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Asking the Tax Code to do Less

By Ike Brannon

There is a famous experiment in behavioral economics that asks the subject to imagine he is standing next to the stadium before a big football game with a ticket and a $100 bill—which, coincidentally, happens to be the going rate for his ticket—and to suggest two different scenarios. In the first, the $100 bill disappears from his pocket, mysteriously. A nearby scalper offers that he is willing to buy that ticket from him for $100. Would he take the offer? Most people would decline and go to the game.

In the second scenario, it is the ticket that disappears. This time, the friendly scalper offers to sell a ticket for a seat in the same row for $100. Most people respond by declining the offer and choosing to head home.

The larger question the two different answers raise is why it should matter which piece of paper disappeared—a $100 bill or a ticket instantly and painlessly redeemable for $100. Economists say it should not matter in the slightest, but of course it does.

This same dichotomy helps to explain why we run so much social and economic policy through the tax code.

The first and primary focus of the tax code should be to raise revenue as painlessly as possible—the proverbial "pluck as many feathers as possible with the least squawking," as the philosopher Colbert noted a few hundred years ago. Conducting policy with the tax code compromises this goal. It also obscures the true cost of various programs, such as the mortgage interest deduction, which does nothing to accomplish its ostensible goal of increasing homeownership while costing nearly $100 billion per annum in foregone tax revenue. A streamlined income tax that does not pull on simultaneously pull thousands of policy levers would force Congress and the nation to have real debates over what we want the government to do, and what it should refrain from doing.

For instance, without the ability to deduct mortgage interest, would the government ever send subsidies to homeowners for the amount of their mortgage interest? If not, then why does this tax break persist, other than through inertia?

What Income Should Be Included in the Base?

While we use the tax code to incentivize all kinds of activities, the code itself does a relatively poor job encouraging people to save. We double-tax most investment income that is not in some sort of tax-preferred account, first by taxing the money when someone earns it and then, after they invest that money, taxing its returns as well. While liberals see lower taxes on capital gains and income as giveaways to the rich, most economists see *any* tax on this income—which is a reward for foregone consumption—as a very expensive way to collect revenue in terms of foregone growth and a poor way to achieve progressivity in the tax code.

Making it easier for working families to save should be an essential part of any tax reform. And families of all income levels respond to savings incentives: the Harlem Children's Zone, a policy experiment that provides subsidies to the returns to savings for the participants in the program—mainly low-income families in New York City—showed that even families we typically ascribe as being incapable of setting money aside manage to do so when their returns are high enough[1].

While concomitantly criticizing the tax code for conducting policy and advocating for another incentive may appear to be contradictory, the returns from saving should simply not be a part of the tax base. If that is politically impossible then we should help as many people to save as much as possible without the government taking a portion of it. And the best way to achieve that is by simplifying the tax code.

We currently offer a welter of tax-preferred savings accounts for families that want to save, all of which direct the money towards specific uses, such as retirement, education, and health care. But these all come with caps, contribution limits, and penalties for violating the strictures governing them.

The universe of tax-free savings accounts could be improved. The mishmash of accounts at the federal and state level can be difficult to navigate, and states exploit their quasi-monopoly for college savings accounts by allowing the vendors to charge management fees well above the norm. For instance, the typical index fund charges a fee of less than 0.2% of assets, but the index fund provided in the D.C. college fund, charges a fee a half percent higher, a discrepancy that cannot be rationally explained other than via political largesse.

The Bush administration's proposal to create Lifetime Savings Accounts and Retirement Savings Accounts[2] for all Americans is worth revisiting. It put retirement benefits in one account and health, education, and others in the other, taxing the money upfront and allowing returns to accumulate tax-free. It would be a great simplification and could be done in the context of a fundamental tax reform that makes progressive changes to the tax code elsewhere, such as by eliminating or capping various deductions or converting deductions to a flat credit, thus preserving its political viability.

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[1] "Lessons from SEED: A National Demonstration of Child Development Accounts." Published by the New America Foundation, September 2010.

[2] Each would allow $15,000 a year to be set aside in after-tax dollars, and withdrawals (after one year for the former and at age 65 for the latter) would not be taxable events.

A much bigger child tax credit—popular among many social conservatives (and most notably championed by Ramesh Ponuru and Bob Stein) is the wrong way to go. It does nothing to change savings incentives, nor does it affect anyone's incentives to work. It's also not particularly progressive, as it would go to rich and poor alike—although if it were not made fully refundable it would go overwhelmingly to the wealthy. Again, a relevant question to ask is what would be done if such a program were administered outside of the tax code: would there be any possibility of the government mailing $7,000 checks to every family for every child they have? If not, then why would we do this via the tax code?

Finally, it might be time to ask whether we want to include some sort of tax incentives to encourage higher birthrates. The average fertility for a woman in the United States is 1.85 births, or below replacement rate. And it is falling just as longevity for those who reach age 65 is growing at a rate faster than we've seen in quite some time.

Don't Use the Tax Code to Incentivize College

It is undoubtedly true that the "sticker price" for attending college has gone up steeply in the last two decades. My own alma mater, Augustana College, exemplifies this trend: the price for tuition, room and board when I began school was under $8000 in 1984 and remained under $9,000 when I graduated. Today, the price is over $40,000, an increase of roughly 5.3% over the last 30 years.

However, the actual price of college is much less than the sticker price of college, thanks to financial aid and the practice of colleges of using aid to perfect the practice of price discrimination. Approximately one percent of Augustana's students pay the full price. Using the Augustana tuition—or Harvard's—as an indicator of the true cost of college presents a wildly unrealistic view.

Let me suggest another datum to use when calculating the true cost of college: In my hometown of Peoria there is a very fine junior college called Illinois Central College, where I also studied under a group of uniformly excellent teachers. Today, annual tuition is just under $3,000. The tuition at the state's four-year universities is $11,800. In other words, without any financial aid whatsoever, a resident of central Illinois can get a four year degree for under $30,000. A family with an income under $100,000 (roughly 97% of all households in the Greater Peoria area, incidentally) and students with exceptional GPAs or ACT scores receive merit-based financial aid.

While it is very much true that the impending cost of college is a prime concern of most middle class families with children, using the tax code to help alleviate this has been counterproductive.
It's not necessarily the job of the federal government to make private universities affordable to the middle and upper middle classes, and the inelastic supply of such services means that the universities capture most of the subsidies the government provides.

Do No Harm

As a former staffer for the Energy and Commerce Committee, I am well aware of the tendency towards jurisdictional imperialism. Nowhere did the minority and majority staffs work more closely than when the chair and ranking member perceived that another committee was encroaching on our jurisdiction. But if the Ways and Means and Finance Committee were to produce a greatly simplified tax code that stripped out the various incentives currently in place to buy a house, an energy-efficient car, home weatherization, and a thousand other myriad and sundry things, it would result in a tax code less costly to administer and comply with as well as one more amendable to economic growth, permitting us to keep the tax rates on work lower than they currently are. I have no idea what Henry Thoreau would think of our current tax code but his sentiment to “Simplify, simplify, simplify” is certainly an apt one today.

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