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Forget the Cliff, Fix the U.S. Tax System

By Betsey Stevenson & Justin Wolfers - Dec 3, 2012

Spoiler alert: The “fiscal cliff” will be resolved. At the 11th hour, saner heads will prevail, a deal will be struck, and the [U.S. Congress](#) will steer the economy away from its date with destruction.

Congressional compromise will ensure that the scheduled tax increases and spending cuts are pared back and phased in only gradually.

The real danger, then, is not that we’ll fall off the cliff. It’s that Congress will solve the problem badly, missing a once-in-a-generation opportunity to design a better tax system.

Current rhetoric suggests that Congress will employ the same design principles that undergird our current shamolic tax system: populist politics, lobbying pressure, last-minute compromises and policy inertia. The result is likely to be a deal that tinkers at the edges and may even make the system worse.

Instead, imagine if simple economic insights were used to give us a better system. What would it look like?

One important insight is that there’s no difference, economically speaking, between the government giving you an extra dollar or choosing to tax away one fewer dollar. Yet the budget process treats the two very differently. If the government wants to send you a regular check, it must first obtain the funds through an appropriations bill subject to annual scrutiny. If the government wants to spend money by giving you a tax break, the expenditure need only be approved once. The result is a complex [tax code](#) riddled with ineffective tax preferences for a mind-boggling array of activities.

Better System

A better system would require Congress to reauthorize each tax expenditure annually, a reform that would help eliminate wasteful loopholes and simplify the system. Just capping deductions at \$25,000, as lawmakers are currently considering doing, isn’t enough. It’s Congress at its least courageous, refusing to ask the harder question of which tax breaks make sense.

Nearly all economists agree that the tax break for mortgage debt is a bad idea. It encourages people to take on more debt than they can afford and favors owners over renters. By contrast, the tax break for

charitable contributions makes sense. It subsidizes something of value to broader society, and there's [evidence](#) that it achieves its goal of stimulating giving. By simply capping deductions, Congress would reduce the incentive to give without eliminating the incentive to get too deep into debt.

Other tax breaks simply don't work very well. Recent [research](#), for example, suggests that we get very little bang for our buck by making retirement savings tax-deductible. Hence, we should consider revisiting the billions of dollars our government spends every year on retirement-savings incentives.

More generally, we should question the idea of using deductions rather than credits. For example, the charitable- giving deduction is effectively a government matching grant: The government matches each contribution with an amount defined by the contributor's tax bracket.

As a result, a family wealthy enough to be in the 35 percent bracket gets a bigger grant than a middle-class family in the 15 percent bracket. It would be far [simpler](#) and fairer if the government just matched everyone's charitable contributions at a rate of, say, 20 cents per dollar.

A more equitable system would also do a better job of taxing families. Currently, the number of earners in a family has no bearing on how it is taxed. Yet the two-earner family often has to pay for child care, meal preparation and laundry, while the single-earner family has someone with an extra eight hours in the day to help meet those needs.

Level Field

Failing to recognize the value of work done in the home is just one way the tax system implicitly subsidizes single-earner families, creating a disincentive for many to join the formal workforce. By shifting from levying taxes on households to levying them on individuals, the government could put different kinds of families on a more level playing field.

If we modernize our tax system, we shouldn't need to maintain the backup mechanism known as the alternative minimum tax. Originally designed to make sure the highest earners pay some tax, the AMT has instead become a burden on middle-class families, negating much of the benefit they would have received from the Bush tax cuts. Instead of applying a temporary fix every year to prevent the AMT from doing too much damage, Congress should abolish it.

Finally, economics tells us that the official ceiling on federal debt should be eliminated. By giving Congress a regular opportunity to default, the arbitrary limit raises the cost of financing the national debt.

[Think about it](#): If you imposed a ceiling on how much of your credit-card balance you were willing to pay, would your bank continue to lend to you at the same rate, if at all? No wonder [Standard & Poor's](#)

downgraded the government's credit rating after last year's debt-ceiling standoff.

We should raise the bar on our policy makers. Avoiding the fiscal cliff with yet another Rube Goldberg fix isn't good enough. Taxpayers should insist on real reforms that respect the basic principles of economics and of common sense.

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