Taxation Without Complication

IT'S TIME FOR CONGRESS TO ZERO OUT ALL THE DEDUCTIONS AND LOOPHOLES AND START OVER

By Peter Coy

As Congress gears up for a rethink of federal tax policy, America is having a Chicken of the Sea moment. Like the actress Jessica Simpson, who famously didn't know what to make of her canned tuna—"Is this chicken, what I have, or is this fish?"—Americans are confused about deductions, exemptions, and other special treatments in the Internal Revenue Code. If Congress repeals a tax break to reduce the deficit, does that mean it's raising taxes and stealing money from your pocket? Or is it cleaning up a backdoor form of federal spending—what economists call a tax expenditure?

The positioning matters. Many Americans, not just those in the Tea Party, oppose any kind of tax increase, arguing that the budget should be balanced strictly through spending cuts. They don't trust government to use wisely the extra money it collects. That argues for leaving tax breaks in place. "To claim that forgone tax revenue is a government expenditure implies that the money at stake actually belongs to the government, which is graciously letting taxpayers keep it, rather than to the people who earned it," Michael F. Cannon, health policy studies director at the Cato Institute, wrote in a Cato blog last November.

Yet Americans also dislike special treatment for favored constituents, as National Taxpayer Advocate Nina E. Olson observed in January in her annual report to Congress. And they're skeptical of using the tax code for social engineering—steering people toward certain activities and away from others. That, along with the ballooning federal deficit, argues for repealing some of the tax breaks. Revenue carve-outs such as the home mortgage interest deduction are "simply spending in drag," says Howard Gleckman, resident fellow at the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. "It makes no economic difference whether you give somebody a subsidy through the tax code or you give them a subsidy via spending."

A trillion dollars a year rides on settling this chicken-or-fish confusion. If left untouched, tax expenditures of various kinds will reduce the federal government's revenue by about $5 trillion between 2010 and 2014 from what it would have been with no such breaks, according to the nonpartisan Joint Committee on Taxation. Repealing some of the breaks would allow the government to lower overall tax rates dramatically and still raise the same amount of money, or lower rates a little and raise a lot more.

Here's an idea: Stop the unproductive debate over how to characterize tax breaks and focus on what really matters—setting a tax policy that raises the necessary revenue in a way that's fair and simple, and doesn't discourage work, investment, and growth. Using those criteria, a lot of entrenched tax breaks would disappear. And the Alternative Minimum Tax—a hated tool to stop taxpayers from claiming too many breaks—would no longer be necessary.

The best way to begin thinking about this was put forward in November by Republican Alan Simpson and Democrat Erskine Bowles, co-chairmen of the National Commission on Fiscal Responsibility and Reform. Their most drastic option, the "Zero Plan," would eliminate every tax expenditure as well as the AMT and other encrustations. Doing so, they said, would let the government cut the top individual rate to 23 percent from 35 percent while bringing in $80 billion more.

It's not realistic to wipe out every tax break, but a clean slate is always a good place to start. It dangles the carrot of low rates in front of lawmakers, while exposing the cost of adding back tax breaks. Adding the earned income tax credit and the child tax credit, for example, would bump the top rate back up by one percentage point to 24 percent, according to Simpson and Bowles. Adding mortgage, health, and retirement benefits in addition, plus changing the taxation of international income, would force the top rate up to 28 percent. And so on.

On Feb. 3, the conservative website Daily Caller quoted Senator Saxby Chambliss (R-Ga.) as saying that he and Senator Mark Warner (D-Va.) would introduce a bill that started out with zero deductions and loopholes. But aides to Chambliss quickly said that nothing has been decided. The alternative to the clean slate—taking on tax breaks one at a time—is politically difficult because it doesn't share the sacrifices. Nobody wants to give up a break if the other guy gets to keep his.

The tax breaks now on the books range from worthy and necessary to silly to outright harmful. They also make the tax code murderously complex. Olson, the national taxpayer advocate who runs an independent unit within the IRS, estimates the cost of preparing returns and coping with tax laws at $163 billion in 2008—11 percent of income tax receipts. No one can hope to understand the entire code. The wealthy can get a tax credit for buying a $100,000 Tesla electric sports car, but Olson says that in 2006, 37 million ordinary taxpayers failed to claim a telephone excise tax credit of $30 to $60—apparently because the tax code was so complex they didn't know the credit was available. Olson, citing her obligation to advise Congress under "Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code," says all tax expenditures should be eliminated "unless a compelling business case can be made" for them.

Eugene Steuerle, who was economic coordinator of the Treasury Dept.'s tax-code-simplification effort from 1984 to 1986, says the country needs a repeat of that Reagan-era exercise. "The tax code has become a giant mess," says Steuerle, a co-founder of the Tax Policy Center. "We've got to dig...and find out what works and what doesn't work."

Two tax breaks that many economists regard as costly and inequitable are the home mortgage interest deduction and the break for employer-provided health insurance.

Because they benefit well-connected upper-income families, they will be very difficult to dislodge, Steuerle says.

Start with the mortgage break. According to the Joint Committee on Taxation, it cost $77 billion in forgone revenue in 2009, and provided close to $7,000 in tax relief on average to the highest-income families—compared with less than $2,000 in relief on average to all other families. (Renters, of course, get nothing.) Research by economist Edward Glaeser of Harvard University demonstrates that the break has little effect on homeownership rates because most of the benefits go to those who would buy houses anyway. Plus, it gives people an incentive to overborrow. To avoid unsettling the housing market, Glaeser advocates lowering the amount of mortgage principal on which interest payments can be deducted in gradual stages over seven years.

The break for employer-provided health insurance is doubly unfair. If you're lucky enough to have an employer that provides health insurance, you get the additional good luck of a tax break from the government. No employer-provided insurance, no tax break. Some people who do get employer-provided insurance cling to jobs that are wrong for them just to keep that benefit. And again, the people with the highest incomes get the biggest breaks. Forgone revenue? About $660 billion over five years, according to the Joint Committee.

To Congress, targeted tax breaks are like a drug; they please supporters and don't require appropriations. If a clean-slate look at the IRS code is ever to become more than a thought experiment, lawmakers need to go into tax rehab.

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