The Tax Code Shouldn't Steer Capital to State and Local Governments at the Expense of Private Investment

Daniel J. Mitchell February 21, 2013

I mostly write and talk about the flat tax, though I'd be happy to instead accept a national sales tax if we could somehow get rid of the 16th Amendment and replace it with something so ironclad that even Justices such as John Roberts and Ruth Bader Ginsburg couldn't rationalize that the income tax was constitutional.

But since there's no chance of any good tax reform with Obama in the White House, there's no need to squabble over the best plan. Instead, our short-term goal should be to educate voters so that we create a more favorable intellectual climate for genuine reform in 2017 and beyond.

That's why I've argued in favor of lower tax rates and shared the latest academic research showing that tax policy has a significant impact on economic performance.

But tax reform also means getting rid of the rat's nest of deductions, credits, exemptions, preferences, exclusions, shelters, loopholes, and other distortions in the tax code.

Why? Because people should make decisions on how to earn income and how to spend income on the basis of what makes economic sense, not because they're being bribed or penalized by the tax code. That's just central planning through the back door.

And if you don't think this is a problem, I invite you to peruse three startling images, each of which measures rising complexity over time.

The number of pages in the tax code.

The number of special tax breaks.

The number of pages in the 1040 instruction booklet.

Today's Byzantine system is good for tax lawyers, accountants, and bureaucrats, but it's bad news for America. We need to wipe the slate clean and get rid of this corrupt mess.

But as I explain in this appearance on Fox Business News, we won't make progress until we control the burden of government spending and unless we make sure that deductions are eliminated only if we use every penny of revenue to lower tax rates.

I've previously explained why it's okay to get rid of itemized deductions for mortgage interest, charitable contributions, and state and local tax payments.

Let's now take a moment to explain why the internal revenue code shouldn't be artificially steering capital toward state and local governments at the expense of private investment.

Under current law, there's no federal income tax imposed on interest from municipal bonds. No matter how rich you are, Uncle Sam doesn't tax a penny of the interest you receive if you use your wealth to lend money to state and local governments.

Should the tax code steer money to Detroit politicians?

This "muni-bond exemption" has two unfortunate effects.

It makes it easier and cheaper for state and local governments to incur debt, thus encouraging more wasteful spending by cities such as Detroit and states such as California.

By making the debt of state and local governments more attractive than private business investment, the loophole undermines long-term growth by diverting capital to unproductive uses.

The politicians at the state and local level certainly understand what's at stake. They're lobbying to preserve this destructive tax break. Here are some excerpts from a story in the New York Times.

Mr. Firestine [of Montgomery County, MD] is on the front lines of a lobbying campaign by local and state governments, bond dealers, insurers and underwriters that is trying to pre-empt any attempt to limit or even kill the tax exemption. …At present, the federal government forgoes about $32 billion a year in taxes by exempting the interest that investors earn from municipal bonds. …The National Commission on Fiscal Responsibility and Reform, known as the Simpson-Bowles commission, has suggested taxing all municipal bond interest, not just the interest paid to people in the top bracket. …Officials of some other government groups, like the New York City Housing Development Corporation, have formed a coalition with Wall Street groups like the Bond Dealers of America to lobby on the issue. But there is the sense of an uphill battle. …Capping the tax exemption would cause high-bracket taxpayers to look for higher-yielding investments, he said, and the county would have to offer more interest to lure them back.

Based on the last sentence in the excerpt, I gather we're supposed to think it would be bad news if we got rid of this tax preference and taxpayers shifted more of their money to private-sector investments.

Needless to say, that's misguided. Only in the upside-down world of Washington do people think it is smart to create tax preferences that lead to more wasteful spending by state and local governments, while simultaneously imposing punitive forms of double taxation on saving and investment in the private sector.

By the way, this shouldn't be an ideological issue. If this amazing chart is any indication, leftists who want workers to enjoy more income should be clamoring the loudest for a tax system that doesn't tilt the playing field against capital formation.

P.S. While simplicity is a good goal for tax policy, you will understand why it shouldn't be the only goal if you check out this potential Barack Obama tax reform plan.