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That GOP 'Middle Class' Tax Cut Might Be A Big Fat Trojan Horse For The Rich

The middle class and the poor are already paying less in federal taxes than they have in decades.

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WASHINGTON — If taxpayers are looking for someone to blame for federal deficits and the state of the U.S. tax code as the filing deadline approaches, a good place to start might be the mirror.

For decades, politicians from both parties have told Americans their federal taxes are too high, or even that they've been increasing. For their part, voters have been eager to believe them, making the promise of a "middle-class tax cut" a perennial campaign favorite.

President Donald Trump talked about it on the trail, and again last week: "The middle class has just been taken advantage of in this country for so many years," he told Fox Business.

Yet for decades, that underlying premise has been wrong: Americans at almost every income level are paying a smaller percentage of their salaries in federal taxes than they were 10, 20 even 30 years ago.

Only the richest one-fifth of households are paying a higher percentage in federal taxes than they were a decade or two ago, and that's only because of increases passed under former President Barack Obama to pay for his signature health care law.

Meaning that for liberals who support the idea of a progressive income tax — one that imposes higher rates on the wealthy — the promise of a middle-class tax reduction as part of a coming "tax reform" package could actually be a Trojan horse. Given House Speaker Paul Ryan's (R-Wis.) longtime desire to lower the top rates, any reduction for middle and lower-income taxpayers would almost certainly be dwarfed by savings for the wealthiest.

"They keep saying: There are not going to be any tax cuts for the rich. Yeah, right," said Roberton Williamson, with the liberal-leaning Tax Policy Center.

"It's almost became a religious belief, a religious cult. Tax cuts are an elixir for everything. They are always good," said Norman Ornstein, of the conservative-leaning American Enterprise Institute, who in recent years has grown critical of congressional Republicans. "And the lowest rates are best for the richest, since they drive the economy. Evidence is not a part of this."

While supporters of Sen. Bernie Sanders (I-Vt.) may disagree, the tax code today already leans heavily on the country's wealthy. The richest 1 percent of households in the nation pays 25 percent of all federal taxes. That includes personal income tax, payroll taxes, corporate income taxes and excise taxes – according to a 2016 analysis by the Congressional Budget Office.

The richest one-fifth — whose average income in 2013, the latest year available in the CBO report, was $265,000 — paid 69 percent of all federal taxes collected by the U.S. Treasury that year.

The middle 20 percent — whose average household income was $69,700 — paid 9 percent of all federal taxes.

That share of the total burden worked out to an average federal tax rate of 12.8 percent in 2013, compared with 13.6 percent in 2003, 17.2 percent in 1993, and 17.5 percent in 1983 — immediately after President Ronald Reagan's big first-term tax cuts.

That overall tax reduction is similar to other income groups: The poorest 20 percent saw their average federal tax rate drop from 8.7 percent in 1983 to 3.3 percent in 2013. The next one-fifth of households saw their federal tax rate drop from 12.8 percent to 8.4 percent.

Only the wealthiest one-fifth saw their average federal rate go up, from 23.8 percent in 1983 to 26.3 percent in 2013 — but that was only because of tax increases under Obama following his re-election. That group's tax rate had been 23.9 percent in 2012.

"We basically have had a downward ratchet, and haven't raised taxes on the vast majority of people since the 1980s," said Jason Furman, chairman of Obama's Council of Economic Advisers during his second term.

Unlike Republicans' push to repeal and replace the Affordable Care Act, which Democrats uniformly oppose, the idea of tax "reform" is one that could gain some Democratic support.

After all, the tax code and the Internal Revenue Service that administers it are almost uniformly disliked. Arguments to make tax law simpler and fairer sound attractive on their face — a fact the Trump White House and its allies are counting on.

“Many Democrats have reached out to say that they want to help on this process too. They recognize it’s been 30 years since significant tax reform was done,” White House legislative affairs director Marc Short said recently. “I think there will be bipartisan interest to work on tax reform.”

Yet if Democrats do wind up agreeing to work for a tax package with the shared goal of “closing loopholes” and simplifying the code, they could inadvertently wind up with a system far less progressive in its structure than the existing one,

“Trump is very good at shiny, symbolic gestures,” said Harry Stein, director of fiscal policy at the liberal Center for American Progress. “And this is something progressives are going to have to watch for in tax reform.”

Even the idea of eliminating the many dozens of deductions and credits with the promise of ending giveaways to the well-connected ignores that most of the biggest deductions and credits are those that benefit the average taxpayer, not a particular special interest.

The biggest of the “tax expenditures,” as Congress’ Joint Committee on Taxation calls them, lets employers deduct health insurance premiums for their workers as a business expense. That alone costs the U.S. Treasury $220 billion a year. Eliminating it would make health insurance more expensive for every single American who gets it as an employee benefit.

The second-biggest tax break comes from something most homeowners don’t even realize they’re getting. The ability to live in one’s home rent-free may not seem like a tax break — but it offers homeowners a substantial tax advantage over renters. Monthly rent payments are treated as taxable income by landlords, and that extra cost is built into the rent. Meanwhile, the so-called “imputed income” of not having to pay yourself rent to live in your home goes untaxed by the IRS. The price tag in uncollected revenue: $105 billion a year, according to the Joint Committee on Taxation.

That total does not include the deduction for mortgage interest on those homes — worth $68 billion — and local property taxes on those homes — an additional $36 billion.

Letting taxpayers deduct their state and local income taxes from their federal taxes costs the treasury $55 billion. Charitable deductions cost $59 billion.

In contrast, the tax breaks politicians typically point to as abuses are significantly smaller. The “carried interest” loophole that lets some investment managers pay a reduced rate on their income costs the treasury about $2 billion a year. The “corporate jet” loophole costs the treasury $300 million a year.

“That is where good analysis is so important,” Stein said, adding that Democrats should not get snookered into agreeing to a deal that closes a few loopholes, but winds up giving the wealthy much more valuable rate reductions in exchange. “There are provisions that are important, but do not have as much value.”

The current tax code, of course, did not become complicated one day by itself. Each deduction, each credit, was passed either on its own, or as part of a package by Congress and then approved by the president at the time.

Chris Edwards, with the libertarian Cato Institute, said a fair number of those benefit specific, small constituencies, and only passed because lawmakers traded votes with each other. “It’s mostly the result of log-rolling,” he said. “Congress often passes laws that do not reflect the interests of the American public.”

But while some of the breaks are industry-specific with dubious public policy benefit, many were passed to encourage what was considered a desirable social objective.

Parents, for example, benefit from $24 billion in credits for having minor children, and $5 billion in credits for day care expenses. Owners of clean-fuel cars get credits totaling $670 million. Investors in “clean coal” plants benefit from $400 million a year. Employers and employees putting money into retirement plans get a number of big-dollar breaks: $65 billion for employer-sponsored plans, $31 billion for self-employed plans, and $17 billion for those putting money into IRAs.

Other breaks go to taxpayers facing particular challenges. Benefits flowing to disabled coal miners are not taxed, costing the treasury $20 million a year. Blind taxpayers get a break that costs the government $40 million.

Those keen on cleaning up the tax code will be faced with justifying the elimination of tax breaks for the blind, or the disabled. Or explaining why ending incentives to save for retirement makes sense in the long run.

In other words: Tax reformers will face the exact issues that led to the passage of those tax breaks and credits in the first place.

And while some tax economists argue that the code should not be the place to effect government policy, doing so offers some advantages. Creating a government program to help parents with child care, for instance, would mean administering it, adding to the bureaucracy. Offering tax credits brings the same result, but much less intrusively, said the American Enterprise Institute’s Ornstein.

“If you don’t like government bureaucracies, or if you believe the better, less obtrusive way to do so is through the tax code, then you should do more of it,” he said.

But for advocates of simplifying the tax code and lowering rates, the current environment, with Republicans running both chambers of Congress and Trump in the White House, offers the best opportunity in decades for getting anything done.

“Tax cuts and tax reform has been the singular glue holding the Republican Party since Newt Gingrich became speaker of the House,” said the Cato Institute’s Edwards. “Whatever they pass, he’ll sign.”

That knowledge, proponents of a progressive tax structure warn, should keep lawmakers who don’t want to see a plan skewed in favor of the wealthy on their guard.

Furman said that Democrats who want to close loopholes that would truly make the code fairer could push to end preferential treatment for capital gains and dividends, which combined currently cost the Treasury $122 billion a year. That would revert the code to how it was following the 1986 tax reform under Reagan, when “unearned” income was taxed identically to wage income.

That differential tax treatment disproportionately benefits the wealthiest, who own the most assets that generate that kind of income. Eliminating that break could also start making up for the dramatic increase in income and wealth the richest one-fifth have enjoyed — and only the richest one-fifth — since Reagan’s tax cuts.

“Whatever you thought progressivity should have been 30 years ago, you should think it should be more so now,” Furman said.

But with Republicans — and some Democrats — not at all likely to go along with that, Furman said a small step that would actually encourage more efficient investments in the economy would be to tax capital gains every year, rather than only when the asset is sold. That would end the incentive to hold onto underperforming stocks merely to avoid taxes in any given year, Furman said.

In any event, said Stein from the Center for American Progress, Democrats need to pay attention and sweat the details of anything Trump and congressional Republicans offer as they unroll their tax-reform plans in the coming weeks.

“If you like the tax system being progressive, we need to make sure that we’re not doing anything to give rich people and corporations more ways of not paying taxes,” Stein said.