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A Better Tax System (Assembly Instructions Included)

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IT'S that time again. Start filing all those W-2s, 1099s and scraps of paper you'll need for your annual tax return. No doubt, this isn't your favorite activity. At some point, you may ask yourself whether there's a better way.

There is. Economists who study public finance have long agreed with William E. Simon, the former Treasury secretary, who said that "the nation should have a tax system that looks like someone designed it on purpose." Here are four principles of tax reform that most of those economists would endorse:

BROADEN THE BASE AND LOWER RATES The United States tax code is filled with deductions and exclusions that shrink the basis of taxation. The smaller base in turn requires higher tax rates to raise the revenue needed to fund government. The starting point of reform is to reverse this process.

This principle was endorsed both by President George W. Bush's tax reform commission in 2005 and by President Obama's deficit reduction commission in 2010. Neither report had much impact, because eliminating deductions and exclusions is politically treacherous. Yet each made a good case on the merits.

Consider the deduction for mortgage interest. The policy is politically popular, but economists have long thought it has little justification. Because of this provision, among others, our tax system gives a better treatment to residential capital than it does to corporate capital. As a result, too much of the nation's saving ends up in the form of housing rather than in business investment, where it could have increased productivity and wages.

This efficiency cost might be worth bearing if the deduction had a benefit from the standpoint of equality, but it fails there as well. Subsidies to homeowners are, in effect, penalties on renters — after all, someone has to pick up the tab. But there is nothing wrong with renting. And once one acknowledges that renters are poorer, on average, than homeowners, the mortgage interest deduction becomes even harder to justify.

TAX CONSUMPTION RATHER THAN INCOME Almost four centuries ago, the philosopher Thomas Hobbes suggested that taxes should be based on consumption, not income. Income measures a person's contribution of labor and capital to society's production of goods and services. Consumption measures the quantity of those goods and services he gets to enjoy. Hobbes reasoned that because consumption better reflects the benefits a person receives as a member of society, it is the proper basis of taxation.

Much modern economic theory confirms that conclusion. In standard models, a consumption tax allows the economy to achieve the best allocation of resources over time, whereas an income tax needlessly discourages saving, investment and economic growth.

Moving to a consumption tax might seem to require wholesale reform of our current system. But such a politically difficult step isn't necessary. In fact, as our tax system has evolved over many years, legislators have come to appreciate the logic of taxing consumption, if only implicitly.

The United States now has an income tax, or at least that is what it is called. But because many Americans do most of their saving through tax-preferred accounts, such as I.R.A.'s and 401(k) plans, they in effect pay taxes based on how much they consume. Tax reform could expand and simplify the availability of such tax-preferred savings accounts. In this way, our progressive income tax could further evolve toward a progressive consumption tax.

TAX BADS RATHER THAN GOODS A good rule of thumb is that when you tax something, you get less of it. That means that taxes on hard work, saving and entrepreneurial risk-taking impede these fundamental drivers of economic growth. The alternative is to tax those things we would like to get less of.

Consider the tax on gasoline. Driving your car is associated with various adverse side effects, which economists call externalities. These include traffic congestion, accidents, local pollution and global climate change. If the tax on gasoline were higher, people would alter their behavior to drive less. They would be more likely to take public transportation, use car pools or live closer to work. The incentives they face when deciding how much to drive would more closely match the true social costs and benefits.

Economists who have added up all the externalities associated with driving conclude that a tax exceeding $2 a gallon makes sense. That would provide substantial revenue that could be used to reduce other taxes. By taxing bad things more, we could tax good things less.

KEEP IT SIMPLE, STUPID This engineering aphorism is based on the timeless insight that complex systems are more likely to break down, often in ways the designer failed to anticipate. It applies with force to tax systems.

Indeed, unlike engineering systems, complex tax systems go awry because an army of highly paid accountants and tax lawyers is ready to take advantage of any loophole it can find. Remember when President Obama's stimulus plan offered tax credits for electric cars? Suddenly, the sale of golf carts took off.

To be sure, any tax system will be subject to gaming, which is why we will always need the Internal Revenue Service. But the more we use narrowly targeted taxes and tax breaks, the more gaming there will be.

Filling out tax returns will never be a delight. But if reform included simplification, the task might become a bit less onerous. And if a few accountants and tax lawyers were induced to become engineers and doctors instead, society will have moved a big step in the right direction.