



Needed: Tax Rhetoric Reform

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Comprehensive tax reform is, along with meaningful health care reform and Social Security reform, one of the federal economic policy Holy Grails; ideals long-sought by crusaders of both parties, but seemingly fated never to be secured.

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Occasionally there is a significant policy breakthrough, as with the 1983 Social Security Amendments and the 1986 Tax Reform Act. But after these strenuous bipartisan exertions, the political process resumes its inexorable erosion of the ideals that had been advanced with such difficulty. President Bush's Advisory Panel on Federal Tax Reform summarized the trend:

"Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it dramatically more complicated, unfair, and economically wasteful."

We thus tend to think of "tax reform" as a counter-attack upon the uncontrolled proliferation of tax deductions, tax credits and loopholes. This guided the thinking behind the 1986 Tax Reform Act, and President Bush's Advisory Panel, as well as the (persistently offered) proposals to shift to a flat tax or VAT, and the latest bipartisan reform proposal from Senators Ron Wyden and Judd Gregg.

The Obama Administration, too, has proposed to limit itemized income tax deductions (albeit for high

earners only). It has, however, been unable to resist a specious rationale for doing so, and has offered specifics that would worsen rather than ameliorate tax complexity. In this year's budget proposal, the Office of Management and Budget explained its proposal to limit itemized deductions for high earners as follows:

"Reduce the Itemized Deduction Write-Off for Families with Incomes Over \$250,000. Currently, if a middle-class family donates a dollar to its favorite charity or spends a dollar on mortgage interest, it gets a 15-cent tax deduction, but a millionaire who does the same enjoys a deduction that is more than twice as generous. By reducing this disparity and returning the high-income deduction to the same rates that were in place at the end of the Reagan administration, we will raise \$291 billion over the next decade."

The sole reason, of course, that the value of a deduction at the end of the Reagan administration was limited to 28% was because the highest-earners' marginal tax rates were then limited to 28%. It was most assuredly not because the Reagan administration favored a policy of taxing high earners at one marginal rate while limiting itemized deductions to an arbitrary lower rate.

The Administration's budget language creates the misimpression that a *new benefit* has been conferred upon high earners because the top marginal rate is now *higher* than it was during the Reagan era. Indeed, the logic of the passage is that highest earners receive a special favor every time their marginal tax rates are *increased* – a somewhat odd conclusion.

One must reframe the issue to foster clear thinking. In reality, the tax rate applied to charitable donations given by middle income families is exactly the



same as charitable donations made by high-income families – that is to say, zero. The substantive difference between their respective situations is not the treatment of *untaxed* income but instead the *higher* marginal rate applied to the taxable income of higher earners.

This use of doublespeak is significant because it clouds perceptions of the issues involved in income tax policy, and of existing proposals to limit itemized deductions.

Moreover, politicians as a class tend to succumb to entreaties to deliver special benefits through the tax code for favored constituencies and activities. These various goodies cost federal revenue, which is made up by higher marginal rates on those not so favored. Nothing serves the interest of a politician more directly than to be seen to be socking it to “the rich” (through higher marginal tax rates) while delivering for favored constituencies. Thus, over time marginal rates rise, deductions and credits multiply, the tax code grows more complex, and individual decision-making becomes ever more distorted by federal policy.

Periodic efforts at fundamental tax reform represent concentrated rebellions against this trend. Success takes the form of a simpler tax code, with lower marginal rates, and a limitation upon the complexities and special-interest provisions as in the 1986 tax reform law.

It is important to recognize that movement back and forth in tax code complexity is not about the size of the federal government, nor is it about the progressivity of tax law. Federal taxation has roughly averaged 18% of GDP over the decades even as the complexity of the tax code has varied. Roughly the same amount continues to be collected, but

the complexity of calculations and who pays what changes.

Moreover, as many astute politicians on the left have noted, a loophole-ridden tax code with high marginal rates is at least as likely to be exploited by high-earners as it is by lower earners. The tax code can actually be made *more* progressive with *lower* marginal rates upon high earners, if deductions are more tightly constrained. This is why left-leaning politicians have often joined colleagues on the right

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in advocating comprehensive tax reform.

The Obama Administration, however, is not attempting to move towards simplicity. Instead, it is advocating both *higher* marginal rates upon high earners and *fewer* itemized deductions at the same time. This changes the rationale from one of simplification and neutrality, to the simple collection of additional revenue.

Obviously, taxing income at one marginal rate, while applying a differential rate to itemized deductions, is a significant step away from simplification. It is a gross misrepresentation to imply that this at all represents a return to Reagan-era tax policy norms.

To return to the policies of 1986, of course, would mean establishing *lower* marginal rates for high earners, not the higher rates sought in the Obama Administration’s budget. Indeed, a policy of lowering marginal rates while limiting deductions could indeed result in a more progressive tax code and advance the social values proclaimed throughout the Administration’s budget. This, however, may not



satisfy the federal government's thirst for additional new revenues, and is unlikely to be pursued any time soon.

In the meantime, however, we can all improve the public discussion of tax reform if we first reform our *rhetoric*. Rhetoric should accurately frame the general issues as well as our respective policy goals – instead of, for example, offering potentially misleading nods to Reagan-era policies that there is no intention to pursue. Only then can we have a fruitful comparison of alternative policy approaches, whether advanced by President Obama, the Wyden-Gregg bipartisan team, or anyone else.