs-pdf/f1040.pdf>.

²⁸ IRS, SCHEDULE A: ITEMIZED DEDUCTIONS (2009), available at <http://www.irs.gov/pub/irs-pdf/f1040sa.pdf>.

²⁹ See IRS, SCHEDULE B: INTEREST AND ORDINARY DIVIDENDS (2009), available at <http://www.irs.gov/pub/irs-pdf/f1040sb.pdf>.

³⁰ See IRS, FORM 5405: FIRST-TIME HOMEBUYER CREDIT AND REPAYMENT OF THE CREDIT (2009), available at <http://www.irs.gov/pub/irs-pdf/f5405.pdf>.

³¹ See generally IRS.gov, Forms and Publications, <http://www.irs.gov/formspubs/index.html> (last visited Mar. 30, 2010).

³² See TAX POL’Y CTR.: URBAN INST. & BROOKINGS INST., *THE TAX POLICY BRIEFING BOOK: A CITIZENS’ GUIDE FOR THE 2008 ELECTION AND BEYOND III-3-1* (2010), available at http://www.taxpolicycenter.org/briefing-book/TPC_briefingbook_full.pdf [hereinafter TAX POLICY BRIEFING BOOK] (arguing that the tax system should be simplified to minimize taxpayer confusion and the resulting belief that a complex code is unfair).

experts to determine which company operations are subject to U.S. taxes and to perform the intricate calculations required by the tax code.³³ To take one example, in 1973, a major multinational U.S. oil company filed a return that ran to 620 pages of tax documents and supporting materials.³⁴ Ten years later, the same firm filed a nearly 2000-page federal tax return that required the resources of a dedicated corporate tax department of 283 people.³⁵ Though large, multinational businesses can likely afford the costs associated with tax compliance, economists and corporate taxpayers alike agree that resources allocated toward tax compliance would be better spent on research and development³⁶ or by simply passing the cost savings to the end user in the form of cheaper products and services.³⁷

Thus, it should come as no surprise that the general public looks on taxation with pronounced skepticism. Many Americans believe that they pay too much in taxes³⁸ and that the tax system is too unstable.³⁹ Moreover, many taxpayers, particularly those in middle-income brackets, believe that the tax system is full of special tax breaks of which they are unaware, and that such loopholes only inure to the benefit of the wealthiest and craftiest members of society who can afford sophisticated tax planning advisors.⁴⁰ Such deep misgivings about the fairness of the tax code are not without basis. Prior to the enactment of the last major overhaul to the federal tax code in 1986, wealthy taxpayers took advantage of the proliferation of tax shelters and allowable

³³ See, e.g., Miller, *supra* note 22, at 70; see also Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007); Henry M. Paulson, Jr., *Our Broken Corporate Tax Code*, WALL ST. J., July 19, 2007, at A15 (noting that American business spend forty billion dollars annually on tax compliance costs).

³⁴ Miller, *supra* note 22, at 70.

³⁵ *Id.*

³⁶ See, e.g., NAT'L COMM'N ON RESTRUCTURING THE IRS, PUBLIC HEARING BEFORE THE NATIONAL COMMISSION ON RESTRUCTURING THE INTERNAL REVENUE SERVICE: TESTIMONY OF MICHAEL E. MARES, CHAIR, TAX EXECUTIVE COMMITTEE (1996), available at <http://www.house.gov/natcommirs/aicpa4.htm> (“[S]ome observers express concern that the compliance burden borne by the taxpayers and the IRS diverts resources from more productive endeavors.”).

³⁷ Cf. Joann M. Weiner, *U.S. Corporate Tax Reform: All Talk, No Action*, 116 TAX NOTES 716, 719 (2007) (indicating that consumers actually bear the cost of high corporate tax rates in the form of higher prices).

³⁸ Although according to Gallup poll results Americans' dissatisfaction with their level of taxation is at its lowest point since 1961, forty-six percent of Americans still believe that they pay too much in taxes. Gallup, Taxes and Tax Cuts: Gallup's Pulse of Democracy, <http://www.gallup.com/poll/1714/Taxes.aspx> (last visited Mar. 30, 2010) [hereinafter Gallup Tax Poll].

³⁹ Karlyn Bowman, *Americans Today Would Prefer Tax Stability*, AM. ENTERPRISE INST. FOR PUB. POL'Y RES., May 14, 2003, available at <http://www.aei.org/article/17203>.

⁴⁰ See Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 32 (2010) (remarking that the prevalence of tax planning opportunities in the tax code leads taxpayers to “fear that they are ‘leaving money on the table’ because of their lack of knowledge, sophistication, or high-quality advice, while richer taxpayers with high-priced advisors take advantage of elective loopholes”).

exemptions, finding new ways of reducing their taxable income.⁴¹ They shielded large sums of money in various tax shelters, including IRAs, municipal bonds, oil well investments, horse-breeding farms, indoor racquetball clubs, and even New York plays.⁴² Responding to problems in the pre-1986 tax code, including these tax shelters, Representative Jack Kemp (R-N.Y.) exclaimed: “Honest taxpayers increasingly feel that they are suckers if they obey the laws. . . . This sense of frustration and disgust undermines the voluntary compliance which is the basis of our income tax system.”⁴³

Contemporary examples of wealthy individuals and corporations avoiding tax liability through exemptions, shelters, or simple evasion also abound. For instance, in 2004, the General Accounting Office (“GAO”)⁴⁴ reported that more than sixty percent of all U.S. corporations paid no federal taxes between 1996 and 2000,⁴⁵ and roughly eighty-two percent of large corporations, those holding the vast majority of all assets reported on corporate returns,⁴⁶ reported tax liability of less than five percent of their income in 2000.⁴⁷ Similarly, in 2005, the IRS collected over three billion dollars from wealthy individuals participating in the Son of Boss tax shelter scheme.⁴⁸

The ability of these high-earning entities and individuals to avoid paying their fair share in taxes foists the tax burden on the shoulders of the middle class. According to one commentator, the richest one percent of Americans enjoys a lower tax burden than the middle class, and the poor are taxed more heavily than the “super rich.”⁴⁹ Unsurprisingly, then, sixty percent of respondents in an April 2009 Gallup poll believed that upper-income individuals did not pay their fair share in taxes.⁵⁰ Sixty-seven percent of those polled felt that corporations also paid too little in taxes.⁵¹ Only five

⁴¹ JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 10* (1987); Miller, *supra* note 22, at 71.

⁴² Miller, *supra* note 22, at 71.

⁴³ *Id.* (quoting Rep. Kemp). Representative Kemp would go on to play a major role in the 1986 tax reform debates. *See generally* BIRNBAUM & MURRAY, *supra* note 41.

⁴⁴ On July 7, 2004 the General Accounting Office officially changed its name to the Government Accountability Office. GAO Human Capital Reform Act of 2004, Pub. L. 108-271, § 8, 118 Stat. 811, 814 (2004) (codified at 31 U.S.C. § 702 (2006)).

⁴⁵ GAO, GAO-04-348, *TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN AND U.S. CONTROLLED CORPORATIONS, 1996–2000 15* (2004), available at <http://www.gao.gov/new.items/d04358.pdf>.

⁴⁶ *Id.* at 2.

⁴⁷ *Id.* at 7.

⁴⁸ IRS, IR-2005-37, *IRS COLLECTS \$3.2 BILLION FROM SON OF BOSS; FINAL FIGURE SHOULD TOP \$3.5 BILLION* (2005), available at <http://www.irs.gov/newsroom/article/0,,id=137095,00.html>; *see also* William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 9–10 (2009) (discussing ways the wealthy can avoid tax liability without detection); Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 717 (2009) (identifying the ability among sophisticated and aggressive “tax avoiders” to “pay millions of dollars for highly complex tax shelters” and to “learn how to ‘push the envelope’ from tax accountants and preparers”).

⁴⁹ JOHNSTON, *supra* note 3, at 13.

⁵⁰ Gallup Tax Poll, *supra* note 38.

⁵¹ *Id.*

percent of respondents indicated that middle-income taxpayers paid too little in taxes, while fifty percent believed that middle-income earners paid their fair share in taxes and forty-three percent believed such taxpayers paid too much.⁵² Because of these problems, there is a national consensus among both major political parties that the federal tax code is in need of reform.⁵³

Most proposals for fundamental tax reform, including the one offered in this Essay, involve replacing our current income tax system with a consumption tax, usually one with a single, or “flat tax,” rate.⁵⁴ This will simplify the tax code, thereby reducing the confusion engendered under the current system, ending the opportunity for tax evasion, and allowing for more efficient tax collection.⁵⁵ Critics may question whether these proposals will improve macroeconomic performance, adequately address equity concerns, and manage the transitional costs of changing the system.⁵⁶ However, most tax experts agree that Congress must drastically change the underlying tax base if it intends to truly fix the unwieldy system currently in place.⁵⁷

III. THE NECESSITY OF FUNDAMENTAL REFORM: THE DEVELOPMENT OF TAX POLICY

As the foregoing description of the current tax structure makes plain, some form of fundamental tax reform is necessary. Congress stands poised to debate necessary and foundational changes to the federal tax code; however, substantial reformation of national tax policy is nothing new to federal

⁵² *Id.*

⁵³ See, e.g., BICKLEY, *supra* note 13, at 6–7 (discussing three proposals for fundamental tax reform submitted to the 111th Congress by Republican members); Jeanne Sahadi, *Obama Tax Panel on Treasure Hunt*, CNNMoney.com, Mar. 27, 2010, http://money.cnn.com/2009/03/26/news/economy/obama_tax_reform_taskforce/index.htm (reporting on the Obama administration’s plans to “form a task force to propose ways to simplify the tax code, reduce evasion, close loopholes and make changes in corporate breaks”); Hector Barreto, Adm’r, Small Bus. Admin., Address at National Press Club Luncheon (Sept. 21, 2004), available at http://www.sba.gov/idc/groups/public/documents/ny_syracuse/sy_pressclubremarks_doc.doc (Hector Barreto, Administrator of the Small Business Administration under President George W. Bush, remarked that “the time that people spend complying with an overly complex tax code is a burden and a waste of resources.”). As Michael Graetz notes, “[t]hree decades ago, when he was running for president, Jimmy Carter described our nation’s tax system as a ‘disgrace to the human race.’ And it still is.” GRAETZ, *supra* note 4, at xiii.

⁵⁴ See, e.g., HALL & RABUSHKA, *supra* note 4; see also BICKLEY, *supra* note 13, at 1.

⁵⁵ See Ezra Klein, *Congress is Long Overdue for a Serious Effort at Tax Reform*, WASH. POST, Mar. 14, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/03/13/AR2010031300103.html?hpid=topnews> (“Economists of all stripes agree that the tax code has become so complex and inefficient that we’re raising less money than we could with a simpler tax code that offered lower rates.”).

⁵⁶ BICKLEY, *supra* note 13, at 1 (identifying the major concerns raised by critics of tax reform in favor of a consumption tax).

⁵⁷ *Id.* (“Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates but rather stem from difficulties associated with measuring the tax base.”)

policymakers. Since the inception of the federal income tax in 1913,⁵⁸ Congress has passed major changes to our tax system on numerous occasions.⁵⁹ The last major overhaul to the tax code was the Tax Reform Act of 1986,⁶⁰ which represented the culmination of nearly two years of policy development and debate by tax analysts, economists, and policymakers in Congress and the Department of Treasury.⁶¹ Given the current congressional proposals to modify the tax system, including the proposal made by this author, an analysis of the reforms made in 1986 is instructive for the following reasons. First, in order to evaluate the chances of current tax reform legislation, it is important to analyze whether the reasons motivating the 1986 tax reforms remain pertinent today. Moreover, to better understand the successful passage of the Tax Reform Act of 1986, it is helpful to examine whether the reasons for reform that helped shape that tax reform bill also motivated previous attempts at reform. Even more fundamentally, a brief examination of the theoretical underpinnings of tax policy may lead to a coherent understanding of how tax policy is developed, the reasons for taxing the general populace, and why prior reform efforts seemingly failed to adequately address public policy concerns regarding the federal income tax.

During the first seventy years of the income tax, efforts to modify the federal tax code were undertaken in order to provide for the exigencies of war⁶² and to establish and deal with the costs of robust welfare programs.⁶³ Prior to the Great Depression, the federal government played a relatively subordinate role to states and localities, the primary locus of policymaking.⁶⁴ Further, before World War I, the federal government had not engaged in direct taxation of the American people⁶⁵; it took the financial necessities of

⁵⁸ Tariff Act of 1913, ch. 16, 38 Stat. 114 (current version in scattered sections of 26 U.S.C.).

⁵⁹ See, e.g., Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 (codified as amended in scattered sections of 26 U.S.C.); Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C.); Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

⁶⁰ Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.).

⁶¹ See Alicia H. Munnell, *The Economics of Tax Simplification: An Overview*, NEW ENG. ECON. REV., Jan.-Feb. 1986, at 11-12 (noting that the 1986 tax reforms stemmed from President Ronald Reagan's directive to simplify the tax code, issued to his Secretary of the Treasury during the 1984 State of the Union address).

⁶² See Barbara Bradley, *Behind '86 Tax Talk: A Record of Ups and Downs on Prior Reforms*, CHRISTIAN SCI. MONITOR, June 10, 1986, at 27. For example, World War I, World War II, the Korean War, and the Vietnam War were largely financed by raising taxes or eliminating tax exemptions. *Id.*

⁶³ See, e.g., GRAETZ & SCHENK, *supra* note 2, at 8 (describing the enactment of Social Security as "the most significant tax legislation of the years between the First and Second World Wars"); STEUERLE, *supra* note 1, at 62-64 (discussing 1983 tax reforms motivated by the need to address problems with the Social Security system).

⁶⁴ See MARTHA DERTHICK, *Roosevelt as Madison: Social Security and American Federalism*, in KEEPING THE COMPOUND REPUBLIC: ESSAYS ON AMERICAN FEDERALISM 123, 136 (2001) (discussing how President Franklin Roosevelt's administration "invited citizens to look . . . to the national government more than state and local governments").

⁶⁵ See W. ELLIOT BROWNLEE, *FEDERAL TAXATION IN AMERICA* 47 (1996).

war to spur the Wilson administration to create the foundations of a progressive tax scheme.⁶⁶ Even after the end of World War I, though, corporate and Republican backlash against President Woodrow Wilson's tax reforms effectively curtailed growth of the federal tax system.⁶⁷ Additionally, the United States reversed the massive wartime industrial and military mobilization that had previously required the federal government to raise and maintain large sums of capital.⁶⁸

The subsequent experiences of Americans during the 1930s and 1940s caused several major shifts toward a federal system of income taxation that included the promotion of the general public's social welfare.⁶⁹ First, the Great Depression subjected a devastating number of people to abject poverty, thereby undermining faith in unregulated markets and leading to greater governmental regulation.⁷⁰ Under the banner of President Franklin Roosevelt's New Deal, the federal government developed social service programs aimed at ensuring a basic minimum standard of living for all Americans.⁷¹ In doing so, the New Deal laid the foundations for the modern welfare state and began a permanent shift in the focus of policymaking to the national level.⁷²

Second, the New Deal represented the first time that the federal government undertook the responsibility of looking after America's elderly population, among the groups hardest hit by the economic crisis of the 1930s.⁷³ The ravages of the Great Depression highlighted the fact that even those who had worked hard their entire lives could find themselves poverty-stricken in the face of a national economic depression.⁷⁴ Therefore, the government created

⁶⁶ W. Elliot Brownlee details the way in which World War I served as a catalyst for tax reform. *Id.* at 48–53. Tapping into the desire of progressives for redistributive taxation, the Wilson administration “chose to cooperate with a group of insurgent Democrats in arranging wartime financing on the basis of highly progressive taxation.” *Id.* at 49.

⁶⁷ *Id.* at 58, 70.

⁶⁸ *Id.* at 59.

⁶⁹ See THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862–1963 28 (Lillian Doris ed., William S. Hein & Co. 1994) (1963) (noting that the amount of money collected in taxes soared from \$1.6 billion in 1922 to \$45 billion in 1945, fueled by Social Security and wartime taxation); BROWNLEE, *supra* note 65, at 88–89 (describing the Great Depression and World War II as formative events in the development of federal tax policy).

⁷⁰ See, e.g., Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613, 1619–21 (2009) (noting that the system of modern banking regulation was put in place during the Great Depression, when it became clear that unregulated markets lead to financial crisis).

⁷¹ See, e.g., Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1072 (1997) (arguing that “the enactment of Social Security in 1935 was the culmination of a long period of agitation for ‘industrial welfare’ and social reform, and was an important element in antipoverty efforts in the wake of the Great Depression”).

⁷² See, e.g., Daniel B. Klaff, *Evaluating Work: Enforcing Occupational Safety and Health Standards in the United States, Canada and Sweden*, 7 U. PA. J. LAB. & EMP. L. 613, 617 (2005) (citing the New Deal as laying the groundwork for the modern welfare state).

⁷³ See Dilley, *supra* note 71, at 1119 (remarking that the U.S. government first undertook the responsibility to care for the elderly with the passage of the Social Security Act of 1935).

⁷⁴ *Id.* at 1122.

the Social Security program to prevent dependency and poverty in old age; by making coverage compulsory and assessing contributions on both employees and employers, the government established a program that would hopefully ensure individual financial solvency later in life.⁷⁵ Thirty years after the passage of Social Security, the federal government enacted Medicare, a federal guarantee of healthcare for older Americans,⁷⁶ to further protect its elderly citizens.⁷⁷ These expansive senior citizen welfare programs have become mainstays of national policy; however, they require incredible amounts of tax revenue to remain viable.⁷⁸

Third, in the wake of the two World Wars, Americans came to the bitter realization that war had exacted a heavy toll on the nation.⁷⁹ Many soldiers were killed in action, leaving behind families to face the emotional and economic prospects of going on without the men they had sent off to battle.⁸⁰ Returning veterans, for their part, struggled to acclimate back to civilian life.⁸¹ The federal government sought to assist the reentry of its returning soldiers into society by offering assistance finding work or unemployment pay, access to educational opportunities, and low-cost loans to purchase homes.⁸² Ultimately, the Great Depression and World War II created expect-

⁷⁵ See Social Security Act of 1935, Pub. L. No. 74-271, 49 Stat. 620 (codified as amended in scattered sections of 42 U.S.C.); Dilley, *supra* note 71, at 1124–25; see also Social Security Online, Historical Background and Development of Social Security, <http://www.ssa.gov/history/briefhistory3.html> (last visited Mar. 30, 2010).

⁷⁶ Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286 (codified as amended in subchapter XVIII of 42 U.S.C.).

⁷⁷ See Philip Harvey, *Is There a Progressive Alternative to Conservative Welfare Reform?*, 15 GEO. J. ON POVERTY L. & POL'Y 157, 157 (2008) (linking Social Security and Medicare as part of the progressive reform effort to protect elderly Americans).

⁷⁸ See CONG. BUDGET OFFICE (“CBO”), CONG. OF THE U.S., THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2010 TO 2020 app. F (2010), available at <http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf> [hereinafter CBO, BUDGET AND ECONOMIC OUTLOOK]. In 2009, the federal government spent \$677.7 billion on Social Security and \$499 billion on Medicare. *Id.* These programs accounted for over fifty percent of the mandatory outlays in that year. See *id.*

⁷⁹ See, e.g., John Milton Cooper, Jr., *The Great War and American Memory*, 29 VA. Q. REV. 70, 81 (2003) (“[I]n April 1937 a Gallup poll found that 70 per cent [sic] of respondents believed that it had been a mistake to enter World War I. ‘No more foreign wars’ was the watchword of the day . . .”).

⁸⁰ See DEP’T OF DEF., PRINCIPAL WARS IN WHICH THE UNITED STATES PARTICIPATED: U.S. MILITARY PERSONNEL SERVING AND CASUALTIES (2008), available at <http://siadapp.dmdc.osd.mil/personnel/CASUALTY/WCPRINCIPAL.pdf>.

⁸¹ See, e.g., Don Corbett, *Stunted Growth: Assessing the Stagnant Enrollment of African-American Students at the Nation’s Law Schools*, 18 TEMP. POL. & CIV. RTS. L. REV. 177, 188 (2008) (indicating that housing shortages forced many veterans into cramped living conditions or, worse, into homelessness).

⁸² See Anne L. Alstott & Ben Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans’ Bonus and the Defeat of the Mellon Plan*, 59 TAX L. REV. 373, 374 (2007) (stating that the U.S. government spent billions of dollars on the GI Bill of Rights after World War II, “which helped millions of veterans return to civilian life and ascend to the middle class”); Namrata Kotwani & Marion Danis, *Expanding the Current Health Care Reform Debate: Making the Case for Socio-Economic Interventions for Low Income Young Adults*, 12 J. HEALTH CARE L. & POL’Y 17, 25 (2009) (describing the governmental assistance provided to veterans returning from World War II).

tations of a large and powerful federal government with a robust array of policies to tackle various social and military problems—policies supported by an expansive federal system of taxation.⁸³

In stark contrast, the Tax Reform Act of 1986, the last major overhaul of the U.S. tax code, was propelled by the goal of reducing government interference in the economic and social order⁸⁴ and was regarded as a landmark achievement for the Reagan administration.⁸⁵ The reform efforts were undertaken with the goal of implementing a more progressive system of taxation with improved incentives for compliance, yet achieving a greater degree of simplicity than in previous efforts.⁸⁶ The objective was met by creating a simplified marginal tax rate structure that consisted of two statutory tax rates: fifteen percent and twenty-eight percent.⁸⁷

President Ronald Reagan's personal desire to reform the tax code into a system that was less burdensome to private enterprise was echoed by members of his own party in Congress and officials in his administration.⁸⁸ The President had long shared with the public his personal antipathy toward the tax system as a product of liberal social engineering. For example, in comments given to the Orange County Press Club in California in 1961, President Reagan decried the size of the tax code as a law that was originally thirty-one words, but had expanded to the impressively voluminous size of 440,000 words.⁸⁹ Reagan asserted that the federal tax code was a "progressive tax" received directly from "Karl Marx, who designed it as the prime

⁸³ See Alstott & Novick, *supra* note 82, at 374 (commenting that the federal income tax system put in place to fund U.S. military efforts during World War II "continued as the workhorse of the federal revenue structure, helping to support the beginnings of the modern welfare state"); cf. STEUERLE, *supra* note 1, at 13 ("The vast expansion of income taxation in the United States can be directly associated with the financing of this nation's participation in World War II. . . . 'From a class tax to a mass tax' was a common expression used to describe the World War II explosion in coverage and collections.").

⁸⁴ See LANDMARK DEBATES IN CONGRESS: FROM THE DECLARATION OF INDEPENDENCE TO THE WAR IN IRAQ, *supra* note 1, at 437 ("President Reagan, who had long objected to a number of the New Deal and Great Society programs as well as the progressive income tax, personally wanted to drastically reduce taxes and limit government's role in the economy.").

⁸⁵ GRAETZ, *supra* note 4, at 23 (noting that "[t]he Tax Reform Act was widely heralded as the most significant change in our nation's tax law since the income tax was extended to the masses during World War II"); Bradley, *supra* note 62, at 27 (quoting John Witte as stating, "Ronald Reagan sees the tax area as his major contribution historically").

⁸⁶ STEUERLE, *supra* note 1, at 121.

⁸⁷ See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

⁸⁸ Nicholas Confessore, *Breaking The Code*, N.Y. TIMES, Jan. 16, 2005, § 6 (Magazine), at 35. Some Congressional Republicans and members of the Reagan administration were early supporters of what would become the Tax Reform Act of 1986. *Id.* ("Republican supply-siders—the architects of Reagan's large 1981 tax reduction—were looking to push new cuts through Congress. . . . Some of Reagan's political advisers had become concerned that loopholes for the wealthy might become a Democratic campaign issue in '84, while others had come to believe that narrow tax breaks weren't a very effective way to encourage growth in particular industries.").

⁸⁹ Ronald Reagan, *Encroaching Control—Keep Government Poor and Remain Free*, 27 VITAL SPEECHES OF THE DAY 677, 679 (1961), quoted in Marvin A. Chirelstein, *Back from the Dead: How President Reagan Saved the Income Tax*, 14 FLA. ST. U. L. REV. 207, 207 (1986).

essential of a socialist state”⁹⁰ By the time Reagan fought for tax reform as President, his views on the subject had not changed.⁹¹

Despite initial support for President Reagan’s reform efforts among congressional Republicans, they remained wary of the legislation’s proposed elimination or reduction of tax shelters, loopholes, and exemptions that were heavily favored by their constituencies.⁹² Accordingly, they balked at the proposed changes to the tax code and abandoned reform.⁹³ However, President Reagan’s immense popularity in the wake of his 1984 landslide victory over Walter Mondale ultimately cemented legislative support for his proposals.⁹⁴ With his electoral success, President Reagan firmly established his popularity and thereby asserted greater dominance over Congress.⁹⁵ Reagan’s victory at the polls, along with the popular perception that the tax code was nothing more than a tool for wealthy individuals to retain their wealth at the expense of the middle class,⁹⁶ provided the momentum necessary to push a fundamental tax reform bill through Congress.⁹⁷ As much as anything, it was Reagan’s popularity and avowed determination to overhaul the tax system that made the 1986 tax reforms possible.

While the foregoing examples suggest that there is not a unitary approach to the formation of national tax policy, they demonstrate several of the most important influences on restructuring the tax scheme. Indeed, the lessons of tax reform both after World War II and in 1986 reveal the ways in which fundamental theoretical models, such as public finance theory⁹⁸ and political economy theory,⁹⁹ can explain tax policy formation, as well as the deficits in such overarching narratives. Together, these conflicting and inter-

⁹⁰ *Id.*

⁹¹ See Chirelstein, *supra* note 89, at 208. Upon signing the 1986 tax reforms into law, President Reagan noted that the legislation was returning America to its “first principles,” leaving an “un-American” tax code behind. President Reagan’s Remarks During Tax Bill Signing Ceremony (Oct. 22, 1986), in 33 TAX NOTES 413, 413 (1986).

⁹² BIRNBAUM & MURRAY, *supra* note 41, at 158.

⁹³ *Id.*

⁹⁴ *Id.* at 286.

⁹⁵ See *id.*; David Treadwell, *Reagan Enters New Term Backed by 68% of Public*, L.A. TIMES, Jan. 29, 1985, at 1 (noting that early in his second term President Reagan enjoyed a sixty-eight percent public approval rating and that “54% approve of the way Reagan is handling taxes”).

⁹⁶ See Miller, *supra* note 22, at 71 (describing the opportunities in the pre-1986 tax code for wealthy tax planners to evade taxes and shelter their assets and the resulting impression that middle-class taxpayers were “suckers” for abiding by the law).

⁹⁷ BIRNBAUM & MURRAY, *supra* note 41, at 285 (“When [President Reagan] put his full weight and power behind an idea that tapped such a fundamental frustration of the American people [as the failures of the tax code], others in Washington could hardly ignore it.”).

⁹⁸ See Richard L. Doernberg & Fred McCesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891, 896 (1987) [hereinafter Doernberg & McCesney, *Doing Good or Doing Well?*] (outlining the basic approach of public finance theory); Richard L. Doernberg & Fred McCesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 924–25 (1986) [hereinafter Doernberg & McCesney, *Accelerating Rate*] (same).

⁹⁹ Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 926–27 (discussing political economy theory in the field of tax policy).

connecting theories of taxation, as well as unique historical factors, may provide guidance for current plans to revamp the U.S. tax system.

A. Public Finance Theory

The public finance theory of tax policy postulates that taxes are levied on individuals to finance government expenditures that necessarily benefit the general public.¹⁰⁰ Taxation allows the government to provide programs that are socially desirable yet impossible to achieve through the forces of private markets, due to the inability or unwillingness of private enterprise to meet these public needs.¹⁰¹ By definition, the benefits of public goods cannot be limited to only those consumers who pay for them.¹⁰² Thus, there is an incentive for individuals to consume these goods without paying, a phenomenon known as the free-rider problem.¹⁰³ Private producers will not provide these goods without the ability to compel payment from all consumers, and the government will therefore need to offer these goods, financing them through taxation.¹⁰⁴ Expenditures on public welfare programs enacted during the Great Depression, such as Social Security, and defense initiatives during and after World War II are two such examples of necessary spending that only the government could undertake.¹⁰⁵

Both of these areas of government spending remain relevant to national tax policy today. For example, defense expenditures account for approximately 20.1% of all government expenditures in the United States,¹⁰⁶ or \$656 billion in 2009.¹⁰⁷ Similarly, mandatory health and social security expenditures account for roughly 45% of the federal budget and are growing in cost.¹⁰⁸

Public finance theory also proposes that taxes may be levied upon a specific subset of the population whose actions impose negative externalities on the general public.¹⁰⁹ For instance, the government often levies what are commonly referred to as “sin taxes” on the consumption of products such

¹⁰⁰ See *id.* at 924–25 & nn.68–69.

¹⁰¹ *Id.* at 924.

¹⁰² *Id.* at 924 n.68.

¹⁰³ Russell Hardin, *The Free Rider Problem*, in STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Edward N. Zalta ed., Fall ed. 2009) (2003), available at <http://plato.stanford.edu/archives/fall2009/entries/free-rider>.

¹⁰⁴ Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 924 n.68.

¹⁰⁵ See *id.* (describing national defense as the paradigmatic example of a public good).

¹⁰⁶ JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 16 (3d ed. 2010).

¹⁰⁷ CBO, BUDGET AND ECONOMIC OUTLOOK, *supra* note 78, at 68.

¹⁰⁸ GRUBER, *supra* note 106, at 16.

¹⁰⁹ See MOLLY F. SHERLOCK & DONALD J. MARPLES, CONG. RESEARCH SERV., NO. RL32808, OVERVIEW OF THE FEDERAL TAX SYSTEM 12 (2009) (discussing excise taxes that impose the true cost of certain activities—including the negative impact on society generally—on those individuals engaging in the activity in question).

alcohol and tobacco.¹¹⁰ Such taxes are designed to achieve the goal of “internalizing the externality,” or aligning the private costs one faces with the social costs one imposes so that people produce or consume at the socially optimal level rather than the private optimal level.¹¹¹ For example, cigarette smoking imposes direct costs on the general, non-smoking public. Smokers require substantial medical treatment, which increases healthcare costs.¹¹² These costs impose themselves in three ways: (1) for those with private insurance through an employer, smoking-related medical costs raise overall premiums; (2) for those with government insurance, the lack of higher premiums for smokers means that medical costs are borne by all citizens; and (3) if the smoker is uninsured, the cost of care will be imposed on either the government or private insurers, driving up the prices on other medical services.¹¹³ The costs of treating non-smokers exposed to secondhand smoke are also costs attributable to smoking.¹¹⁴ By levying taxes on cigarettes that cover the costs of smoking-related medical treatment, smokers are forced to internalize the costs they inflict on the larger society.

B. *The Political Economy of Tax Policy*

The public finance theory indicates that the government should tax the public whenever doing so is necessary to provide a public good that cannot be obtained through the free market.¹¹⁵ However, critics of the public finance model assert that the theory does not adequately describe how taxes are actually imposed.¹¹⁶ As such, critics claim that the public finance model is a poor predictor of future circumstances in which the government may elect to impose taxes on the general public.¹¹⁷ The political economy model of tax policy attempts to offer a better predictive account of when taxes will be levied.¹¹⁸ The political economy model postulates that government taxation is merely an economic tool used by government to regulate behavior that impacts society socially and economically.¹¹⁹ Under this theory, government regulation is not the product of a motivation to benefit society generally, but

¹¹⁰ See, e.g., The Children’s Health Insurance Program Reauthorization Act of 2009, Pub. L. No. 111-3, § 701, 123 Stat. 8, 99–101 (codified at I.R.C. § 5701(a)–(g) (Supp. III 2009)) (increasing cigarette taxes).

¹¹¹ GRUBER, *supra* note 106, at 135.

¹¹² *Id.* at 166. See generally Centers for Disease Control and Prevention, Smoking and Tobacco Use, <http://www.cdc.gov/tobacco> (last visited Apr. 8, 2010) (providing information on the health and economic impact of tobacco use).

¹¹³ GRUBER, *supra* note 106, at 167–68.

¹¹⁴ *Id.* at 169; see also OFFICE OF THE SURGEON GEN., DEP’T OF HEALTH AND HUMAN SERVS., THE HEALTH CONSEQUENCES OF INVOLUNTARY EXPOSURE TO TOBACCO SMOKE: A REPORT OF THE SURGEON GENERAL (2006), available at <http://www.surgeongeneral.gov/library/secondhandsmoke/report/executivesummary.pdf>.

¹¹⁵ See Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 926.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

rather results from pressure exerted by particular special interest groups that wish the government to engage in or refrain from taking specific action that would directly impact a specific portion of the population.¹²⁰

Many of the exemptions found in the tax code that shield particular segments of the populace from tax liability are the result of successful lobbying by a particular interest group.¹²¹ For example, the First Time Homebuyer credit has proven very popular, encouraging many Americans to purchase homes and take advantage of the tax credit.¹²² Tellingly, however, the credit was enacted at the urging of lobbying groups such as the National Association of Realtors and the National Association of Home Builders,¹²³ and was structured to suit their interests.¹²⁴ Advocates for real estate interests asserted that the extension of the First Time Homebuyer credit to all homebuyers would aid in the stimulation of a moribund economy by encouraging more people to purchase homes.¹²⁵ Even the perceived “populist” tax reform achieved in 1986¹²⁶ was not devoid of breaks for special interest groups.¹²⁷ In fact, before the 1986 tax reforms were made into law, “defeated lobbyists were already preparing to launch a campaign to restore their favorite tax breaks as part of the ‘technical corrections’ bill of 1987.”¹²⁸

In practice, aspects of both political economy theory and public finance theory are represented in the formulation of tax policy. Depression-era welfare programs and World War II defense spending demonstrate the relevance of the public finance model of policymaking. On the other hand, the 1986 tax breaks, created in the midst of a comprehensive attempt to overhaul and fix the tax system, represent the salience of the political economy model of policymaking. Furthermore, President Reagan’s ability to achieve major tax

¹²⁰ *See id.*

¹²¹ *See, e.g.,* GRUBER, *supra* note 106, at 545 (stating that, with respect to the mortgage interest deduction in the tax code, the beneficiaries of the subsidy were likely organized, while the losers were “neither organized nor aware of the cost”).

¹²² IRS, IR-2009-83, FIRST-TIME HOMEBUYER CREDIT PROVIDES TAX BENEFITS TO 1.4 MILLION FAMILIES TO DATE, MORE CLAIMS EXPECTED (2009), *available at* <http://www.irs.gov/newsroom/article/0,,id=213375,00.html>.

¹²³ *See* News Release, Nat’l Ass’n Home Builders, Builders Call on Congress to Extend and Enhance Home Buyer Tax Credit (Aug. 10, 2009), *available at* http://www.nahb.org/news_details.aspx?sectionID=122&newsID=9568.

¹²⁴ *See* Sylvia Cochran, *National Association of Realtors Applauds Use of First Time Homebuyer Tax Credit as Real Estate Downpayment*, ASSOCIATED CONTENT, May 12, 2009, http://www.associatedcontent.com/article/1740312/national_association_of_realtors_applauds.html?cat=3 (remarking that the National Association of Realtors had been “clamoring” for a rule allowing the homebuyer credit to be applied to down payments on real estate); News Release, Nat’l Ass’n of Realtors, Senate Stimulus Bill, Treasury Stability Plan Good Start, Says NAR (Feb. 10, 2009), *available at* http://www.realtor.org/press_room/news_releases/2009/02/senate_stimulus_bill_treasury_stability_plan_good [hereinafter NAR, Senate Stimulus Bill].

¹²⁵ *See, e.g.,* NAR, Senate Stimulus Bill, *supra* note 124.

¹²⁶ BIRNBAUM & MURRAY, *supra* note 41, at 287.

¹²⁷ *See, e.g., id.* at 94 (identifying the oil and gas industry’s ability to maintain its tax preferences during the 1986 tax reform process).

¹²⁸ *Id.* at 290. Birnbaum and Murray identify the failure of special interest groups to unite against the Tax Reform Act of 1986 as one of the chief reasons it was able to succeed. *Id.* at 287.

reform suggests the potential for presidential popularity and political will to implement tax reform.¹²⁹ Although none of these theories seems fully capable of predicting tax policy formulation, each has something to offer in creating a fuller understanding of the motivating forces behind tax legislation.

IV. DESIRABLE CHARACTERISTICS EXPECTED IN TAX REFORM

The theoretical principles of tax policy formation provide a basis for analysts and policymakers to identify particular characteristics that are desirable in either modifying the existing tax structure or creating the foundation for a fundamentally new basis of taxation.¹³⁰ Using a set of basic principles allows for comparison between proposals. Legislators involved with previous reform efforts, including the Tax Reform Act of 1986, considered several principles as a basis for policy formation, including: (1) simplicity; (2) equity; and (3) efficiency.¹³¹ To illustrate the importance of these criteria, this Part will first introduce each principle. It will then discuss the role of each principle in the 1986 tax policy overhaul. Finally, it will briefly describe tax legislation in the current Congress and discuss the strengths and weaknesses of each proposal.

A. *The Principles of Policy Development*

1. *Simplicity*

An easily understandable tax code is more likely to find acceptance with the general public.¹³² Simplification can also encourage voluntary compliance with the tax code, which is desirable for the taxing authority.¹³³ The complexity of the current code, however, requires vast amounts of resources to train administrators on the details of the code, including the proper forms to use for filing, which documents and records need to be submitted or retained, as well as estimating or predicting the amount of tax the taxpayer may be subjected to in the future for the purposes of economic planning.¹³⁴ A complex tax code is also likely to create increased rates of non-compliance due to taxpayer misunderstanding of which taxes need to be paid, as well as

¹²⁹ See BROWNLEE, *supra* note 65, at 153 (arguing that “[t]he history of national crises suggests that the cause of tax reform must have effective presidential leadership”). It appears that President Barack Obama is embracing the principle of tax reform. See Sahadi, *supra* note 53. Only time will tell if he is willing and able to dedicate his administration to overhauling the tax system.

¹³⁰ See Edward Yorio, *The President’s Tax Proposals: A Major Step in the Right Direction*, 53 *FORDHAM L. REV.* 1255, 1256–64 (1985).

¹³¹ GRAETZ & SCHENK, *supra* note 2, at 28–30.

¹³² See 1 DEP’T OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT* 15–16 (1984).

¹³³ *Id.*; see also Am. Bar Ass’n, *Recommendation of the American Bar Association to Establish a Program to Simplify the Internal Revenue Laws*, 29 *TAX LAW.* 722, 723 (1975).

¹³⁴ See DEP’T OF THE TREASURY, *supra* note 132.

incidents of purposeful tax avoidance, thereby requiring further government expenditures to ensure proper compliance.¹³⁵

2. *Equity*

There are two related forms of equity to be considered in tax policy formation: vertical equity (taxpayers who earn more should pay more in taxes) and horizontal equity (similarly situated taxpayers should pay similar taxes).¹³⁶ Wealthier individuals are expected to pay a greater percentage of taxes than individuals of lesser economic means.¹³⁷ In fact, the expectation that people of greater means should pay a greater percentage of tax obligations is one of the fundamental characteristics of a progressive tax structure.¹³⁸ Achieving equity in tax policy is undermined, however, when there are seemingly illogical or arbitrary differences in the manner in which taxpayers in different income classes are treated.¹³⁹ For example, the principles of fairness are violated if tax breaks in the form of exemptions and deductions are provided to taxpayers in the upper income tax bracket, but are not similarly provided to taxpayers in the middle income tax bracket. In contrast, characteristics of a regressive structure violate the principles of equity because people who earn less pay disproportionately more than people who earn more.¹⁴⁰

Equity—as any characteristic—is never the only concern for a policymaker. Situations may arise in which policymakers determine long-term national fiscal interests may supersede near-term considerations of equity in the tax code. For example, some tax subsidies, such as lower tax rates for capital investment, violate the principles of equity. A taxpayer who earns more income may, through investment of that income in municipal bonds, pay lower taxes than a taxpayer who earns a lower income.¹⁴¹ Although this would make the tax system more regressive, some violations of equity may be justified because it encourages business growth.

¹³⁵ *Id.*

¹³⁶ See Yorio, *supra* note 130, at 1258.

¹³⁷ *Id.*; see also Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 139 (1989) ("Horizontal equity (HE) is the command that equals be treated equally.").

¹³⁸ See Yorio, *supra* note 130, at 1258.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ See WILLIAM D. ANDREWS, *BASIC FEDERAL INCOME TAXATION* 393 (5th ed. 1999) (discussing the fact that the exemption from taxation of proceeds from state or municipal bonds is a subsidy to state and municipal borrowers).

3. Efficiency

In a fully competitive market without any market failures,¹⁴² a completely efficient tax system allows the market to maximize social outcome.¹⁴³ However, the imposition of certain taxes causes people to change their behavior, disrupts the social maximizing competitive equilibrium, and thus generates a deadweight loss (“DWL”).¹⁴⁴ While these taxes allow the government to raise revenues, it does so by distorting people’s choices and making them worse off.

Furthermore, DWL and efficiency losses from taxes are much worse if there is an existing tax or market failure.¹⁴⁵ DWL rises as the square of the tax rate.¹⁴⁶ Hence, efficiency loss from an increase in marginal tax rates from five to ten percent is not double the increase from no tax to five percent, but rather four times as large.

Not only do these distortive effects hurt people by constraining their choices, but these distortions reduce the base upon which the tax is imposed.¹⁴⁷ People avoid taxes as much as they can, and, in turn, this eventually reduces revenue collection by the government.¹⁴⁸ Hence, creating efficient taxes is not only important to prevent negative effects on people, it is important for the government as well, because an efficient tax system helps to maximize revenue collections.

Thus, governments must engage in this careful balancing act, which is often very difficult. Indeed, as many economists show, our current income tax system is far from optimal. Not only does the income tax discourage labor supply decisions (i.e., the number of hours one works and the effort put in), but our complex web of deductions and exemptions also encourage people to shift to tax exempt forms of compensation (i.e., fringe benefits, such as health insurance) and over-consume in certain categories (i.e., home purchases, which are deductible).¹⁴⁹

B. Principles Applied to Tax Reform Initiatives in 1986

In his 1984 State of the Union Address, President Reagan directed the Secretary of the Department of Treasury to formulate a tax policy that simplified the tax code in its entirety so that all taxpayers were “treated more

¹⁴² Market failures are “problem[s] that cause the market economy to deliver outcome[s] that do[] not maximize efficiency.” GRUBER, *supra* note 106, at G-6.

¹⁴³ *Id.* at 589.

¹⁴⁴ *Id.* DWL is “the reduction in social efficiency from denying trades for which benefits exceed costs.” *Id.* at G-3.

¹⁴⁵ *Id.* at 594.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ Martin Feldstein, *Effect of Taxes on Economic Behavior*, 61 NAT’L TAX J. 131, 137 (2008).

fairly.”¹⁵⁰ The Secretary was to submit the policy proposal to Congress for consideration that expressly retained the economic principles of tax “fairness, growth, and simplicity.”¹⁵¹ After approximately one and a half year’s worth of formulation, critique, and revision, the Secretary submitted the basis of the Tax Reform Act of 1986 to Congress for its consideration.¹⁵²

1. *Simplicity in the Tax Reform Act of 1986*

Calls for the simplification of the tax code by President Reagan resonated deeply with the average taxpayer, who viewed the tax code as unduly complex.¹⁵³ The Tax Reform Act of 1986 proposed to simplify the code by reducing the number of tax brackets in the code from fourteen to four.¹⁵⁴ Ironically, because much of the tax code’s complexity originates from computing the amount of taxable income as opposed to applying a tax rate to that amount, reducing the number of brackets ultimately contributed very little to the goal of simplicity.¹⁵⁵ In addition, tax exemptions advocated by policymakers and special interest groups further complicated the code and increased the likelihood the average taxpayer would need specialized assistance from a tax attorney or professional accountant, ultimately mitigating the effect of reducing the marginal tax rate.¹⁵⁶

2. *Equity in the Tax Reform Act of 1986*

The equity criteria was partially satisfied in the Tax Reform Act of 1986 through the reduction of the number of tax brackets, because it meant that more like taxpayers were taxed similarly.¹⁵⁷ Even with the presence of only four tax brackets rather than fourteen, the legislation retained a progressive tax structure in which similarly situated taxpayers were obligated to remit the same rate of tax to the federal government.¹⁵⁸ The progressive nature of the legislation may be somewhat diminished, however, due to the apparent difference in tax rates between the bottom two brackets.¹⁵⁹ The first tax

¹⁵⁰ Munnell, *supra* note 61, at 11 (quoting President Reagan’s 1984 State of the Union address).

¹⁵¹ *Id.*

¹⁵² *Id.* Specifically, the Treasury Department submitted what later became known as “Treasury I,” a comprehensive plan to implement the President’s tax reform goals. *Id.*; see also DEP’T OF THE TREASURY, *supra* note 132 (an example of one portion of Treasury I).

¹⁵³ See Bradley, *supra* note 62; Lea Donosky, *Tax Overhaul Rides a Rough Road*, CHI. TRIB., Apr. 27, 2006.

¹⁵⁴ Tax Law Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified in scattered sections of 26 U.S.C.); H.R. REP. NO. 99-841 (1986).

¹⁵⁵ See Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 911.

¹⁵⁶ *Id.* at 913.

¹⁵⁷ See *id.* at 914; see also BIRNBAUM & MURRAY, *supra* note 41, at 288–89.

¹⁵⁸ See generally Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 913–17 (discussing equity in the Tax Reform Act of 1986 and noting that, while the progressive nature is mostly maintained, it is weakened by loopholes in the Code).

¹⁵⁹ *Id.* at 917.

bracket obligates taxpayers to pay fifteen percent tax, but the middle tax bracket obligates taxpayers to twenty-eight percent.¹⁶⁰ Since the rate of the upper tax bracket is thirty-three percent,¹⁶¹ the differential between the middle and upper tiers is less significant and seemingly more equal.¹⁶² Further, the Tax Reform Act of 1986 was also not perfectly progressive due to the proliferation of tax exemptions, specific deductions, and credits which greatly diminished the desirable characteristic of ensuring taxpayer equity.¹⁶³

3. *Efficiency in the Tax Reform Act of 1986*

The exemptions present in the Tax Reform Act of 1986 undermined efforts of achieving tax efficiency.¹⁶⁴ Though President Reagan's apparent disdain for exemptions and exceptions was strong, he was forced to accede to the demands of Congress to include popular exemptions that existed in the code prior to the overhaul.¹⁶⁵ Thus, the Tax Reform Act of 1986 did not sufficiently allow for economic growth.

C. *Current Legislative Proposals Evaluated*

As in 1986, legislators look to the same principles of equity, simplicity, and equity to evaluate current proposals. This Section introduces and evaluates some of the tax measures currently being discussed in Congress.

1. *The Fair and Simple Tax Act of 2009*

The Fair and Simple Tax Act of 2009¹⁶⁶ ("H.R. 99") establishes an alternative determination of tax liability for individuals. As proposed in the bill, a "simplified taxable income" would equal gross income less the sum

¹⁶⁰ Tax Law Reform Act of 1986, Pub. L. No. 99-514, tit. I, subtit. A, § 101, sec. 1(a)–(e), 100 Stat. 2085, 2096–97 (codified as amended at I.R.C. § 1(a)–(e) (2006)); *see also* Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 917.

¹⁶¹ Tax Law Reform Act of 1986, tit. I, subtit. A, § 101, sec. 1(h), 100 Stat. at 2098–99 (repealed 1993). The code as implemented was slightly more complicated: the thirty-three percent rate applied to a certain range of upper income earners' wages to make up for the fact they were paying fifteen percent on the first few thousands of dollars of income. *See* The Tax Foundation, *Federal Income Tax Rates History* 6, <http://www.taxfoundation.org/files/federalindividualratehistory-200901021.pdf>.

¹⁶² Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 917.

¹⁶³ Chris Edwards, *Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation*, POLY ANALYSIS (CATO Inst., Wash. D.C.), Oct. 17, 2001, at 7, available at <http://www.cato.org/pubs/pas/pa416.pdf> ("As Congress has larded up the income tax code with special preferences, inequities have increased."); *see also* Tax Law Reform Act of 1986, 100 Stat. 2085 (including an increase in the standard deduction, a deduction for costs associated with employee achievement awards, and a moving expense deduction, among others).

¹⁶⁴ Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 921 ("There is little question that the 1986 Act has eliminated some provisions that distorted investment and consumption decisions, but in their place it has created new distortions.").

¹⁶⁵ *Id.*

¹⁶⁶ H.R. 99, 111th Cong. (2009).

of deductions for personal exemptions, the deduction allowed for the acquisition of indebtedness with respect to the principal residence, the deduction allowed for state and local income taxes, the deduction allowed for charitable giving, and the deduction allowed for medical expenses.¹⁶⁷

H.R. 99 replaces the current tax system with simplified tax rates of 10% on the first \$40,000, 15% on the income over \$40,000 but under \$150,000, and 30% on income over \$150,000.¹⁶⁸ The maximum corporate income tax rate would be reduced to 25%, and the 15% rate on dividends and capital gains of individuals would be reduced to 10%.¹⁶⁹ The basis for assets for purposes of determining capital gain or loss would be indexed to inflation.¹⁷⁰ Finally, H.R. 99 creates tax-free accounts for retirement savings, lifetime savings, and lifetime skills.¹⁷¹

Similar to the Tax Reform Act of 1986, the centerpiece of H.R. 99 is the reduction of the number of tax brackets, as well as the marginal tax rates set for each tax bracket. As was the case in 1986, reducing the number of tax brackets would likely do little to reduce the complexity of the tax code because most of the complexity of the tax code originates from the number of exemptions allowed in the code, not how to apply the rate of tax.¹⁷² Further, most of the deductions proposed in the bill are found in the current tax code.¹⁷³ The bill arguably enumerates fewer deductions and exemptions than found in the current tax code. In other words, H.R. 99 does not take drastic enough measures to achieve simplicity in the tax code, although it takes steps in the right direction.

The impediments to legislation maintaining taxpayer equity that were present in the Tax Reform Act of 1986 are also present in H.R. 99. If the bill eliminated many of the exemptions present in the code, it would increase the likelihood of similarly situated taxpayers being treated the same.¹⁷⁴

2. *The Fair Tax Act of 2009*

The Fair Tax Act of 2009¹⁷⁵ proposes to repeal the individual income tax,¹⁷⁶ the corporate income tax,¹⁷⁷ all payroll taxes, and the estate and gift taxes.¹⁷⁸ Instead, the bill creates a twenty-three percent national retail sales

¹⁶⁷ *Id.* § 2(a).

¹⁶⁸ *Id.* § 2(a), sec. 59B(c).

¹⁶⁹ *Id.* § 5.

¹⁷⁰ *Id.* § 7, sec. 1023.

¹⁷¹ *Id.* §§ 8–10.

¹⁷² See Doernberg & McCesney, *Accelerating Rate*, *supra* note 98, at 911.

¹⁷³ See BICKLEY, *supra* note 13, at 6 (for example, the deduction for medical expenses above a certain floor is retained).

¹⁷⁴ *Id.*

¹⁷⁵ H.R. 25, 111th Cong. (2009).

¹⁷⁶ *Id.* § 101.

¹⁷⁷ *Id.* § 102.

¹⁷⁸ *Id.* § 103.

tax as a replacement.¹⁷⁹ Thus, the tax-inclusive retail sales tax would equal twenty-three percent of the sum of the sales price of an item and the amount of the retail sales tax. In an effort to address the proposal's potential regressive effects, the bill stipulates that each family will receive a rebate of the sales tax on spending amounts up to the federal poverty level, plus additional sums of money as necessary to prevent any marriage penalty.¹⁸⁰ Therefore, a family making twelve thousand dollars per year would incur an annual net tax liability of zero after the refund.

Exports would be excluded from the national retail sales tax proposal.¹⁸¹ States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee.¹⁸² Taxpayer rights provisions are incorporated into the act.¹⁸³ The sales tax would sunset at the end of a seven-year period beginning on the enactment of the bill provided that the Sixteenth Amendment, which provides Congress the power to impose and collect income taxes, is not repealed.¹⁸⁴

In contrast to H.R. 99, the Fair Tax Act of 2009 proposes to simplify the tax code by implementing a consumption tax.¹⁸⁵ Generally, income is considered all appreciable resources that are under an individual's command, control, or domain in a given period of time.¹⁸⁶ While the expansive definition of income includes all sources of revenue, consumption taxes exclude savings as a source of revenue.¹⁸⁷ Thus, consumption is the sum of all of the resources under an individual's control during a given period of time minus savings, such as retirement funds or bank certificates of deposit.¹⁸⁸ Insufficient data exists as to whether the income tax is superior to the consumption tax.¹⁸⁹

By utilizing the consumption taxation approach, The Fair Tax Act of 2009 is partially successful in creating a mechanism that simplifies the taxation process.¹⁹⁰ The simplicity of the Fair Tax proposal is derived from the proposal's eliminating the need to calculate applicable sources of income,

¹⁷⁹ *Id.* § 201(a).

¹⁸⁰ *Id.* § 201, sec. 301.

¹⁸¹ *Id.* § 201, sec. 102.

¹⁸² *Id.* § 201, sec. 401.

¹⁸³ *Id.* § 201, sec. 605. For example, under this bill the taxpayer would have a right to professional assistance, a right to record interviews, and a right to final notice of amount due if her amount of tax remitted was disputed.

¹⁸⁴ *Id.* § 401.

¹⁸⁵ See BICKLEY, *supra* note 13, at 4.

¹⁸⁶ *Id.* at 2; see also *Eisner v. Macomber*, 252 U.S. 189 (1920) (providing a similar definition of income).

¹⁸⁷ See BICKLEY, *supra* note 13, at 2. Somewhat counterintuitively, income also consists of financial instruments of savings such as accounts used for college funds, pension and retirement accounts, and certificates of deposit.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* ("There appears to be insufficient theoretical or empirical evidence to conclude that a consumption-based tax is inherently superior to an income-based tax or vice versa.")

¹⁹⁰ *Id.* at 3.

minus any exemptions of income that are incorporated into the code.¹⁹¹ The consumption tax approach creates a single rate of twenty-three percent, which is payable at the point of sale or exchange.¹⁹² Similar to a sales tax paid on retail items, a national sales tax should be relatively easy for the taxpayer to understand. Since the tax is collected at the time of the sale or exchange, substantially less documentation should be necessary for the taxpayer to submit to the federal government to ensure tax compliance.¹⁹³

Relatively easy compliance requirements, however, for the taxpayer provided in this bill may not necessarily yield less burdensome results to administer the tax for the federal government. The continued presence of exemptions for certain business activities may require the use of increased resources by the federal government to ensure that businesses claiming the exemption do so in a manner consistent with federal tax regulations.¹⁹⁴ Fear of overly burdensome government audits would cause businesses to invest more resources in tax compliance.¹⁹⁵ The cost of compliance to the business taxpayer would thus increase, thereby reducing the efficiency of remitting tax payments at the time of purchase or exchange.

The Fair Tax Act of 2009 obligates taxpayers to pay the same rate of tax in the form of a national sales tax, largely irrespective of calculated income.¹⁹⁶ Given the potentially negative or regressive impact a national sales tax imposes upon lower-income taxpayers, the bill also fails to ensure taxpayer equity.

3. *Flat Tax Proposals: The Freedom Flat Tax Act, The Simplified, Manageable and Responsible Tax Act, and The Flat Tax Act of 2009*

There are also three flat tax proposals currently before Congress. The Freedom Flat Tax Act¹⁹⁷ proposes to authorize an individual or business to make an irrevocable election to be subject to a flat tax rather than being subject to existing tax provisions.¹⁹⁸ For individuals, the initial tax rate would be nineteen percent, but it would decline to seventeen percent after two years.¹⁹⁹ The individual flat tax would be levied on all wages, salaries, retirement distributions, and unemployment compensation.²⁰⁰

¹⁹¹ *Id.* at 6–7.

¹⁹² H.R. 25, 111th Cong. § 201(a) (2009).

¹⁹³ See BICKLEY, *supra* note 13, at 4.

¹⁹⁴ *Id.*; see also H.R. 25 § 201(a) (including a bad debt credit and an administration credit).

¹⁹⁵ Edwards, *supra* note 163, at 22.

¹⁹⁶ H.R. 25, § 201(a), sec. 101.

¹⁹⁷ H.R. 1040, 111th Cong. (2010).

¹⁹⁸ *Id.* § 2, sec. 60.

¹⁹⁹ *Id.* § 2, sec. 60A(a).

²⁰⁰ *Id.*

Another flat tax proposal, The Simplified, Manageable, and Responsible Tax Act,²⁰¹ mandates a consumption-based tax as a replacement for the individual and corporate income taxes and the estate and gift taxes. The individual wage tax would be levied at a rate of seventeen percent.²⁰² All wages, salaries, pension distributions, and unemployment compensation would be subjected to the tax.²⁰³ A similar proposal, The Flat Tax Act of 2009,²⁰⁴ stipulates a twenty percent tax be imposed on all wages, salaries, and pensions.²⁰⁵

The flat tax proposals satisfy the basic objective of implementing a simplified tax system. Each of the proposals reduces the number of exemptions to the income tax, which would also simplify the resources needed to administer the tax to ensure proper compliance. Taxpayers would also likely need to seek relatively less professional assistance in filling out their tax forms due to the lack of exclusions.

A closer examination of the flat tax proposals, however, reveals that the bills encounter equity problems similar to the issues enumerated with the Fair Tax Act.²⁰⁶ Given the regressive nature of the flat tax, the impact of the tax would be substantially greater upon a taxpayer of lower income than a taxpayer with greater financial resources.²⁰⁷ Further, depending on the manner in which the tax is administered, it is possible that a lower-income taxpayer may be subjected to an even higher rate of tax than the current multiple tax bracket system.²⁰⁸

V. A BETTER SOLUTION: TAXING FINANCIAL AND RETAIL TRANSACTIONS

In contrast to the proposals discussed above, this Essay advocates for a transaction tax. A transaction tax imposes a fee on a broad range of transactions involving any kind of a payment instrument, such as cash, checks, and credit cards. According to estimates from the Federal Reserve, the annual volume of transactions in the U.S. economy in 2008 was approximately \$755 trillion.²⁰⁹ Raising revenues to cover the roughly \$2.6 trillion federal budget would require a transaction fee on all transactions of up to one per-

²⁰¹ S. 932, 111th Cong. (2010).

²⁰² *Id.* § 101, sec. 1.

²⁰³ *Id.*

²⁰⁴ S. 741, 111th Cong. (2010).

²⁰⁵ *Id.* § 2, sec. 1(a).

²⁰⁶ See BICKLEY, *supra* note 13, at 2.

²⁰⁷ *Id.* at 2–3.

²⁰⁸ *Id.* For example, a taxpayer in the 15% tax bracket under the current tax system could incur greater tax liability under a flat tax system in which the minimum tax is 17% or 20%. Conversely, a taxpayer in one of the upper tax brackets of 28% or 33% under the current system may experience a substantial reduction in tax liability, thereby creating pronounced taxpayer inequity.

²⁰⁹ Board of Governors of the Federal Reserve System, Fedwire Funds Services Annual Data, http://www.federalreserve.gov/paymentsystems/fedfunds_ann.htm (last visited Mar. 31, 2010).

cent.²¹⁰ By expanding the base of revenue collection to the broadest possible level, the percentage fee could be reduced to a near miniscule amount. This section lays out the features of the author's transaction tax proposal and then discusses how it exemplifies each desirable principle of a system of taxation.

A. *The Proposal: A One-Percent Transaction Tax*

The author's transaction tax proposal, the Debt Free America Act,²¹¹ requires that the fee on every financial transaction should be an amount equal to one percent of the amount of the transaction. The purpose of the fee is to assess a nominal tax on each transaction that is almost imperceptible to the individuals paying the tax. One of the challenges with setting an exact tax rate is the potential for the fee to devolve into a rigid regressive tax structure that is inherent in the framework of the flat tax proposal. Depending on the type of transaction, a one percent fee may be prohibitively exorbitant. For example, it may be difficult to establish a rate pattern that would treat all financial instruments equally. Setting a higher rate might shut down financial markets in the United States, moving the activity abroad.²¹² However, as the language is constructed in the draft bill, the Secretary can set the fee at an amount equivalent to one percent.²¹³ Therefore, the Secretary has the flexibility of establishing the rate as a percentage of the value of the transaction (*ad valorem*) or as a flat fee or a percentage per transaction.

The transaction fee proposal could be structured at marginally higher rates for larger transactions, with measures put into place to prevent avoidance by structuring large transactions into a series of small ones. Policy incentives like homeownership or charitable giving could be preserved by adjusting, reducing, rebating, or eliminating the fee on those transactions. The fee could also be adjusted to avoid industry-specific distortions in economic sectors, like financial markets, that would be extraordinarily sensitive to a per transaction fee. Thus, a low nominal fee could yield revenue at a fair and effective rate.

The transaction tax exhibits significant advantages over sales and usury taxes. Sales and usury taxes, which are generally categorized as consumption taxes, are only added to transactions with the final consumer. The transaction fee, by contrast, could be levied on every transaction so that every owner of a good would contribute at a lower nominal rate. The fee would be technically easy to collect, levied on all transactions—including those processed through the Federal Reserve Bank—and collected at the point of sale for every transaction. Further, the appeal of the transaction tax comes

²¹⁰ Cf. MAXIM SHVEDOV, CONG. RESEARCH SERV., NO. RL32266, TRANSACTION TAX: GENERAL OVERVIEW 7 (2004) (noting that a 0.5% transaction tax on \$13 trillion in stock and options transactions would generate approximately \$65.6 billion).

²¹¹ H.R. 4646, 111th Cong. § 3, sec. 4501 (2010).

²¹² SHVEDOV, *supra* note 210, at 8.

²¹³ H.R. 4646 § 3, sec. 4501.

from the opportunity to impose a tax at a very low rate because the taxable base of transactions may be very large.

For example, the number of transactions occurring within the financial industry alone is very large. Hence, revenues from this sector of the economy might represent a large share of the total transaction tax collections.²¹⁴ In addition, many countries, including the United States, already impose some sort of transaction tax or economically similar levy on such transactions.²¹⁵ Therefore implementing a new transaction tax would be easier because it could take advantage of existing infrastructure and practices.

The proposal further gives the Secretary the authority to issue regulations and guidelines that establish a standard categorization of the type of transactions that are subject to the fee, including the amount and form of the fee.²¹⁶ Categorizing transactions allows for the development of a systematic framework that captures transactions that are currently excluded or underreported.

B. Simplicity, Equity, and Efficiency of the Debt Free America Act

In contrast to the other bills introduced in the 111th Congress, simplicity in the Debt Free America Act is better realized due to its core concept of applying a relatively low rate of taxation to a widely expanded revenue base. Rather than focusing on maximizing the amount people should pay in taxes, as found in the multi-tiered and flat tax proposals, the transaction tax proposal focuses on increasing the size of the taxable base by greatly expanding the criteria that is used to determine what type of exchanges should be subject to a federal tax.²¹⁷

In addition, the multi-tiered and flat tax proposals attempt to streamline the federal tax code by limiting who should be subject to the tax, as well as the circumstances in which the tax should be paid, thereby resulting in the unintended consequence of narrowing the potential tax base. A shift in focus that expands the type of exchanges that qualify for federal taxation, rather than the amount people pay in taxes, will substantially reduce the systematic impediments that prevent the effective implementation of simplicity in tax reform.²¹⁸

One of the primary barriers to achieving simplicity in the federal tax code is the legislative process itself.²¹⁹ Essentially, the complexity of the political processes involved in producing legislation creates additional rules and regulations for sought-after exemptions to the tax code, thereby under-

²¹⁴ SHVEDOV, *supra* note 210, at 8.

²¹⁵ *Id.* at 2.

²¹⁶ H.R. 4646 § 3, sec. 4501(f).

²¹⁷ H.R. 4646.

²¹⁸ See generally John G. Cullis & Alan Lewis, *Why People Pay Taxes: From a Conventional Economic Model to a Model of Social Convention*, 18 J. ECON. PSYCH. 305 (1997).

²¹⁹ See TAX POLICY BRIEFING BOOK, *supra* note 32, at III-3-1.

mining the goal of assuring simplicity in the tax code.²²⁰ Policy proposals are not drafted in a vacuum without influence or input from policymakers, politicians, and specific interest groups.²²¹ Policy officials and legislators typically draft legislation with their own set of ideal criteria that they wish to be present in policy proposals.²²²

Simplicity in the transaction tax proposal is achieved by eliminating virtually all of the exemptions in the tax code that address the social policy motivations of the federal government to maintain tax exemptions.²²³ Although the removal of the tax exemptions hinders the government's ability to encourage desired social behavior through the tax code, the transaction tax proposal requires the Secretary of Treasury to study whether there are specific circumstances that warrant the selective application of the transaction tax.²²⁴ The completed study by the Secretary is to be submitted to Congress for review to determine whether the transaction tax should be amended to fit the circumstances outlined in the submitted report.²²⁵ Ideally, only a limited number of circumstances should warrant an exemption from the transaction tax to maintain simplicity.

Simplicity in the transaction tax proposal is further achieved by diminishing the incentive for taxpayers to limit their tax liability due to the dramatically lower rate of the transaction tax. The low rate of taxation, along with the frequency of its application, would hopefully reduce the desire of the taxpayer to find savings by claiming tax exemptions. In addition, it may be particularly burdensome for a taxpayer to find significant savings for each transaction in which a one percent fee is assessed. Rather than putting energy into avoiding the tax, the taxpayer may be more willing to pay the assessed tax because it is so insignificant. Therefore, the need to utilize a tax exemption is eliminated and the simplicity of the revised tax code is kept intact.

Because it could be collected at the point of sale for each good or service sold, a transaction tax would be relatively simple compared to the current system of income tax. Because it would involve only one flat rate for individuals with few exceptions, it would be easy for the public to understand. It would also likely gain favor with the public because it would eliminate the need for many people to file a tax return.²²⁶ One potentially mitigating factor in the area of simplicity is similar to a concern with the Fair Tax Act of 2009: because the transaction tax would be collected by companies, the IRS may need to periodically conduct audits of their records or

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ See H.R. 4646, 111th Cong. (2010) (replacing the current tax code, including all exemptions, with a one percent transactions tax).

²²⁴ *Id.* § 3, sec. 4501(e).

²²⁵ *Id.*

²²⁶ SHVEDOV, *supra* note 210, at 6.

collect information from them. This process would likely be no more complex than current audit processes, however, and it might be eliminated if transactions were automatically reported and fees remitted directly from corporations to the Treasury.

A transaction tax is also more equitable than other current proposals and the existing tax code. In contrast to a flat tax, it applies the same rate to each person. This means that consumers who spend similarly will be similarly taxed. Based on the idea that individuals who earn more usually spend more (conduct more transactions), it is likely that this proposal would be very progressive in nature. Also, because the proposed tax rate is only one percent, hopefully this would be such a small amount that consumers would not change their behavior simply because it was being levied on each transaction.

A transaction tax is also ultimately more efficient than the current system of taxation, even though there may initially be a period of uncertainty or adjustment. A transaction tax would affect different sectors of the economy differently.²²⁷ For example, it would likely cause the number of transactions in the financial sector to decrease.²²⁸ It is possible that the cost sensitivities of capital markets may create undesirable market mobility of financial interests that benefit U.S. markets. Even a small fee may result in significant reduction in activity in the U.S. financial market, causing trading activity to take place abroad rather than in the United States.²²⁹ Furthermore, if the markets were to move abroad, it is not known whether the adjustment or complete reversal of the imposed transaction tax would adequately render financial markets to the original state. Once an offshore trading site becomes established, there may be little incentive to relocate back to the United States.²³⁰

Nevertheless, several countries already impose a transaction tax in some form at various low rates.²³¹ Therefore, the range of the rate of imposed taxes is unlikely to cause a large impact on the domestic stock market, and the losses in the financial sector might be made up through the transaction fees in areas that are not currently taxed, such as the governmental bond market. Additionally, a transaction tax “creates incentives to minimize the number of transactions necessary to manufacture a product and bring it to the final consumer.”²³² Thus, a transaction tax encourages overall efficiency in productivity and represents an overall more efficient system of taxation.

²²⁷ *Id.* at 7.

²²⁸ *Id.*

²²⁹ *Id.* at 5.

²³⁰ *Id.*

²³¹ *Id.* at 3 (noting the presence of transaction taxes in Japan and Peru).

²³² SHVEDOV, *supra* note 210, at 4.

VI. CONCLUSION

This Essay seeks to promote extraordinary or “outside of the box” solutions to address the historically difficult policy problem of enacting a revenue-generating mechanism that is sufficient in scope, easily understood, and fairly applied. Similar to the debate concerning the need to overhaul the healthcare system in the United States, the consequences of the nation’s inability to implement a systematically coherent federal system of taxation is increasingly evident in a variety of socioeconomic factors that negatively impact society.²³³ The imbalance of federal expenditures to collected federal revenues exacerbates the rapidly expanding annual federal deficit, as well as the national federal debt, at an unsustainable rate.²³⁴

Sustained economic debt most likely will lead to greater inflation, ultimately making it prohibitively more costly for families and individuals to manage to pay for basic necessities such as food and clothing.²³⁵ However, a significant reduction of the federal debt cannot occur without the implementation of fundamental tax reform. The Debt Free America Act represents a new way of looking at the problem of implementing tax policy that is economically feasible.

In comparison to the other tax proposals being considered in the 111th Congress, the transaction tax proposal mostly closely achieves the three criteria that are necessary in achieving effective and fundamental tax reform. Similar to the manner in which sales taxes are collected, the transaction tax can be remitted at the time the transaction occurs. Administering the tax should be no more difficult than administering and collecting sales tax, which satisfies the criterion of simplicity. The transaction tax meets the equity criteria by obligating all taxpayers to pay a small percentage on all financial and retail transactions, without the creation of exemptions that are applicable to a particular influential or wealthy subset of the taxpaying population. The broad base of the transaction tax and the absence of numerous exemptions address the tax policy goals of creating a tax-neutral system that raises sufficient revenues to cover government expenditures, while still facilitating economic growth and thus creating an efficient system.

The United States must do better to implement a tax structure commensurate with its financial prowess and capability. Federal policymakers have worked too long with narrowly constructed tax benefits and credits that do little to provide substantive change, allowing the further devolution of the

²³³ Peter G. Peterson Found., *Federal Budget on Unsustainable Path*, June 30, 2009, <http://www.pgpf.org/newsroom/MainFeature/june30/> (“Unless tax revenues increase just as rapidly, the rise in spending will produce growing budget deficits and accumulating debt. Large budget deficits would reduce national saving, leading to more borrowing from abroad and less domestic investment, which in turn would depress income growth in the United States.”).

²³⁴ *Id.*

²³⁵ *Id.*

tax code towards complete incomprehensibility. Congress cannot leave this legacy of complication and opacity to future generations.

In testifying before Congress, former GAO Comptroller General David Walker warned, “We could be doing nothing more than paying interest on federal debt in 2040.”²³⁶ In the author’s view, the transaction tax is the only legislation that potentially restructures the tax code to provide a mechanism to eliminate the national debt through increased tax collection and compliance. To protect America’s future and fiscal solvency, it is incumbent upon policymakers, advocates, and the general public alike to create a tax system worthy of America’s legacy and future prosperity.

²³⁶ *The Future of Social Security: Hearing Before the Comm. on Ways and Means*, 109th Cong. 9 (2005) (statement of the Hon. David M. Walker, Comptroller General, U.S. GAO).

