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An Overview of Federal Taxation

Comprehensive Problems

1. Currently, the United States has a very complex tax system. One of the ways to cure this problem is to enact changes in the U.S. tax laws that eliminate some of the complexity. Listed below are some of the more popular suggestions for raising additional revenue, together with a statement of the law as it currently exists. Comment on the suggested changes as they relate to the discussions involving public policy, equity, and simplicity in Chapter 1 of your text.

Subject *Current Law* *Proposed Change*

National sales tax of 5 percent on most sales (Value Added Tax; VAT) Does not exist at the Federal level but is very popular with state and local American governments and Western European governments. Apply a 5 percent VAT to most sales as an additional Federal revenue source.

Home mortgage interest deduction Deduction may be taken for interest paid on the first $ 1 million of principal. Limit the deduction to $20,000 of mortgage interest for a couple filing a joint return.

Health insurance premiums currently paid by employers Generally not included in employees' income for tax purposes. Include the value of employer provided health insurance in the gross income for tax purposes of employees.

Meal and entertainment expenses 50 percent currently deductible if related to a trade or business. Reduce the 50 percent to 10 percent.

Note to instructor: The response to this question is a subjective one with no "correct" answer. The student should incorporate in his answer, however, the basic discussion in the text regarding the role of a tax in the political system and the various standards used to evaluate that role in modern society.

Solutions to Comprehensive Problems

1. a. VAT is a system adopted throughout Western Europe as a popular form of governmental revenue raising. Additionally, many American states and local governments use a sales tax as a principal form of revenue raising. If a VAT were introduced nationally into the United States, it could be attacked upon grounds of fairness in that it is a regressive tax. The greater one's overall wealth, the smaller the percentage of that wealth one would pay in VAT. Additionally, unless sizable exceptions were created for food, medicine, and other basic necessities, the impact of the VAT could be very harsh on those with fixed incomes, such as the poor and the aged. Although superficially such a tax seems fairly simple, the

introduction of exceptions and qualifications, which seems endemic to a fair national sales tax, would quickly introduce great complexity into what seems to be a simple system. Presumably, the impact of the VAT would be on the *incremental value* added to the property by each successive vendor. If this were the case, determining what value was added for purposes of levying the tax could become quite complicated because that determination would produce the impact of the tax on each successive vendor.

The tax is commonly employed in Europe, where, at least in some European countries, the rate of voluntary compliance with tax rules is low. . Although there is little evidence to suggest that the rate of voluntary compliance has decreased significantly in the United States over the last several years, the very serious lack of sufficient Federal revenues may cause the United States to adopt a national sales tax, despite the obvious disadvantage that it detrimentally impacts low-income groups. To some extent, Congressional reluctance to introduce a tax that does not extract a larger percentage contribution from wealthier citizens has been ameliorated by the 10, 15, 25, 28, 33 and 35 percent tax rates.

b. The home mortgage interest deduction has long been a sacred deduction in the Internal Revenue Code. Presumably, the advantage of the deduction was the stimulus it provided home owners, the home building industry, and other allied industries. Commentators for many years have questioned the fairness of allowing those who own homes to deduct their mortgage interest if renters were not allowed to deduct some or all of their rental payments. It appears that the deduction favors the middle and upper class since only those sufficiently wealthy to acquire a house are able to take the mortgage interest deduction. If the deduction is to remain, a good argument could be made on the grounds of equity that it be limited. The current principal amount, $1 million, seems far too high. Why should someone who can afford to buy a $1 million residence be allowed to deduct the mortgage interest on such a purchase when lower-income individuals who cannot afford to purchase a house are allowed no deduction for their rents?

   The mortgage interest deduction is very popular with the American middle class because it is a "tax break" they can all identify as being very advantageous to them. Hence, the deduction is politically popular. Additionally, the deduction has very strong support from the home building industry, which will lobby Congress to ensure the continuance of the deduction. In summary, on grounds of equity, the deduction should be modified or eliminated, but the strong public policy arguments made by its very powerful proponents will be difficult for anyone to overcome.

c. For many years, employers who paid the medical insurance premiums of their employees provided these employees with a non-taxed benefit because Congress provided that the benefits were not taxable. As can be imagined, the American labor movement fought long and hard for this exemption and its continuation is a product of their strong lobbying on its behalf. But the exemption is inequitable to those who must pay for their own health insurance and/or some or all of their own medical bills. Since, as the chapter points out, a deduction is only worth the amount expended times the marginal tax rate, a person who deducts his own medical insurance receives only a partial benefit (i.e., 35% of the amount of the insurance premiums). The rest of the expenditure is borne solely by the taxpayer. It is much better for the employee if the employer pays the premium and the government does not tax the benefit of the payment. Such a system is very inequitable for anyone who pays his or her own premiums or medical bills. The result is a system where the best-treated workers (e.g., those highly paid with strong unions) are better treated than minimum wage workers who receive no employer-provided health benefits. The situation is made worse, of course, by the 7.5 percent limitation now imposed on the deductibility of medical expenses, which has totally eliminated the benefit of the deduction for all but those with very large medical expenses. The net result is that a fair tax system would either include employer-provided health benefits as income or increase the medical-expense deduction to benefit lower-paid workers. Given the great political controversy that the elimination of this benefit would generate, however, and the ease with which Congress has almost totally eliminated medical expense deductions by increasing the base from 5 percent of A.G.I. to 7.5 percent of A.G.I. in 1986, conditions favor a continuation of current policy.

d. The justification of a deduction for meal and entertainment expenses is that such expenditures are ordinary and necessary expenses of a trade or business. The 50 percent limitation was imposed to obtain some control over taxpayers who exercised no control over their expenditures under the theory that the government would subsidize their extravagance. The 50 percent the taxpayer cannot deduct presumably encourages employers to encourage moderation among their credit card-carrying executives. In point of fact, this deduction is probably a testament to the ignorance of the vast majority of taxpayers about even the basics of their own system. Many taxpayers believe that if they are allowed to deduct $1,000 annually in meals and entertainment the government is subsidizing them by $1,000. In fact, of course, the subsidy is only the taxpayer's marginal tax rate times 50 percent of the costs; the remainder of the expenditure is borne by the taxpayer.

   If Congress were really concerned about abuses in this area, it might consider eliminating this deduction altogether. The vast majority of American workers do not have any tax deductible meals or entertainment. This is a deduction usually reserved to the professional classes with higher marginal tax rates. And, as most commentators have observed, the distinction between business and personal enjoyment is hard to draw in many of these cases. In summary, although an equitable system might eliminate this deduction, a 10 percent limitation, as suggested, is a move in the right direction.