

Tax Reform That Is Kept Simple Presents A Win-Win Opportunity

First In A Series

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By appointing a distinguished advisory panel to help him fix the U.S. tax code, President Bush has given tax reform an extra shot of gravitas and, in the process, rescued it from the policy wonks. From now on, pencils should be sharper, thinking more precise, and the focus more on real world reforms that the Congress can reasonably be expected to enact in 2006.

Tax reform is not the complex, Herculean task that many have thought. The half dozen aberrations in the tax code that are most damaging to economic growth are also sources of much tax complexity. Remove the most egregious impediments to economic growth and get major simplification as a free byproduct. Not a bad deal.

Indeed, if government tax revenues can be raised in ways that are fair, simple and better for the economy, what, pray tell, could be the excuse for not taking advantage of this win-win opportunity?

Nearly all tax reform options eliminate the Double taxation of saving, investment and international trade, and, in the process, cut out big chunks of complexity as well.

If the dozen different IRA and 401(k) variations in the current code are replaced with a better alternative that really does eliminate the double tax on saving — as tax reform promises to do — the tax code and regulations will shrink by more than 1,100 extraordinarily complex pages.

Replacing the current code's half-dozen different depreciation systems with simple and effective first-year expensing for machinery and equipment will cut out another 400 pages of code and regulations that put a double whammy on the economy: The existing depreciation rules impede investment and constrain productivity, and they increase compliance costs enormously.

A straightforward exclusion of export income will moot another 100 to 200 pages occupied by several overlapping, partially irrelevant and generally failed "Rube Goldberg" schemes that have cluttered up the tax code for decades.

One, called FSC/ETI, kept the Congress and the international business community tied in knots for two years before being repealed. Now U.S. Treasury officials say they cannot figure out how to administer Congress' most recently enacted attempt to temper slightly the continuing harm to U.S. manufacturers that comes from exports being taxed twice (once here and again in the country of destination).

In addition to fixing the export situation (where U.S. businesses produce here and sell abroad), some tax reform options do away with the tax code's archaic two-tax regime for income earned when a U.S. business produces abroad and sells abroad. There are 950 pages of rules about such "foreign source" income. Most hamper the ability of U.S. companies to compete in global markets. Few appear to raise any tax revenues. Critics say they cost tax revenues.

Experiments in the 1990s indicate that eliminating double taxation, in combination with other simplifications and a plain-English rewrite of the tax law, will halve the size of the Internal Revenue Code.

Concentrating tax reform on eliminating double taxation also provides the most bang for the buck in terms of economic growth.

For example, for each \$1 of static revenue cost, switching from depreciation to first year expensing will produce roughly \$9 more GDP, and switching from double to single taxation of personal saving will produce \$4 to \$7 more GDP—but a traditional corporate rate cut would produce only about \$2.70 more GDP.

Relief from double taxation, in combination with recently enacted cuts in high personal tax rates, ought to make it politically possible to do some judicious "loophole"-closing — certainly enough to pay for abolishing the now notorious alternative minimum tax (AMT).

All told, there is a list of more than \$2 trillion in loopholes to choose from, not including the deductions for home mortgage interest and charitable giving that President Bush has properly taken off the list.

Squeezing the list a little harder would also pay for the remaining \$400 billion-\$500 billion 10-year static revenue cost of tax reform — but that may not be necessary. Once the advisory panel and Congress really start sorting through the core components of tax reform, they may find one or two "silver bullets" that not only provide sufficient offsetting tax revenues, but are potentially good policy and good politics as well. (A subsequent column in this series will explore several hypothetical possibilities.)

Revenue-neutral tax reform will entail tax increases as well as tax decreases, and, because of that, much astute political maneuvering will be required. The most hopeful prospect is that, counting back to the Bush tax cuts in 2001 when tax reform really began, the overall mixture of tax pluses and minuses will leave most important constituencies net better off by enough of a margin to keep tax reform moving forward intact.

The further hope is that when explained to them in plain English, the American people will buy on to the idea—and see, despite all the Beltway folderol, that tax reform is a

simple process made up of familiar components, and is economically smart. If so, good economics will become good politics and tax reform will succeed.

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