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Tax reform timidity

By Richard W. Rahn

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The president's tax reform panel's report is due at the end of this month, but don't hold your breath if you were looking for the reform that is really needed. Preliminary signs are the panel will recommend relatively modest (but several desirable) changes to the federal tax system.

For decades the present income tax system, with its tens of thousands of rules and regulations, has been widely recognized as so complex no one human, no matter how talented, can understand it.

The present system puts even those who fully intend to comply with the code at risk of being convicted as tax felons because it is impossible to know with certainty when one is or is not in compliance (even federal tax courts rulings sometimes rule contradict other federal tax courts).

The short, but correct, word for such a system is tyranny. It is also extraordinarily expensive to administer, both by the government and the private sector.

If the tax reform panel (officially "The President's Advisory Panel on Federal Tax Reform") is serious about correcting fundamental problems, it would have to present a package calling for an end to the present code. The replacement could either be (1) a simple low rate flat tax, or (2) a national sales tax or value added tax (VAT). The panel would have to recommend one or the other, but not both, which would only increase complexity and tax tyranny.

The reform package should recommend specifics for eliminating the double tax of capital. Good economists have long known taxing capital is economically destructive, because capital is the "seed corn" of the modern economy. When capital is taxed, it diminishes economic growth and job creation.

To illustrate, corporate dividends and capital gains are taxed at least three times. The capital is taxed when the invested capital is first earned, is taxed by the corporate income tax and then the shareholder is taxed on dividends or capital gains.

The commission should also call for reducing any tax rate above the long-run revenue and welfare maximizing rates -- which includes the present top personal income and corporate tax rates. Such rates only discourage work, saving and investment, and

encourage tax evasion and tax avoidance. They reduce economic opportunity, employment, and the standard of living of almost everyone.

The corporate income tax should be abolished or "integrated" with the personal income tax. The U.S. now has the world's second-highest corporate tax rate, which makes the U.S. noncompetitive and encourages American multinationals to incorporate elsewhere. It also discriminates against public companies (such as most manufacturing firms) because they need the corporate form of ownership, while enterprises such as law firms are normally partnerships or limited liability companies, which are taxed only once.

The tax panel should insist on serious dynamic scoring (i.e., full accounting for all the behavioral changes by taxpayers) in making tax changes. The present static revenue system gives precisely wrong answers that always overestimate revenue gains from any tax rate increase and overestimate revenue losses from any rate cut (and ignores the fact some rate cuts, such as on the capital-gains tax, actually increase revenue). Current reports from panel members indicate they will give a "nod" to dynamic scoring rather than insist upon it.

Without most of these necessary changes, the panel's report will have little effect; it will only rearrange the deck chairs.

There are many fine, knowledgeable individuals on the advisory panel, but the way it was established and constrained almost doomed it to failure. Insistence on a bipartisan panel that reflects various viewpoints and produce "revenue neutral" recommendations on a static basis means there is almost no way to secure a consensus on radical reform (even though, individually, many members understand the need).

It is also unlikely many good recommendations by the commission will be passed into law. The simple reason: A desirable commission recommendation, such as ending the alternative minimum tax, would have to be offset by ending something popular, such as the homeowners' property tax deduction, causing an uproar from taxpayers and lobbyists.

All the various special interest groups that shaped the present tax code mess are not impotent but ready to fight any change affecting their welfare.

Richard W. Rahn is director general of the Center for Global Economic Growth, a project of the FreedomWorks Foundation.