

WALL STREET JOURNAL.

© 1986 Dow Jones & Company, Inc. All Rights Reserved.

TUESDAY, MARCH 4, 1986

PALO ALTO, CALIFORNIA

End Deductions and Have Them, Too

By ROBERT E. HALL,
JAQUELIN H. HUME
And ALVIN RABUSHKA

As the Senate considers tax revision, the debate can be moved back to the type of flat-tax system many of us were urging at the outset of the current reform push. The vehicle for doing so could be one traditionally associated with forces that have opposed a flat tax as a boon for the rich: the minimum tax.

The tax bill passed last year by the House is a brave attempt at improved incentives and a more equitable tax system. However, it fails to meet fully the major objectives of tax reform. First, it lowers the top personal rate from 50% to only 36%. The goal of the tax-reform movement has been to get the top rate down to the 20% range. Second, it still doesn't tax fringe benefits, of state and local taxes, and of a good deal of interest income. The House bill's failure to plug these major gaps in the tax base is the reason its tax-rate reductions are so meager. Third, the bill provides woefully inadequate investment incentives. It fails to come close to the investment incentives of a consumption tax, the consensus goal of tax reform.

Given political realities, Congress isn't going to enact the 19% across-the-board tax contained in the original Hall-Rabushka plan. But it's a fact that the U.S. already has a flat tax on the books. By beefing it up, most of the benefits of the pure flat tax could be achieved.

Unique Political Attraction

The flat tax in place is the Alternative Minimum Tax. The individual taxpayer pays the AMT if it exceeds the amount due on his ordinary tax. The AMT takes a flat 20% on a broad definition of income above a very high exemption level of \$40,000 for a married taxpayer. The purpose is to curb the worst abuses of the tax system. The AMT makes it more difficult for a wealthy taxpayer to zero out his tax bill through a proliferation of deductions.

Tax reform through an improved AMT has one unique political attraction—it permits the retention of existing tax law without change. Nobody is deprived of favorite deductions or preferences because they are taken off the books. Rather, in those instances where they are allowing high-income taxpayers to escape taxation, an effective minimum tax at a low rate will come into play.

We propose that the AMT be made more effective by lowering its exemption level to perhaps \$15,000. This by itself would subject a much larger number of taxpayers to a simple, effective tax with a low rate. But other reforms are also needed to make the AMT the cornerstone

of an efficient, fair tax system.

The first is to institute an alternative minimum tax on corporations and similar businesses and tax shelters organized as limited partnerships. The House bill proposes such an AMT as well, though unfortunately it would set the AMT rate at 25% rather than 20%. Our corporate AMT would have two crucial features to enlarge the tax base. First, fringe benefits paid to employees would not be allowed as a deduction. Second, interest payments would not be deductible. Because so much interest escapes the tax system today, this change would add more than \$100 billion to the tax base and permit a substantial lowering of tax rates. (This would have dramatic consequences for tax-deferred pension plans, the source of much of the current interest leakage, but it would not adversely affect the overall economy because of saving incentives described below.)

The second reform would excuse indi-

viduals from having to pay any more tax on the interest, dividends and partnership income they receive from businesses that pay the AMT. The tax would be collected at the source of the income, in the business. Interest and dividends paid by AMT corporations would be identified on form 1099s. It follows, then, that this reform would end most interest deductions under the individual AMT—interest in general would be treated on an after-tax basis. There would be two exceptions: The current AMT allows interest deductions only up to the amount of taxable interest received, and we would continue that provision. And, because of transitional problems involving fixed-rate home loans, we would where there is no refinancing permit the continuation of the deduction for mortgage interest, which to maintain symmetry would be taxable income for the recipient.

Substantial rate reductions under the ordinary tax are an essential part of our proposal for two reasons: The strengthened AMTs would raise added revenue, which we agree with the president should be applied to rate reductions and not added government spending; and unless ordinary rates were cut significantly, too many taxpayers would still be taxed under the existing schedule, and the favorable incentive effects of the flat tax would be limited.

The current AMT permits a deduction for charitable contributions, and we would retain that deduction. The revenue loss from this is modest. We would also permit individuals and corporations to continue depreciation under existing law for invest-

One of the principal political obstacles to true tax reform is the public's view that a flat tax is unfair because it puts too little of the tax burden on the rich.

ments made before the new AMT came into effect.

The goal of this plan is to get virtually all corporations and the overwhelming majority of higher-income, sophisticated taxpayers under the AMTs. In other words, the flat tax is to be applied in the areas where the improvements in incentives would be most dramatic.

Taxing limited partnerships under the AMT would immediately end the practice of using tax shelters to zero out individual taxes. A partnership would carry forward its tax losses, not pass them on to its limited partners. A legitimate investment would receive full incentives through the carry-forward process; after the investment paid off, its subsequent earnings would be taxed.

AMT corporations would not face any increase in borrowing costs from losing the interest deduction. Because their interest payments would not be taxable income to the bondholder, the corporations would be able to borrow at lower rates. AMT corporations' bonds would command the same low rates as tax-exempt municipals today. These lower rates would exactly compensate them for a loss of interest deduction. Corporations would be allowed to make a permanent election to be taxed at all times under the AMT so that they could promise that their interest and dividends would never be taxable.

One of the important effects of the proposed reform is to eliminate the strong

The third essential reform would permit businesses and individuals to deduct purchases of plant and equipment from their income in computing the AMT—"expensing," as the practice is known. If the amount of the deduction would lower their income to the point that they no longer had to pay the AMT, they could elect to carry forward the deduction to future years. This carry-forward would apply to business operations only, not personal deductions.

The fourth reform would significantly lower tax rates under the existing personal and corporate taxes. Both rates might be

bias of the current tax system toward debt and away from equity. Because corporations can deduct their interest payments but not their dividends, they currently favor debt over equity, at some risk to the economy.

The plan as outlined could raise the same revenue as the current tax system. We have not been able to compute exactly what set of rate reductions would be needed, but the Treasury could easily carry out that computation.

The new tax system would dramatically improve the fairness of U.S. taxation. Low- and middle-income taxpayers would see modest tax reductions because they would remain under the existing tax system. Wealthy individuals with low current tax bills would face tax increases as they moved to the AMT, or as their existing AMT payments were increased. Salary earners who are not currently taking advantage of tax shelters would see lower tax bills and improved incentives, whether they remained on the existing tax system or fell under the AMT flat tax.

Promising Way Around Obstacles

Congress has not been able to tell taxpayers that they will have to start paying tax on fringe benefits and on all of their interest income, nor has it been able to tell them that they have to lose their deduction for state and local taxes. Hence, it has been unable to make much progress on cutting high tax rates. Moreover, what progress toward lower rates that does appear in the House bill is achieved at the cost of gutting investment incentives.

The AMT route to tax reform seems a promising way around these political obstacles. The state and local deduction is not allowed in the present AMT, so that victory is already won. A corporate AMT without a deduction for fringe benefits may not be politically easy, but it is a whole lot easier than telling individual workers that they have to pay cash taxes on non-cash benefits. And taxing interest income at its business source is surely the most promising way to plug that leak in the tax base and permit lower rates.

One of the principal political obstacles to true tax reform is the public's view that a flat tax is unfair because it puts too little of the tax burden on the rich. By linking tax reform to an improved Alternative Minimum Tax, where it is clear that the rich are effectively taxed, this barrier, too, can be removed.

Messrs. Hall and Rabushka are senior fellows at Stanford's Hoover Institution, publisher of their book, "The Flat Tax" (1985). Mr. Hume is founder of Citizens for America.
