

PERSPECTIVE

Scientific Tax Reform Redux: Figuring Out How To Tax Smarter Instead of Heavier

Sixth In A Series

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The task before President Bush and his Tax Reform Advisory Panel is in some respects similar to the one faced by a bipartisan group of lawyers in the Treasury Department in 1920 shortly after enactment of the first federal income tax: How to raise the requisite amount of tax revenue while interfering the least with the ability of the economy to grow. In other words, taxing smarter instead of heavier.

Today, the search for the optimal tax reform is focused primarily on correctly defining income and assuring that it is taxed only once. In 1920, however, the search was for the optimal tax rate. They called this project "Scientific Taxation" in the apparent 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 as much as possible the confiscatorially high World War I surtax and excess profits tax rates that were about to kill the emerging modern industrial economy. At the same time, they had to keep rates sufficiently high to pay off the WWI debt in a short time and to satisfy the ideological demands of the "Progressives" who wanted to tax all income from capital as heavily as possible. Ultimately, the Treasury did succeed in getting the wartime tax rates lowered enough to permit the economy to grow for a few years. (The British, on the other hand, destroyed their economy by continuing wartime tax rates unabated.)

The story of these early episodes in the on-going struggle between the destructive power of the income tax and economic common sense has recently been retold from a new perspective by M. Susane Murnane at Case Western Reserve. She credits the Treasury's efforts to sell its modest tax cuts with having begun the process of educating the public and politicians about the workings of industrial capitalism and the interaction between it and the newly enacted federal income tax. Remember, in those days the income tax applied only to big corporations and the wealthy -- but the Treasury aides correctly explained to the American people that high taxes on the rich hurt the economy, costing jobs and reducing production, and, therefore, that high taxes on the rich were in reality taxes on the "working man." Sounds simple and obvious, but it was not then and to many politicians the economics of taxation remained a mystery for many more decades.

Tax rates went back up and the anti-capital attitudes of the Progressives became the dominant characteristic of the income tax-- which soon became nearly universal, applying to the working man as well as to the capitalist. But even though the average American was taxed like capitalists, the tax code made it very hard for him to become one. High tax rates applied to nearly everyone. Double and treble taxation discouraged millions of Americans from saving money and accumulating wealth of their own. Grossly inadequate depreciation allowances increased the cost of capital investment for small business entrepreneurs seeking to expand. Despite all these impediments, the number of capitalists increased. And as that occurred, the class divisions upon which progressive politics and the tax code's anti-capitalist biases both rested began to crumble. By the 1960s the tax code began to

change-- slowly, grudgingly, and always insufficiently-- and by the 1970s the long march toward tax reform that we see today had begun.

When the top tax rates were up in the fifty to seventy to ninety percent ranges, the double tax bias against personal savings was so prohibitive that even in the 1950s and 60s the tax code began to allow some tax relief for the highly regulated employer-sponsored pension and profit-sharing plans that were strictly reserved for retirement savings. Later on, starting in the 1970s, the tax code began to allow some relief from double taxation for savings in IRAs, Section 401(k) plans and other similar arrangements, but always highly limited in amount and restricted to retirement savings. Although in recent years Congress has also begun to allow relief from double taxation for small amounts of savings for education and medical emergencies, Americans have never been allowed the freedom to save for any purpose of their own choosing. Even the gradual decline in marginal tax rates from ninety to seventy to fifty and now down to less than forty percent has been distorted by the tax code's continuing strong bias against capital. For example, in the late 1960s the top marginal rate was reduced from seventy to fifty percent, but only for "earned" income and the Treasury Department spent several years writing incredibly complex regulations to assure that no income from capital could possibly qualify for the reduced rate of tax. Subsequently, as marginal rates were reduced even more, that particular discrimination against capital was eliminated, and even capital gains taxes have been reduced, but in more recent years the Alternative Minimum Tax has had the effect of taxing the income from capital more heavily than personal earnings.

Since 1960 the heavy tax burden on business capital investment has, in fits and starts and always somewhat hesitantly, been significantly reduced, even to the point that for a period of about eighteen months ending in 2004, businesses were allowed to expense a portion of capital equipment costs. And, of course, beginning most significantly in 1981 with President Reagan and recently with President Bush, marginal tax rates have been reduced significantly.

Further victories for capitalism may be achieved in the current round of tax reform that President Bush has set in motion. But only if a lot more members of Congress, on both sides of the aisle, relearn and apply in today's circumstances the simple truths about the economy and human nature that Ronald Reagan knew so well. The natural human instinct is to strive and succeed. Nearly everyone would actually like to be rich -- and the more people succeed, the better off we all are. But when government taxes away too much of the rewards for hard work, people strive less and produce less, and when that happens, we are all worse off.

President Bush's concept of an "ownership society" encapsulates the new politics of economic growth and upward mobility among younger Americans that may propel tax reform forward. The number of capitalists has increased to the point that roughly 54 percent of American households are now shareholders, either directly or through pension funds.

The gradual evolution of a new tax policy toward saving now seems to have reached the point where Congress may at least be willing to allow Americans 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. This is the root concept of the President's proposal for Lifetime Savings Accounts several years ago and, in more fulsome form, is, by definition, a component of all major tax reform proposals that are likely to come before the President's Tax Reform Advisory Panel for consideration.

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