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Practical tax reform

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Would you be willing to give up all of your tax deductions -- state and local taxes, mortgage interest, church and charitable contributions, etc. -- in exchange for sharply lower tax rates? With the return of Congress, the debate is about to begin again.

One major obstacle to tax reform is the confusion in the minds of most Americans (and many members of Congress) about average versus marginal tax rates. Your average tax rate is the percentage of your total income that you paid in taxes, and your marginal tax rate is the rate you paid on your last dollar of income. The current federal tax rates range from 10 percent to 35 percent (the marginal rates). However, according to a new Congressional Budget Office study, effective tax rates range from less than 3 percent for the bottom half of income earners to 24 percent for the top 1 percent of income earners.

High marginal tax rates discourage work, saving and investment and hence result in lower levels of employment and national income. The present system, by having marginal rates much higher than average rates, does much unnecessary economic damage by reducing productive incentives more than is required to produce the same amount of revenue. (Note: Tax revenues actually increased under Presidents Kennedy's, Reagan's and Bush's tax rate cuts, because disincentives were reduced.)

People make decisions on the basis on their marginal rates, not their average rates. Thus, you may be offered an opportunity to take on an extra money making project, but if your marginal tax rate is 30 percent, (even though your average tax rate is only 15 percent) you may decide the extra effort is not worth it, if you are only going to get 70 cents out of each extra dollar you earn.

The tax system is also highly progressive with the top 1 percent of taxpayers paying 34 percent of the taxes, even though they had only 17 percent of the income. Many liberal Democrats think the tax system should be more progressive (the rich should pay even more) while most Republicans think it should be less progressive, and in fact most of them would favor a flat rate income tax system. (Polls show that most Americans, regardless of income, think the maximum marginal tax rate should be no higher than 20 percent.)

The recently-concluded tax reform advisory group missed the opportunity to propose a politically doable and practical tax reform. There actually is a way to greatly simplify the tax code, while at the same raising the same amount of revenue and not increasing anyone's current tax liability.

To see how we get from where we are to an improved system, it is important to understand the obstacles to tax reform. The first obstacle is getting agreement about whether to make the system more or less progressive. The second obstacle is making sure that there are more winners than losers (which is tough to do without actually cutting taxes).

The way to overcome the obstacles is to greatly broaden the tax base by getting rid of all deductions and exemptions (with the exception of the personal deduction for each taxpayer and dependent), and then reducing the existing marginal rates to roughly the current average rates. (For example, a family would total its income for the year from all sources -- wages, salaries, interest, dividends, capital gains, pensions and so forth -- take a high standard exemption for each person, such as $10,000 -- then have tax rates of 10, 15, 20 and 25 percent.) Under this system, the average family of three would pay close to what it pays now, while facing much lower marginal rates. A family making $30,000 per year or less would pay zero in income tax.

The imposition of the above as a replacement income tax system would produce as much revenue as the current tax system. However, in the short run, it would cause some people to have higher tax bills. This is because they built their financial lives around the existing system -- for instance, perhaps having a much larger house and mortgage than they would have if there were no mortgage interest and property tax deduction. To mitigate the transitional hardships (and tone down the opposition from all the special interests), the new system could be compared in parallel with the existing tax system, whereby each taxpayer could choose the system that is best for him or her during a long transitional period. (Note: We already have an existing parallel tax system with the Alternative Minimum Tax -- AMT, which should be abolished once the new alternative is put in place.)

The above proposed tax reform is far from perfect (the maximum marginal rates would still be too high, and productive savings and investment would continue to be double taxed), but it would be far less economically damaging, greatly simplify peoples' lives and reduce the ambiguity in the current system. However, its greatest virtue is that it should be politically doable because it provides a greatly simplified alternative, while avoiding the fight over whether to make the system more or less progressive.

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