Obama's 'Buffett Rule' Fails the Tax Reform Test

By LIZ PEEK, The Fiscal Times
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President Obama has a new favorite possession – the "Buffett Rule." Like a poodle with a new chew-toy, Mr. Obama can't leave the Buffett Rule alone; he takes it everywhere. For the president, the proposal that everyone earning over one million dollars should pay at least 30 percent of that income in taxes is satisfying on many fronts.

For starters, it reminds voters that, contrary to GOP sniping, Mr. Obama actually does have allies – or at least one ally- in the business world. He hasWarren Buffett, a lonely and awkward boy who grew up to become a ruthless dealmaker and investment genius, and has since become America's best chum.

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As conscience of the wealthy, the Sage of Omaha has further buffed his image by offering up Debbie Bosanek, his secretary, to serve as (in her words) the "average citizen who wants to be treated fairly in the area of taxation." More likely, she wants to keep her job. For President Obama, the Buffett Rule is also a jab at GOP rival Mitt Romney, whose tax rate in 2010 of 13.9 percent is a handy reminder of how our tax code helps the wealthy stay wealthy.

The law, based on the proposed rule being introduced into both houses of Congress, provides the president with yet another reason to blast Republicans for their mule-headed attitude towards taxes. Best of all, it focuses Mr. Obama's campaign; it's a remedy for the resentful. Beyond those virtues, the Buffett Rule is an empty shell. We need serious and fair-minded reform of our tax code, not another gimmicky fix. We need to analyze whether the deductions and loopholes that cost Uncle Sam nearly a trillion dollars per year in lost revenues are appropriate and effective, whether the goals of prior generations are still relevant and – yeswhether our system is fair. There is a reason why rich people sometimes end up with lower tax rates. It is not because the tax code is regressive; on the contrary, the top one percent of filers pays nearly 40 percent of the total.

Messrs. Buffett, Gates, Romney and other tycoons pay a lower overall rate because policy makers have wanted to spur investment, and decided to do so bytaxing long-term capital gains (and certain other investment rewards) at a lower rate than income.
This advantage accrues mainly to the wealthy, the investing class. Add to that everyone who invests in a 401(k) to secure their retirement – roughly 51 million workers, with $3 trillion in assets, according to EBRI (Employee Benefit Research Institute).

The goal of encouraging entrepreneurs and risk-takers through favorable taxation was adopted in 1921; the rules have changed from time to time, but the philosophy has been nearly a constant. The question today should not be: “has this approach favored the wealthy?” This is a given. Instead, we should ask: has the policy worked? If not, is this Buffett Rule the best way to fix what is broken?

Opinion is divided on whether a reduced tax rate on capital gains has actually attracted “risk” capital. Historically, it appears that lower rates correlate with rising contributions of gains to GDP. For instance, when the rate on capital gains dropped from 28 percent to 20 percent in 1981, realized gains as a percent of GDP rose from under 3 percent to over 7 percent -- an all-time high-- within five years. In 1998, the rate was reduced once more, and the contribution to GDP again soared.

Rather than proving that favorable treatment generates higher investment, this result may show that investors are more willing to take profits when the tax cost of doing so is low. Even so, this response may justify existing policy, since capital is not locked up, and therefore flows more freely to the most attractive (and economically efficient) opportunities.

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Where a lower capital gains rate has clearly failed is in generating savings. Despite the low capital gains tax rate of the past decade, for instance, the U.S. savings rate plummeted to near zero. It had been 7 percent as recently as 1990. In my view, this dramatic change reflects in part the overwhelming flow of capital into real estate, and reveals another distortion created by well-meaning tax policy makers.

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Some see our tax system as unfair; nearly everyone views it as grossly complicated. The CATO Institute reminds us that in the early 1900s, federal taxes amounted to only 3 percent of GDP and "federal tax rules filled just a few hundred pages." These days, Uncle Sam's revenue makes up about 18 percent of GDP and our tax regimen fills nearly 72,000 pages. It is impenetrable.

The idea of adding another layer to our tax mille feuille is preposterous. The Buffett rule does just that. It is like the Alternative Minimum Tax, which was also intended to make sure that our wealthiest (and craftiest) citizens didn't avoid taxes. The AMT has instead become a monster. Enacted in 1969, the AMT initially caught 20,000 taxpayers in its web. This year, unless Congress intervenes, some 31 million Americans will pay this levy. Given this history, it is hard to imagine any sane person endorsing a similar approach.

We need to encourage savings, and we are in a global competition for investment capital. For both these reasons capital gains should be taxed at a favorable rate. However, that determination should be made in the context of an overall review of our tax system- an effort that will not happen until after the election at the earliest. In the meantime, there is another pothole in Mr. Obama's road to tax fairness.

The Buffett Rule aims to increase taxes paid by the wealthy. As a result, the value of deductions taken by rich people – such as the deduction for charitable gifts – will decline. An unintended consequence of the new rule might well be a fall-off in charitable giving, which would hit hard our neediest citizens now receiving aid from churches and social services agencies. Philanthropy has often been targeted by Mr. Obama; his new tax proposal could prove a back-door slap at private giving. His intention, as ever, remains obscure.