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A Flax Tax Lesson from Mexico

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With tax season finally behind us, now's an ideal time for policymakers to reform America's tax code. With the absurd complexity of the U.S. tax system is still fresh in everyone's mind, there's certainly political will for such a move.

One of the most popular ideas is the flat tax -- a uniform rate applied to all income, without exemptions, deductions, or special favors. The flat-tax approach could apply to individual incomes taxes as well as to taxes on businesses.

The flax tax is a bold idea, which has caught on in many so-called emerging markets. Done right, it could revitalize America's economy. But my home country of Mexico serves as a cautionary tale for what can go wrong when policymakers try to exploit the flat tax as just another instrument to enhance tax revenues.

In Mexico, the unhappy experience centered on business taxes. In January 2008, thanks in large part to the leadership of President Felipe Calderon, Mexico installed a national 16.5 percent flat tax -- officially known as the "IETU" -- on all corporate earnings. It was eventually adjusted upwards to 17.5 percent, which is the current rate.

The problems that inspired Mexico's IETU are similar to those plaguing the American system. Mexico's code was riddled with an absurd number of deductions and special-interest carve-outs.

Tax code complexity generates massive compliance costs that leave businesses with fewer resources to put toward genuinely productive activities. In Mexico, code compliance expenses involve a transaction cost of almost 2 percent of GDP.

In the United States, citizens spend over 6 billion hours annually filling out tax forms. Research from the Laffer Center shows that for every dollar collected by the IRS, taxpayers incur an additional 30 cents in compliance costs, totaling $431 billion every year.

In Mexico as in the United States, large corporations have the resources and the (perverse) incentive to exploit complexities in the tax code to reduce their taxes. In Mexico, while the official corporate marginal tax rate was 30 percent, many businesses routinely finagled their burden down to as low as 6 percent "effective" tax rate.

To get a sense of the size of that same problem in America, just consider that General Electric paid precisely zero percent in taxes on net income in 2009 and 2010.

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Done right, the IETU would have transformed the Mexican economy, radically simplifying tax compliance and getting rid of mountains of existing loopholes. But something went wrong between conception and implementation.

By the time President Calderon obtained congressional approval and signed the bill into law, it looked wildly different from the ambitious conception of the flat tax.

Policymakers, obsessed only with tax revenue, started tinkering -- and then tinkered and tinkered some more, to the point that the final law actually made the country's tax code far worse. Instead of a simple, straightforward rate on earnings, businesses got handed yet another bundle of complexities in calculating and complying with tax obligations.

Indeed, the worst mutation by far was that instead of replacing the old, broken corporate income tax system, the IETU was introduced as an alternative to compete with it. Every year, businesses now have to tally up how much they owe under both the old corporate rate (with countless of deductions) and the flat tax alternative -- and then, by law, are supposed to pay the higher amount.

Shockingly, instead of using a simple idea to simplify life, the government managed to increase compliance costs. Businesses have to hire double the lawyers and accountants every tax season, leaving even less time and money for productive activities, and making it all the more likely that they might decide to just avoid paying taxes entirely. Tax evasion today represents almost 40 percent of all (non-oil) tax revenues collected!

The IETU was conceived as a way of streamlining the tax code in order to spur business growth and make Mexico more accommodating to investment. But politicians morphed it into a brazen money grab. The law that President Calderon signed is nothing like what flat tax advocates were originally hoping for. In the process, the very idea of a flat tax has unwittingly gotten a bad rap.

American policymakers need to avoid our mistakes. The U.S. tax code needs to be simplified. There could soon be the political will for installing a national, uniform flat rate. When legislators go about writing that rate into law, though, they must keep it pure and simple -- and fight back against any special-interest scheming to recreate the costly and inefficient rules of the past.

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