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ECONOMIC VIEWPOINT
By Glenn Hubbard

Tax Reform's Key? Stop Hammering Investors

My plan for fundamental change would tax all income only once

Many years ago, when I worked at the Treasury Dept. on a study of tax reform, a reporter asked me when it might be completed and implemented. My reply: When my son goes to college (he was then an infant). I am more optimistic today that we'll see the fruits of reform. Recent studies by Alan Auerbach of the University of California at Berkeley and others suggest that fundamental reform -- changing to a broad-based income or consumption levy that taxes income only once -- could yield annual household income gains of 9%. A panel appointed by the White House is working on fundamental changes. And a host of real-world concerns -- from the alternative minimum tax (AMT) to the complexity and inefficiency of the corporate income tax to looming sunsets of present laws -- is sure to keep reform front and center on the political stage.

That's good because simple two-part reform of the way we tax businesses and households can raise living standards, end the double hit on investment income, and maintain fairness. Better yet, these objectives can be achieved under a single tax regime (rather than the current income tax plus AMT) without draining collections. Here's how:

MUCH OF THE GAIN from reform comes from reducing the code's bias against saving and investment, which slows capital formation and wage growth. Any plan -- whether aiming for a broad tax on income or consumption -- should remove taxes on dividends, capital gains, and interest.

But that doesn't mean capital income escapes totally. My brand of reform would tax all income only once -- wages at the household level and business income at the business level. That's a big improvement over the convoluted mix of preferences (special provisions or tax shelters) and biases (double taxation or worse) under current law.

Indeed, unlike today's devilishly difficult code, landmark changes can be simple. First, individuals would pay a tax on compensation, but not on income from savings (dividends, capital gains, and business interest). All businesses would be taxed on sales, less the costs of materials, wages, and a portion of capital expenses. Under an income tax, that capital expense would be a depreciated value over a period of years. Under a consumption tax, it would be 100% expensed. But both would end the double taxation of income on savings.

Are such changes radical? No and yes. President George W. Bush has made progress toward reform by decreasing marginal rates, especially on income from savings. And proposals for more generous saving incentives in the 2006 budget continue this trend. The Treasury Dept.'s 1992 Comprehensive Business Income Tax is just the "income" version of the options I sketched above. The "consumption" variant would add expensing of capital investment by businesses. But some changes are substantial. Both reform options would disallow business interest deductions (though interest income would not be taxed). This treatment levels the playing field between debt and equity in business financing decisions -- and reduces the risk of accounting scandals.

Fundamental income-tax reform or a consumption tax locks in lower marginal rates and would improve the competitiveness of U.S. companies. With tax reform, we can do away with a separate AMT -- either by broadening the base of the current income tax or starting with the AMT base and adding reforms.

But for reform to maintain the same flow of tax receipts, tax reductions for saving and investment and repeal of a separate AMT require changes to offset those hits. To reform the AMT and maintain deductions for home mortgage interest and charitable giving, as the President's panel is trying to do, lawmakers need to find more ways to generate revenues. Two possibilities: eliminating the federal deduction for state and local taxes and further limiting mortgage interest deductions for high-income taxpayers.

Balancing changes to ensure that collections stay the same also makes the tax code fair. For households, changes in deductions ensure that, while individuals capture benefits from lower marginal rates, particularly on saving and investment, richer taxpayers continue to pay as much, on average, as they do today. Soon, the reform panel will make recommendations to Treasury Secretary John W. Snow. We should hope this process succeeds, since there are few other chances for policymakers to make such improvements in our standard of living.

Oh, and my son took the SAT last Saturday.

Glenn Hubbard is dean of Columbia Business School. He chaired the Council of Economic Advisers from February, 2001, to March, 2003.