# Simplify, Simplify, Simplify

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President Bush's bold convention promise to propose fundamental tax reform in his second term creates a real opportunity to modernize a tax code that is a half-century old. There is much reform that is needed, and many ways to do it. But, two predictions seem safe.

First, the plan the president will ultimately propose will reflect his preferences. This was true in 2000 in his sweeping tax reduction proposal. For example, it was his decision to get five million families off the tax roles through tax cuts focused on low- and moderate-income working families with children, not that of his more hard-boiled advisory panel. The same was true with his focus on individual tax relief rather than corporate tax cuts. Mr. Bush is a man who understands the issues and knows what he wants to accomplish.

Second, President Bush is not a man who will let the perfect be the enemy of the good. He reached across the aisle to Ted Kennedy to pass education reform, to Pat Moynihan on Social Security reform, and to the AARP on Medicare reform. The tax-reform bill, and even his proposal, will reflect necessary compromises. But analyzing his objectives of growth, fairness and simplicity indicates where the thinking on tax reform is likely to start.

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The president's first objective will be to promote American economic growth and job creation. There are many ways our tax system retards growth, but three are most important. Trade is the most sensitive. America is the only major country that taxes its companies and individuals no matter where they do business in the world, while letting its consumers buy goods produced overseas by foreign-owned companies tax free. This may have made sense in the 1950s when the tax code was written, it doesn't today, and creates a problem known as "border adjustability." Markets respond. A major reason why Daimler-Chrysler is not Chrysler-Daimler is the discriminatory treatment given to American owned corporations under American tax law.

Fixing this problem is complicated by our obligations to the World Trade Organization. We now are facing tariffs imposed by the European Union because our partial "fix" of this problem was ruled as violating international trade law. Our system, based on directly taxing the incomes of companies and individuals does not allow for a border adjustment. But it does allow Europeans to rebate indirect taxes on goods exported from Europe and impose taxes on goods when they are imported.

Economists believe that this disadvantages American production less than it might seem because the differential taxation will be reflected in the exchange rate. But in a world in which many of our trading partners in Asia and Latin America fix their exchange rates with the dollar, this adjustment is much slower, and less transparent, than it should be. Moreover, if exchange rates are determined by capital flows over the intermediate term, rather than by trade, it might take a long time for the burden of taxes on domestic producers to be offset in the foreign-exchange market.

At the very least, the political rhetoric about Benedict Arnold corporations shows that the political process is not patient enough to wait for markets to adjust, and is throwing up ideas that are not well thought out. For example, the Institute for International Economics has said that the major effect of John Kerry's "off shoring" tax proposals would be to cause even more corporate headquarters to be located overseas. These aren't just "good paying jobs," they are among the best paying jobs. Reforming the tax law to level the playing field with the rest of the world is a much better approach.

Second, growth is held back by the way we tax capital. Taxation of capital has become less onerous in recent years, but is still a problem. Our corporate income-tax rate is among the highest in the world. But, a potentially bigger problem is its unevenness. Some capital income enjoys almost indefinite deferral of tax. Other types, notably dividends, are overtaxed. Prior to last year's tax cut, the double taxation of dividends resulted in an effective tax rate of over 60%. Few would consider such a rate "fair," no one could argue it is good for economic growth.

The other big challenge to capital formation is our very complex depreciation system. Not only does it create a record-keeping problem, but, by its nature, does not reflect economic reality. High-technology goods subject to rapid innovation depreciate in value faster than the law allows, effectively raising the tax rate on them. The best fix is to allow the expensing of all capital goods purchases. In turn, this would result in other changes that would make cash flow the basis for determining the tax base.

Third, growth is inhibited by high tax rates. The economic distortions caused by a tax -- what economists call the excess burden -- is related to the square of the tax rate. So when rates go up, not only does the tax base shrink, but economic activity is redirected to less efficient and useful areas. The combined effect is to make raising revenue very costly in economic terms, as rates rise. For example, when the top income tax rate rises from 40% to 50%, the burden of the extra tax on the public is $1.55 for every dollar collected by the government. Raising rates from 50% to 60% costs the public $1.90 for every extra dollar collected by the government. The only solution to this is to have a tax system with rates that are as low as possible.

Low rates on a broad, cash-flow determined tax base, with equal tax treatment of goods no matter how or where they are produced, is the best approach to encouraging economic growth. It also happens to be a good solution to the problem of fairness in a tax system.

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Fairness, like beauty, is largely in the eye of the beholder, but one can still make some objective observations. If fairness is determined by what share of the income tax is paid by the wealthy, then our tax system has gotten substantially more fair over the last quarter-century. Just before the Reagan tax cuts took effect, the top 1% of taxpayers paid 16% of the income tax. Today they pay 32%. Over that same period, the top tax rate has been cut in half from 70% to 35%. So, by this measure, not only is the tax system far fairer than it was when Jimmy Carter was in office, but raising tax rates does not seem to be the way to make it more fair.

The real fairness problem is not that the rich pay too little relative to others, but that some people pay a lot more than others with essentially the same income, and some people with great wealth pay remarkably little. For example, a summary of Teresa Heinz Kerry's taxes released by the Kerry campaign showed $587,000 in income taxes paid on $5.1 million of income. That level of income, all from capital, implies that she got a return of less than 1% on her estimated fortune of between $500 million and $1 billion. More likely, it is an illustration of the unevenness of capital income taxation. Furthermore, Mrs. Kerry's effective tax rate on the income she did receive was less than 12%. The Congressional Budget Office reports that most taxpayers in the top percentile have average tax rates over 30%.

This low rate of taxation is not the fault of Senator and Mrs. Kerry. Taxpayers have no obligation to arrange their finances in a way that exposes them to taxation. Rather, the problem lies with a tax code that is overly complex and allows taxpayers a variety of ways of shifting or deferring taxation. Simplification, coupled with lower rates and a broader base is the easiest solution to the fairness question.

So, although simplification usually gets short shrift from many tax experts, it is actually an integral part of making the tax code both fairer and more growth oriented. Expensing of investments rather than depreciation, moving to a revenue- or cash-flow based tax system for both companies and individuals, and eliminating the array of differentials in tax treatment of income from different sources are all ways of promoting fairness, simplicity and growth. With an estimated six billion hours spent complying with the current tax system, there are substantial direct benefits to be obtained from simplification as well.

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The problem with simplification is a political one. In 1986, President Reagan led a revenue-neutral tax reform that broadened the base and lowered tax rates in a revenue-neutral way. Later, the Democrats kept the broader base and simply raised rates. Conservatives justifiably fear that the same might happen from any tax reform that moved toward a more level playing field. This is especially true if we were to merely add another tax on top of the existing set of taxes.

Thus, the best form of simplification is the kind that eliminates some taxes completely. The corporate income tax, and most or all of both the payroll and personal income taxes could be replaced by a broad based cash-flow or revenue-based tax. This would shift the compliance burden to business and away from individuals. It would also level the tax playing field among different types of income. Alternatively, the corporate and personal income tax bases could be simplified in a way that significantly reduces the opportunities for sheltering or deferring taxes, and thus allow for lower rates. Whatever path the president ultimately chooses, there are substantial benefits to the American economy from making the effort.

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