



## Revisiting 'Scientific Tax Reform': How To Tax Smarter, Not Heavier

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The task before President Bush and his Tax Reform Advisory Panel is similar to the one faced by the Treasury Department in 1920 shortly after enactment of the first federal income tax: how to raise the requisite amount of tax revenues while interfering the least with the ability of the economy to grow.

In other words, taxing smarter instead of heavier.

Today, tax reform is focused primarily on correctly defining income and assuring that it is taxed only once. In 1920, Treasury's experts were searching for an optimal tax rate. They called their project "Scientific Taxation" in the belief that it is possible to determine the precise point at which economic growth and tax revenues are in perfect harmony.

Their more immediate task, however, was to lower high World War I tax rates that were about to kill the emerging industrial economy.

At the same time, they had to keep rates sufficiently high to satisfy Republicans who wanted to pay off the debt from WWI. They also had to satisfy the ideological demands of the Progressives who wanted to tax savings and investment as heavily as possible.

Ultimately, Treasury Secretary Andrew Mellon succeeded in getting the wartime tax rates lowered enough to permit the economy to grow. (The British, in contrast, nearly destroyed their economy by continuing wartime tax rates unabated.)

A new study by Susan Murnane at Case Western Reserve credits the Treasury's efforts to sell its modest tax cuts in the 1920s with having begun the process of educating the public and politicians about the workings of modern capitalism and the interaction between it and the newly enacted federal income tax.

### **Taxed Like A Capitalist**

Since in those early days the income tax applied only to big corporations and the wealthy, the Treasury had the task of explaining that because high taxes on capital harmed the economy (costing jobs and reducing productivity), they were, in reality, taxes on the "working man."

Sounds simple and obvious, but it was not obvious at the time. To many politicians, the

economics of taxation remained a mystery for many more decades.

The anti-capital attitudes of the Progressives continued to be the dominant characteristic of the income tax - which soon became nearly universal, applying to the working man as well as to the capitalist.

Even though the average American was taxed like a capitalist, the tax code made it very hard for him to become one. High tax rates in combination with double taxation of savings kept millions of Americans from accumulating wealth of their own.

Grossly inadequate depreciation allowances for the cost of capital equipment made it difficult for small-business entrepreneurs to expand. Nevertheless, the number of capitalists did increase substantially and, as that occurred, the economic class distinctions upon which the tax code's anti-capital bias depended began to crumble.

Scientific tax reform reasserted itself in 1960, this time with strong popular political support.

In an attempt to rescue the economy from 91% tax rates and a dangerous decline in business capital investment, President Kennedy increased depreciation deductions, got Congress to enact an investment tax credit and promised across-the-board tax cuts. He explained the economics of taxation in a way that sounded much like Andrew Mellon in the 1920s: "The tax deterrents to private initiatives have too long held economic activity in check."

By the time of President Reagan's "supply-side" revolution in 1981, scientific taxation had changed from being an effort to save the economy from decline and became a calculated effort to achieve higher levels of economic growth by lowering tax rates and removing the anti-capital biases that had characterized the tax code from the beginning.

Overall, up through the tax cuts in Bush's first term, tax rates have been reduced to 35% from 91%, capital gains tax rates have been reduced to 15% from 28% and corporate tax rates have been reduced to 35% from 52%.

In addition, depreciation allowances for capital equipment have been improved four times, to the point that first-year expensing is within reach.

Indeed, starting in 2001, partial first-year expensing was allowed for a temporary period during which time business capital investment increased at an phenomenal rate. So did corporate profits and tax collections, proving yet again the advantages of taxing smarter instead of heavier.

Low marginal rates of tax and first-year expensing are now fundamental components of nearly all tax-reform proposals. Bush and his advisory panel have a historic opportunity to complete the growth-oriented tax reform legacy of Reagan.

Bush can also create his own tax reform legacy by taking the third critical step in the long march of tax reform - removing the double tax on saving.

More personal saving will promote economic growth and help create the "ownership society" he envisions.

Even after the income tax was expanded to reach the working man as well as the rich, the anti-capital bias that permeated the early tax code led to the deliberate double taxation of saving.

### **Not Free To Save**

The first small measure of relief from double taxation did not occur until the 1950s and was strictly limited to savings through highly regulated employer-sponsored pension and profit-sharing plans.

In the 1970s, relief from double taxation was expanded to include savings in IRAs, Section 401(k) plans and other similar arrangements, although always highly limited in amount and restricted to retirement savings. Most recently, Congress has also granted relief for small amounts of savings to pay for education and medical costs.

But Americans have never been allowed the freedom to save, without tax penalty, for whatever purpose they wish, in whatever amounts they wish and for however long (or short) a time they wish.

And the country has never been allowed to experience the burst of economic growth that such freedom can spawn.

Once again, as in the 1920s, it is time for the administration to launch a public educational campaign to explain to the American people how they themselves will benefit from tax reform.

Fortunately, the educational task should be much easier than it was in the 1920s. As a result of the proliferation of IRAs and 401(k) plans, large segments of the U.S. population have had personal experience with savings that are free of double-taxation and will understand how the freedom to save for any purpose without tax penalty can boost their personal wealth.

Moreover, 54% of American households own stocks, directly or through pension funds, and thus have a personal stake in the fortunes of business corporations - many of which will be able to operate more productively after tax reform allows first-year expensing for new capital equipment.

Finally, a new generation of upwardly mobile younger Americans - better educated than prior generations and more comfortable with the concept of themselves as budding capitalists - should be particularly receptive to tax reform that promises them the chance to participate in a new era of economic growth.

With broad public support, Bush can achieve what tax reformers have sought for three-quarters of a century - a tax code that promotes, rather than retards, economic activity.

Christian, a former Treasury tax official, is director of the Center For Strategic Tax Reform in Washington. [The first five parts of this series](#) appeared on Feb. 1, Feb. 15, March 1, March 15 and March 28.