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A bipartisan tax-code fix

By Noam Neusner and Lawrence J. Haas

The midterm elections that gave control of Congress to the Democrats also brought widespread predictions of paralysis in Washington. But is divided government a recipe for inaction? Not necessarily.

Divided government can produce good policy, especially on the budget, while one-party rule does not guarantee positive results. We learned these lessons firsthand while working inside the budget machinery of the White House under two different administrations.

During the Clinton years, a Democratic president and a Republican-led Congress exchanged frequent rhetorical fire but ultimately produced some of the best federal fiscal policies in decades - balancing the budget, limiting spending, and still investing more in education, research and other priorities.

In the Bush years, a Republican president has governed mostly with a Republican-controlled Congress. But because Republicans had to hold their slim majorities on other issues, such as votes on judgeships, party leaders routinely gave in to their big-spending members and sacrificed the party's reputation for fiscal discipline.

Now, both parties are trying to position themselves as fiscally credible in advance of the 2008 presidential campaign, when long-term deficits will be on the agenda. Democrats promise to re-impose "pay as you go" rules that would force Congress to offset the costs of new spending and tax cuts, while Republicans vow to tighten the spending spigot.

Consequently, the political stars are aligning for both parties to support a budget deal. But serious obstacles remain.

For Republicans, any budget deal that means higher tax rates is a big no-no - their voting base thinks they pay too much in taxes already.

For Democrats, a budget deal has to include more tax revenues; their voting base does not want domestic programs to bear the full brunt of a serious deficit-reduction effort.

How do we bridge this gap? By cutting the deficit as part of a long-overdue effort to reform the tax code.

Nobody doubts the need for tax reform. The tax code has grown monstrously complex, making it hard for even specialists to do their own taxes honestly. Many Americans believe the tax code favors corporations over families. Experts believe our income-based code puts the United States at a competitive disadvantage with Europe, where consumption-based codes dominate.

Politically, tax reform would broaden the budget debate. By promising lower tax rates on a broader base of income, tax reform would enable Congress to eliminate special-interest tax provisions that lawmakers would more likely protect as part of the annual budget process - things like write-offs for domestic manufacturing or for farming as a hobby.

And then there's the policy benefits. Tax reform can unlock a lot of good ideas.

On Social Security, tax reform could mean lowering tax rates on worker wages - a plus for conservatives - while raising the current threshold of just under \$100,000 on wages subject to taxation - a plus for liberals. The resulting increase in total Social Security revenues could close the funding gap for future benefits - a plus for everyone.

On health care, tax reform could lower the deductibility of health insurance benefits, which appeals to conservatives, while also appealing to liberals by raising funds to bolster Medicare's long-term solvency.

Congress could use tax reform to pursue a bolder path: Reduce our reliance on the income tax and create a consumption tax. That would please conservatives who believe a consumption tax would spur savings and investment, as well as liberals who think the nation needs more revenue to strengthen Social Security and Medicare and address other priorities.

Although centered on tax reform, any budget agreement would have to include standard features of earlier budget deals in order to gain the necessary support from fiscal conservatives: a line-item veto for the president, pay-as-you-go rules for new spending increases and tax cuts, a greater use of fees to pay for targeted federal services, and a serious look at government programs that have outlived their usefulness or been proved ineffective.

None of this would be easy. But tax reform might provide the right set of incentives and trade-offs to bring conservatives and liberals along. By modernizing the tax code, we could reduce the deficit at the same time.

It's well worth a try.

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