THE WALL STREET JOURNAL.

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OPINION | COMMENTARY

Here's What Genuine Tax Reform Looks Like

The goal is to be simple and fair, with minimal damage. Step one would eliminate the corporate tax.

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By JOHN H. COCHRANE
Dec. 22, 2015 7:00 p.m. ET

Left and right agree that the U.S. tax code is a mess. The men and women running for president in 2016 are offering reform plans, and proposals to fix the code regularly surface in Congress. But these plans are, and should be, political documents, designed to attract votes. To prevent today's ugly bargains from becoming tomorrow's conventional wisdom, we should more frequently discuss the ideal tax structure.

The first goal of taxation is to raise needed government revenue with minimum economic damage. That means lower marginal rates—the additional tax people pay for each extra dollar earned—and a broader base of income subject to tax. It also means a massively simpler tax code.

In my view, simplification is more important than rates. A simple code would allow people and businesses to spend more time and resources on productive activities and less on attorneys and accountants, or on lobbyists seeking special deals and subsidies. And a simple code is much more clearly fair. Americans now suspect that people with clever lawyers are avoiding much taxation, which is corrosive to compliance and driving populist outrage across the political spectrum.

What would a minimally damaging, simple, fair tax code look like? First, the corporate tax should be eliminated. Every dollar of taxes that a corporation seems to pay comes from higher prices to its customers, lower wages to its workers, or lower dividends to its shareholders. Of these groups, wealthy individual shareholders are the least likely to suffer. If taxes eat into profits, investors pay lower prices for less valuable shares, and so earn the same return as before. To the extent that taxes do reduce returns, they also financially hurt nonprofits and your and my pension funds.

With no corporate tax, arguments disappear over investment expensing versus depreciation, repatriation of profits, too much tax-deductible debt, R&D deductions, and the vast array of energy deductions and credits.

Second, the government should tax consumption, not wages, income or wealth. When the government taxes savings, investment income, wealth or inheritance, it reduces the incentive to save, invest and build companies rather than enjoy consumption immediately. Taxes on capital gains discourage people from moving or reallocating capital toward their most productive uses.

Recognizing the distortion, the federal government provides a complex web of shelters, including IRAs, Roth IRAs, 527(b), 401(k), health-savings accounts, life-insurance exemptions, and the panoply of trusts that wealthy individuals use to shelter their wealth and escape the estate tax. If investment isn't taxed, these costly complexities can disappear.

All the various deductions, credits and exclusions should be eliminated—even the holy trinity of tax breaks for mortgage interest, charitable donations and employer-provided health insurance. The extra revenue, over a trillion dollars annually, could finance a large reduction in marginal rates. This step would also simplify the code and make it fairer.

Imagine that Congress proposed to send an annual check to each homeowner. People with high incomes, who buy expensive houses, borrow lots of money or refinance often, would get bigger checks than people with low incomes, who buy smaller houses, save up more for down payments or pay down their mortgages. There would be rioting in the streets. Yet that is exactly what the mortgage-interest deduction accomplishes.

Similarly, suppose Congress proposed to match private charitable donations. But rich people would get a 40% match, middle class people only 10%, and poor people nothing. This is exactly what the charitable deduction accomplishes.

Zeroing out deductions, credits, and corporate and investment taxes matters—for permanence, for predictability and for simplicity. If the corporate rate is drastically reduced, or if deductions are capped, it seems that the economic distortions go away. But the thousands of pages of tax code are still in place, the army of lawyers and accountants and lobbyists is still in place, and the next administration will itch to raise the caps, and the rate.

Why is tax reform paralyzed? Because political debate mixes the goal of efficiently raising revenue with so many other objectives. Some want more progressivity or more revenue. Others defend subsidies and transfers for specific activities, groups or businesses. They hold reform hostage.

Wise politicians often bundle dissimilar goals to attract a majority. But when bundling leads to paralysis, progress comes by separating the issues. Thus, we should agree to first reform the structure of the tax code, leaving the rates blank. We will then separately debate rates, and the consequent overall revenue and progressivity.

Consumption-based taxes can be progressive. A simplified income tax, excluding investment income and allowing a full deduction for savings, could tax high-income earners' consumption at a higher rate. Low-income people can receive transfers and credits. I think smaller government and less progressivity are wiser. But we can agree on an efficient, simple and fair tax, and debate revenues and progressivity separately.

We should also agree to separate the tax code from the subsidy code. We agree to debate subsidies for mortgage-interest payments, electric cars and the like—transparent and on-budget—but separately from tax reform.

Negotiating such an agreement will be hard. But the ability to achieve grand bargains is the most important characteristic of great political leaders.

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