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SALVAGING A GOOD TAX BILL

As this is written, it appears that at the insistence of the U.S. Senate, Congress will approve this year a smaller cut in taxes and a bigger increase in government spending than President Bush had sought to achieve. Instead of the $1,620 billion of tax relief over the next decade that the President had proposed, the compromise reached with the Senate calls for $1,350 billion of tax cuts, with $1,250 billion of that to be used for a 10-year tax relief package and $100 billion to be available for some type of special short-term "economic stimulus".

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The scaling back of the tax package is disappointing because Americans are badly overtaxed. Too many tax provisions are strongly biased against saving, investment, work effort, and entrepreneurship, which hurts productivity and slows growth. Moreover, the staggering complexity of many tax provisions wastes enormous amounts of time and money, and thereby also lowers incomes, production, and living standards. To be sure, modest tax relief is better than no tax relief, but the U.S. tax system has such enormous problems that even the amount of relief proposed by President Bush (about 5% of tax collections over the next decade) would not be sufficient fully to correct them.

With the Senate permitting still less to be done, it is more important than ever that the Senate and the subsequent House-Senate conference concentrate on the areas where the current tax system does the most harm and where reform would do the most good.

• The tax bill should include across-the-board rate cuts, such as those proposed by President Bush. Marginal rate cuts are superb public policy because they generate a large growth dividend by reducing tax biases against saving, investment, and work. The rate cuts that will do the most to spur economic growth are those in the highest tax brackets, where anti-production tax biases are the strongest.

• Repeal of the death tax should also be part of the bill. The death tax hurts the economy both because it sharply discourages saving and because it diverts huge amounts of time and money from productive activities to tax planning and paperwork. Eliminating the death tax quickly would be best, but gradual repeal would be better than leaving it in place.

• Although not part of the Bush proposal, the Senate and the House-Senate conference should consider folding into their package the Portman-Cardin bill (H.R. 10), which passed the House by an overwhelming bipartisan margin of 407 to 24. Portman-Cardin would allow people to contribute more to their pension and retirement accounts and simplify complicated pension rules. H.R. 10's

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revenue cost is small compared to the large contribution it would make in combating the tax bias against saving.

• Another possible addition that would pay a large growth dividend is cutting the capital gains tax. One proposal now circulating on Capital Hill is to exclude half of capital gains from taxable income. That would lower the marginal tax rate on capital gains. A bonus pointed out by the Joint Committee on Taxation is that an exclusion would dramatically simplify what are now complicated and confusing capital gains tax calculations. Dividends also merit relief from double taxation at the corporate and individual levels.

To fit within the limits demanded by the Senate, what tax relief should not be included in the package? This requires painful choices. A good economic policy would be to scale back any changes that do not reduce marginal tax rates or simplify the tax code. Although many of these proposals are politically appealing, they would produce weak growth dividends. One candidate is the proposed doubling of the child credit. The child credit does not affect the marginal tax rate of most recipients. A smaller increase would still help taxpayers with children but at a lower revenue cost. Another way to hold down the revenue cost is to forgo more expensive marriage tax relief provisions in favor of that proposed by President Bush. The President's recommendation would concentrate on reducing the marginal tax rates of the couples most likely to suffer a marriage tax penalty; it would not reduce the taxes of the many couples already receiving a marriage tax bonus. Another provision to reconsider is the charitable deduction for non-itemizers proposed by President Bush. It would not lower marginal tax rates and, if enacted, would actually increase tax complexity.

> ***The most effective type of stimulus would be to quickly reduce tax and regulatory barriers to work, saving, and investment... Discredited Keynesian-style rebate programs, like those touted by the Ford and Carter Administrations during the stagflationary 1970s, are utterly useless and should be avoided.***

Congress should also hesitate about using some of the limited funds available to enact new tax credits. Too often, tax credits, whether directed at households or businesses, are really disguised spending programs. Most credits do not reduce marginal tax rates but do further complicate the tax system.

Some members of the Senate would trim the package by keeping the top tax brackets higher than recommended by the President and voted for by the House. That is a bad idea because it would direct tax relief away from one of the areas where marginal income tax rates are highest and the resulting tax biases against work, saving, and investment are the most damaging. However, if the Senate is determined to scale back the statutory rate reduction in the highest brackets, a possible trade-off would be to abolish some of the complicated and distortionary phase-out provisions now in the tax code, such as the phase-outs of itemized deductions, personal exemptions, and the child credit. These phase-outs currently add between 1 and 6 percentage points to the effective marginal tax rates of upper-bracket taxpayers, often pushing their current marginal income tax rates well into the mid-40-percent area.

Part of the package is to be for short-term stimulus. Regrettably, so-called stimulus plans have been tried at many times and in many countries and have a consistently terrible record. For example, Japan has been mired in recession throughout the past decade despite a succession of Keynesian-style tax and government-spending plans that were supposed to reinvigorate the economy. The main effect of those plans was to swell Japan's government debt. As another example, it is not uncommon for governments to try to pump up their economies shortly before elections. Those schemes typically prove shortsighted, either bringing no economic benefit or causing problems after the election that outweigh any initially perceived gains.

The most effective type of stimulus would be to quickly reduce tax and regulatory barriers to work, saving, and investment. Tax cuts do not work by giving people money to spend. They work if and only if they change the incentives to produce. Among the best options would be to start cutting tax brackets immediately, to lower the capital gains tax now, or to speed up depreciation schedule so that investors could deduct capital costs closer to when they incur the costs. Such initiatives would generate the greatest economic payoff in the long run, but they would also provide a boost in the short run. Discredited Keynesian-style rebate programs, like those touted by the Ford and Carter Administrations during the stagflationary 1970s, are utterly useless and should be avoided.

The Congress still has the opportunity to produce a good tax bill this year. If done right, the bill will clean up some of the tax system's worst problems and lay the groundwork for further legislation making additional improvements. To succeed in laying this foundation, however, the Congress must give priority to reforms that reduce tax distortions and complexities.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.