

Tax Simplification and the Plain Tax

This is a proposal to simplify the federal tax code in small annual steps and move towards a Plain Tax system, one which has almost no credits, deductions, or other special treatments. It applies to both personal and corporate incomes.

Bill Allen, July 12, 2011

It's time to simplify: "America's tax code is broken and must be reformed. ... Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax earmarks – amounting to \$1.1 trillion a year of spending in the tax code – not only increase the deficit, but cause tax rates to be too high."

So said the report issued in December by the president's deficit commission chaired by Erskine Bowles and Alan Simpson. What the commission calls tax expenditures includes all the credits, deductions, and special treatments in the tax code. The commission recommended that the tax code be simplified to eliminate most of these tax expenditures, and that the resulting increase in revenue be used to reduce the deficit and lower tax rates.

The need to raise the federal debt ceiling has prompted work on a 10-year, deficit reduction plan that will include both spending reductions and revenue increases. Gaining support is a proposal to eliminate tax expenditures and use the revenue to reduce both tax rates and the budget deficit.

Elimination of tax expenditures will have adverse consequences for some people. The elimination schedule should be constructed carefully to be fair and cause as little disruption as possible. There is insufficient time now to do this properly for a package of eliminations that will satisfy a 10-year deficit reduction plan. A proposal follows to proceed in small annual steps.

Take annual steps towards the Plain Tax: In its ideal form the Plain Tax is a system in which all income is treated the same for tax purposes and there are no tax expenditures of any kind: no credits, no deductions, no loopholes. Tax rates are progressive. We will probably never achieve this ideal, but it should be the goal we aim for.

I propose the name Plain Tax to distinguish it from the Flat Tax proposed by Steve Forbes and others that would have a single, flat tax rate. The principles apply to both personal and corporate income taxes.

A move from the present broken system to anything close to the Plain Tax in one large step would be traumatic and impractical. *I recommend that we take annual steps along a path that will eliminate almost all tax expenditures in 10-15 years.*

Establish the Tax Simplification Commission described below. This commission will submit a report to Congress each June in which it delineates a package of tax expenditures for elimination. The total will be in the range of \$50 to \$100 billion, and the changes will become effective the next calendar year. The Congress will incorporate this package in a bill and vote it up or down with no amendments.

The Congress may follow its regular procedures and adopt separate legislation to allocate some of the incremental revenue to reduce tax rates. Unallocated revenue will go to deficit reduction.

Tax Simplification Commission: This commission will have twelve members, three in each of four classes as follows.

- Class 1: Democrats currently serving in the House of Representatives.
- Class 2: Republicans currently serving in the House of Representatives.
- Class 3: Democrats holding no other public office, but with relevant experience.
- Class 4: Republicans holding no other public office, but with relevant experience.

The House Democratic and Republican leaders will choose the Democratic and Republican members, respectively. One member will be appointed for each class each year for a single term of three years. Terms will overlap.

The members will elect one of their number to be chair each year, alternating between the parties. Decisions will be by a vote of a simple majority.

The commission will be empowered to hire staff, hold hearings, and call witnesses. Its prime responsibility will be to submit a recommendation to Congress in June, supported by any facts or arguments that it deems appropriate. When invited, members may appear before Congressional committees and explain the commission's recommendations.

The staggered 3-year terms will provide continuity from year-to-year. With a limit of one term, no member will develop undue influence, and the commission as a whole will not become entangled with special interests.

We should assume that commission members will try to make the system work, not sabotage it. They will pick easy candidates first, like deduction of mortgage interest on second homes. They can spread significant deductions like property taxes over two or more years. It will probably be several years before they recommend the elimination of a popular deduction like mortgage interest on primary homes. During these years the benefits of tax simplification will become apparent and the fear of change should subside.

We will probably never get to the ideal Plain Tax, but most tax expenditures should be gone in 10-15 years. When the commission is no longer able to find tax expenditures that Congress is willing to eliminate, its work will be done and it may be shut down.

Pros and cons: Like most recommendations, this one has arguments for and against. But the pros far outweigh the cons.

◇ **Arguments against simplifying the tax code in small annual steps**

- The simplification process proposed here will take many years. It will be like pulling adhesive tape off slowly. Most prefer to pull fast. The pain is greater, but it's soon over.
- Businessmen don't like uncertainty. A one-step plan would provide certainty faster than the multiple steps proposed here. However, a businessman who benefits from a particular tax expenditure can be pretty sure it will go sometime, and he can plan for this.

◇ **Arguments for simplifying the tax code in small annual steps**

- The one-step approach is a bridge too far. Lobbying opposition will develop for every tax expenditure proposed for elimination. Demagogues will trash the plan with outrageous claims. The general mistrust of Congress will escalate to alarm. Members of Congress will find reasons not to support the proposal.

Small annual steps will generate less opposition. Many of the merits of simplification are obvious and will generate support. Substantial simplification with this process is achievable. It is similar to the one used effectively for military base closings.

- The experiences with legislation for health care and cap-and-trade in the last term show that Congress is unable to enact major legislation without huge concessions to special interests. The requirement for a straight up-or-down vote on a limited proposal from a bipartisan commission with shifting membership should solve most of this problem.
- The deficit commission recommended that some tax expenditures be retained. This raises significant issues. Example: Should the tax system be used to incentivize charitable giving? The deficit commission said yes. I disagree. A decision to give should come from the heart, not from a calculation of the tax deduction. A multi-step approach will allow time for careful consideration of issues like this.
- The visible evidence of simpler tax rules, lower tax rates, and deficit reductions will grow over time. Momentum for simplification will build. It will be difficult for a legislator to vote no in the annual straight up-or-down vote.
- Changes in large complex systems can, and usually do produce unexpected results: sometimes good, often bad. We don't know the precise effects tax simplification will have on individual and corporate decisions, and the consequences these will have for the economy and federal revenue. Prudence dictates that we make these changes in small steps.

Reasons to simplify the tax code and eliminate tax expenditures:

- The present tax system is inherently unfair. Each tax expenditure is beneficial for someone and unfair for those who don't use it. Example: The deduction for home mortgage interest is unfair for renters.

I expect that most ordinary tax payers believe the current system is rigged against them, that it gives the best tax breaks to those with the deepest pockets. They are probably right.

The Plain Tax will ultimately be fair, so long as tax rates are progressive and higher earners pay higher rates. Over time most taxpayers will see it that way. We may hope that this will reduce the broad opposition to taxes that we see in the country today.

- Compliance will be easier and less costly with the Plain Tax than with the present system. Enforcement will be easier and more effective. Collection efficiency will rise.

- The president's deficit commission concluded that meeting the debt challenge will require both reductions in spending and increases in revenue. Many others have reached this conclusion. Tax simplification will raise additional revenue without raising rates. Some of the incremental revenue can be used to lower tax rates and some to reduce the deficit.

- Trends are important. Many in the US and in the rest of the world are uneasy about our failure to take meaningful action to balance our federal budget. The trend today is for growing debt. We depend upon some of these people to buy our bonds. Implementation of the proposals here will help reverse the trend and renew their confidence.

Some tax expenditures will probably never be eliminated. Examples:

- Deductions for children.
- Deductions for medical expenses above some threshold.
- Tax credits are currently used to encourage corporate R&D. I believe targeted grants would be more efficient, but these credits serve a good purpose overall and have a lot of support.

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