

The Heritage Foundation **Background**

UPDATE

214 Massachusetts Avenue N.E.

Washington, D.C. 20002

(202)546-4400

5/8/86

Number 9

PACKWOOD'S ALCHEMY COULD MAKE TAXES SIMPLE AND FAIR

(Updating Executive Memorandum No. 100, "The Rosty Horror Tax Bill Show," December 2, 1985.)

In a feat worthy of an alchemist, Senate Finance Committee chairman Robert Packwood, the Oregon Republican, has managed not only to salvage tax reform from a seemingly near certain death, but to transform it into a radical rewrite of the entire tax code. Packwood's accolades are well-deserved.

Two distinct ideas have provided pressure for tax reform: first is the traditional liberal idea that "loopholes" should be plugged to make the "rich" pay their "fair" share; second is the more recent compelling "supply-side" idea that marginal tax rates (the tax rate on the last dollar earned) should be as low as possible to stimulate risk-taking and work effort. The overarching goal, therefore, was to limit tax deductions and use the revenue gained from that to lower the marginal tax rate in a way that maintained total tax revenues at their present level.

The Senate Committee's unanimous proposal goes a long way toward achieving this goal. Marginal tax rates would be cut dramatically to just 27 percent, compared with the 70 percent rate when Ronald Reagan took office in 1981. Indeed, the top rate under Packwood's plan is even lower than that proposed by either Senator Bill Bradley (D-NJ) or Congressman Jack Kemp (R-NY), the two congressional leaders most closely associated with tax reform.

To obtain the revenue necessary to achieve this low rate, the plan envisions several steps to reduce the tax preferences available in the current code. Among them: by ending many incentives, taxes on corporations would rise by about \$100 billion per year, a stiffer minimum tax on corporate and individual earnings would be imposed, so-called "tax shelters" would be curtailed, Individual Retirement Account (IRA) contributions would be limited, and the maximum tax rate on capital gains would be raised from 20 percent to 27 percent.

The revenue made available by these changes would allow some six million taxpayers to be dropped from the tax rolls altogether. This mainly is achieved by increasing the personal exemption from \$1,080 to

\$2,000. Also, the vast majority of taxpayers would be taxed at a single 15 percent rate--the 27 percent rate would only apply to taxable incomes above \$22,600 for single persons and \$42,300 for married couples. Thus the Packwood plan would come very close to a true "flat-rate" tax, where every American pays the same tax rate regardless of his income.

This is not to say there are no problems with the Packwood bill. The 35 percent increase in the maximum capital gains tax, for instance, could dampen the growth that would be stimulated by lower marginal tax rates. Entrepreneurs and venture capitalists, who have fueled so much of the growth in new industries in recent years, are particularly sensitive to taxes on capital gains.

But of much greater concern is the limitation on IRAs, making them available only to taxpayers not covered by a regular company pension plan. With the U.S. saving rate continuing to lag behind other industrialized nations, restricting one of the most popular savings incentives in the tax code could be very damaging. Moreover, reducing the attractiveness of private retirement saving would discourage private supplements to the embattled Social Security system. Congress will be shooting itself in the foot if it seriously weakens America's retirement system while trying to reform the tax system.

There are a number of items in the Packwood proposal which, by themselves, probably never could be enacted. However, by presenting these items as a package deal, with very little margin for adjustment, Packwood has forged a coalition which could well carry the day. The danger will come from special interests determined to maintain their special tax treatment, even at the cost of overthrowing the whole package. However, if the 20 members of the Finance Committee stick together, they will already have about 40 percent of the votes needed to defeat any special interest amendment. Moreover, Reagan has expressed strong support for the bill--not surprising since it closely resembles his November 1984 proposal and is the result, to a great extent, of the President having insisted stubbornly that tax reform and simplification were his No. 1 domestic legislative priority.

The chances are that either something like Packwood's proposal will be enacted or nothing will emerge from the Congress this year. Much will depend on the grass-roots support or opposition which emerges in the coming weeks. The initial reaction, however, seems positive, even among businesses and taxpayers slated to lose some benefits. Americans are clearly willing to support tax reform if it leads to genuine simplicity and fairness. And with such strong backing, the Packwood plan may lead to the most radical tax reform ever enacted in any major industrialized country. It could be a major element in the way the Reagan Revolution is changing America.

Bruce Bartlett
John M. Olin Fellow