NEW YORK POST

Cracking the tax code

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Last Updated: 11:45 PM, February 22, 2013

Posted: 11:30 PM, February 22, 2013

In her most recent report to Congress, National Taxpayer Advocate Nina Olson notes that “tax expenditures” — the exclusions, exemptions, deductions and credits that make the Internal Revenue Code such a bloated, bewildering behemoth — total more than $1 trillion a year.

She explains that she tries to avoid calling these provisions “loopholes” because that word has a pejorative connotation: “Policymakers use the term ‘loophole’ to describe a tax expenditure that they do not agree with . . . and use terms like ‘incentives’ or ‘sound government policy’ to describe tax expenditures that they like.”

President Obama illustrated that tendency in his State of the Union Address, condemning “tax loopholes” for “the well-off and the well-connected,” while advocating “incentives” for companies that hire Americans who have been out of work for a long time. Although Obama called for “bipartisan, comprehensive tax reform,” his main goal seems to be raising taxes by limiting certain deductions.

Meanwhile, he’s been pushing new tax breaks for people who behave as he thinks they should by (for example) hiring veterans, going to college, investing in “green energy” or driving electric cars. This is not the sort of reform we need, since it only compounds what Olson calls “the most serious problem facing taxpayers”: the mind-boggling complexity of the 4-million-word tax code.

The tax code is so complex, Olson reports, that individuals and businesses spend more than 6 billion hours a year complying with its filing requirements, which is equivalent to 3 million full-time workers. That cost totaled about $168 billion in 2010, or 15 cents for every tax dollar collected. The code is so complex that people have trouble figuring out what rate they’re paying. Whatever it is, they’re pretty sure others are paying less.

She cites a 2012 survey in which only 16 percent of Schedule C filers considered the tax code fair and only 12 percent believed others were paying their fair share.

Since “no one wants to feel like a ‘tax chump,’“ she observes, that sort of sentiment encourages noncompliance, which increases the burden on other taxpayers and enhances the sense that the game is rigged.

Even for those determined to obey the law, figuring out how to do so is no easy task. That’s why nine out of 10 taxpayers either hire professional preparers or rely on tax software. But that’s no guarantee against mistakes that can result in civil or criminal penalties. This kind of uncertainty undermines the rule of law, since even the most conscientious taxpayer can’t contemplate an audit with equanimity.

A constantly changing tax code also creates uncertainty about the future, which distorts economic decisions. Tax breaks themselves are often designed to distort economic decisions, although that’s not how their advocates put it.

Even when tax breaks work as intended, they’re based on the dubious premise that politicians can allocate resources better than the market can. And they frequently have unintended side effects, such as the inflation caused by provisions favoring home ownership, higher education and employer-provided health insurance.

Only by eschewing such meddling can legislators hope to achieve the comprehensive tax reform that the president claims to favor. They also have to stop pretending that only “the well-off and the well-connected” will be affected. The biggest tax expenditures include the exclusion of medical benefits from taxable income, the mortgage interest deduction and the deduction for state and local taxes — hardly breaks that are enjoyed only by the wealthy.

But the same people who stand to lose treasured middle-class tax breaks will also benefit from lower rates. “If Congress were to eliminate all tax expenditures,” Olson estimates, “it could cut individual income tax rates by about 44 percent and still generate about the same amount of revenue.” By treating tax reform as an opportunity to raise taxes, Obama risks the enormous benefits such a deal promises.

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