

Tax Reform Languishes as Politicians Play “Gotcha”

In what is certainly the least welcome rite of Spring, over 150 million Americans scrambled in recent weeks to meet the April 17th federal income tax filing deadline.

Complying with the increasingly complex Internal Revenue Code took a major toll on taxpayers in addition to the taxes paid—hundreds of millions of hours and hundreds of billions of dollars, not to mention frayed nerves and lost sleep. The non-partisan Tax Foundation estimates that, in 2007, Americans will spend \$305 billion in federal income tax compliance costs. (By comparison, the federal budget deficit for the 2007 fiscal year is projected to be \$214 billion.) In short, Americans pay 23 cents in compliance costs on top of each dollar that they actually pay in income tax.

Democrats and Republicans emphatically agree that the tax code is a mess, and that fundamental reform is essential. Yet, unlike individual taxpayers, policy makers face no tax related deadlines. Instead, officials at both ends of Pennsylvania Avenue are engaged in an exasperating game of “gotcha”, where each side dares the other to act, knowing that whoever moves first will be punished politically for daring to lance some of the sacred cows that everyone recognizes must be slain if reform is to be meaningful.

In the 2004 Presidential campaign, both President Bush and Senator Kerry, like all candidates since the income tax was initiated under President Wilson, pledged to fight for “fundamental tax reform”, though neither presented detailed plans to do so.

After President Bush was reelected, he promptly moved forward on that promise by appointing the President’s Advisory Panel on Federal Tax Reform in January 2005. The President instructed the Panel to “recommend options that would make the tax code simpler, fairer, and more conducive to economic growth.” But President Bush did not direct how the Panel was to do so, stating only that he would insist on preserving deductions for charitable contributions and mortgage interest (conspicuously omitting state and local taxes from the protected deductions). Although commissions are often formed in Washington for the purpose of deferring action on difficult issues, the stature of the members of the Tax Reform Panel affirmed its seriousness of purpose. The chair and vice chair, former Senators Connie Mack (R-FL) and John Breaux (D-LA), were both highly respected and thoughtful legislators who, as members of the tax-writing Finance Committee, had strong records of developing bipartisan solutions to complicated matters. In addition, the seven other Panel members had earned reputations as knowledgeable and effective tax policy experts.

On November 1, 2005, the Tax Reform Panel presented its report to the Secretary of the Treasury. (Tellingly, the Panel was directed to present it to a cabinet secretary, rather than directly to the President, to permit him to ignore it if he chose to do so.) The report presented a compelling critique of the current system and proposed two alternative systems to replace it: a “Simplified Tax Plan” and a “Growth and Investment Tax Plan”. Both alternatives were presented in considerable detail, with the goal of prompting a substantive discussion of the policy implications of their components.

Any hopes that the Panel's reports might lead to serious policy discussions rather than political gamesmanship were dispelled within hours of its release. On the very day the report was presented, the Senate Finance Committee's senior Democrat (and current chairman), who served with Senators Mack and Breaux, issued a press release stating, in essence, that he agreed with the Tax Panel's recommendations which conferred benefits and were popular, such as repealing of the alternative minimum tax, but criticized recommendations which limited benefits and were unpopular, such as restricting certain deductions. Not an auspicious start.

Having already been bludgeoned with its Social Security reform proposal, the Administration chose not to take further lumps by pressing forward with tax reform as well. For 18 months, the Tax Reform Panel's report has languished at Treasury. Secretary Henry Paulson, who succeeded John Snow in July of 2006, has shown little interest in pushing tax reform at all. In testimony to the Senate Finance Committee on April 18th, the day after Americans filed their tax returns, Secretary Paulson went so far as to state, "There isn't a major tax reform proposal being put forward now, and I don't see that on the dockets in the near future."

In his defense, Secretary Paulson's candid comments reflect a clear grasp on political reality rather than a failure of nerve. As a veteran of the private sector, Secretary Paulson likely concluded that it is not worth doing that which can't be done—proceeding otherwise would be a waste of time. He has not yet adopted the prevailing Washington view—time used to make the other side look bad is time well spent.

Congressional Democrats continue to press Secretary Paulson, and the President, to present a plan for tax reform. Yet, now that they control the Congress, they are entirely capable of presenting a plan of their own. A bold few, such as Senator Ron Wyden (D-OR) and Congressman Rahm Emmanuel (D-IL), have chosen to do so, but they are very much the exception. Instead, most Congressional Democrats are intent on playing "gotcha"—getting the Administration to make some of the difficult choices necessary for reform, and then kicking their teeth in for doing so. Conversely, the Administration, which already has more political problems than it can handle, is content to let Congress take the political hits associated with advancing a serious reform proposal. If Congress chooses to avoid that pounding, the Administration is likely to do nothing at all rather than sticking out its own jaw.

In the meantime, Congressional tax writers are busying themselves with developing a tax package to accompany the proposed increase in the minimum wage that, in theory, will mitigate the impact of the higher wage on small businesses, who both will bear most of its cost and are least able to afford it.

In particular, Congress is trying to determine whether the tax relief to small businesses over the next 10 years should be closer to the \$1 billion initially approved by the House or the \$8 billion later passed by the Senate, notwithstanding the fact that, in either case, the net impact of the package to federal revenues would be zero due to offsetting tax increases to be included in the package. For now, they have decided to split the difference at \$4.8 billion. However, they will need to revisit the issue because the President vetoed the Iraq funding bill to which the tax package was attached. To appreciate just how inconsequential this debate is in the context of the federal budget, consider: over the next ten years, the Congressional Budget Office (which has

consistently and dramatically underestimated federal tax receipts in recent years) projects that the federal government will collect roughly \$33 *trillion*, that is, \$32,954 billion. By comparison, the tax package agreed to by the House and the Senate, even if enacted without any offsets—which it is certain to include—would amount to a tax cut of .0146 percent.

Those hoping for fundamental tax reform are advised to focus on a rite of Spring much more welcome than filing income taxes—the beginning of the baseball season—and recall the defiant optimism of Chicago Cubs fans and their perennial rallying cry, “Wait till next year.”