



**Over the past year the budget debate in Washington has heated up – driven by an angry populist energy that screams out at our political class demanding government reform its profligate spending. For the first time in my recollection, Congress is seriously considering substantive cuts in the scope and cost of government programs. It is understandable and appropriate. It is commendable. But it attacks only one side of the problem – and perhaps the less important side.**

Effective fiscal reform cannot be achieved by focusing on just the expense side of the equation. We must demand Congress address the revenue side of our tax policies, not just because we need to generate more revenue, but more importantly because our current policies are deeply inequitable and riddled with misguided incentives.

Incentives matter. And the incentives currently imbedded in our tax code are stimulating, speculative,

nonproductive trading activities, driving jobs and investment overseas, and obstructing the fluid reallocation of capital to more productive uses. The unintended consequences of existing investment tax policies have been instrumental in destabilizing our economy. High nominal corporate tax rates discourage domestic hiring and investment and encourage tax avoidance activities, including offshore transfer of profitable operations. Reduced tax rates on investment returns and deferral of taxes on “unearned income” subsidize low profit-and-loss operations, discourage capital reallocation and actively stimulate asset valuation bubbles. We are crippling our economic engine.

As to equity: We lie to ourselves and pretend we have a progressive tax system, but inclusive of employment taxes, the working middle class bears a marginal federal tax burden twice as high as that imposed upon their more affluent neighbors. Where is the public rage against this inequitable assessment of our tax burden? Today a large part of our population argues against their own principles of equal treatment and personal self-interest because our leadership pretends employment taxes are “contributions”, not taxes. But Washington, beware, someday the public will wake up to this deception and the resulting demands for change will be far louder and insistent than anything seen from the Tea Party so far.

Why do Warren Buffett and his fellow billionaires pay tax rates only half as high as the working middle class? Why does our society, founded on the principles of democracy and capitalism, perpetuate policies which provide preferential treatment to the wealthy, distort investment decisions, and are resulting in an ever-increasing concentration of wealth?

Justification certainly can't be found in the theories of Adam Smith, who advocated, “Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry and capital into competition with those of any other man or order of men.” I'm confident Mr. Smith wasn't contemplating an unequal competition in which the wealthiest and most privileged among our society are subsidized with preferential tax rates.

True believers in capitalism, who understand how entrepreneurial vitality in pursuit of competitive self-interest drives economic growth, should recognize that preferential tax policies offered to an elite class of citizens are incompatible with the core premise of capitalism. It constitutes cronyism; and cronyism is not just ethically wrong, it destroys the vitality and benefits of capitalism.

Effective tax revenue reform will require structural change, not just a change in rates. But if we reform investment tax policies and eliminate the subsidies and mis-incentives that currently distort investment decisions, we can normalize tax rates between labor and investments while simultaneously stimulating more productive investment in America. We can once again unleash the full entrepreneurial energy of capitalism. **TSL**

Douglas Hopkins is president of Kestrel Consulting, LLC ([www.kestrellic.com](http://www.kestrellic.com)) and the author of *A Citizen's 2% Solution: How to Repeal Investment Income Taxes, Avoid a Value-Added Tax, and Still Balance the Budget*.