Should Taxpayers Be Classified by a Comprehensive Measure of Income?

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In recent years, some commentators have objected to Treasury's attempt to classify taxpayers by using a comprehensive measure of income. The purpose of a classification system is to determine who pays taxes at different income levels and at what rates. Certainly no income classification system is perfect, and there are legitimate reasons why one system may be good, or even optimal, for one purpose but inappropriate for another purpose that requires a different system.

Unfortunately, what should be a technical debate has become a political issue. And those stirring the pot are likely to get just the opposite of what they intend to accomplish. These commentators think that by using alternative measures of income they will help keep tax rates down. In fact, by hiding the ways in which income avoids taxation, they may be supporting a less efficient tax system, larger government, and higher tax rates.

The Treasury system of classifying taxpayers according to the full extent of their income was adopted during the Reagan presidency. The impetus was broad-based tax reform and the need to try to reflect as best as possible the effects of adopting a system with a broader base and lower tax rates. I should know, I was partly responsible. I can state unequivocally that the Reagan tax reform of 1986 would not have been possible without the very deliberate effort to measure income comprehensively and classify people accordingly. Thus, it is surprising that some of those who favored the 1986 tax reform as one of Reagan's true successes now attack the very means by which it was achieved.

Here was the main issue at stake then. Tax reform was likely to involve some exchange of reduced opportunity to shelter income for lower tax rates. Those investing in tax shelters generally were individuals with higher incomes and greater wealth. However, they didn't "look" that way when they reported net income, such as adjusted gross income (AGI), on their tax returns. Shelters involved the generation of large deductions from partnerships and other vehicles, which in turn led to large amounts of negative income being reported on tax returns. For example, a real estate shelter might report large amounts of interest deductions even while the property was appreciating in value. In effect, an investment leveraged with large amounts of debt might have positive economic income but produce large reported losses for tax purposes.

Now suppose that tax reform raised taxes on some higher income people with shelters in exchange for lower rates on those without shelters. What would happen if the distribution tables were based on net income reported for tax purposes? It would look as if the attack on tax shelters resulted in higher taxes on the poor, not on the rich. After all, on the basis of their AGIs, a large number of the rich looked like they were poor.

There was another problem. Broad-based tax reform was wide- ranging. Who knew what Congress or the administration would finally accept? Tax reform can deal with any aspect of a person's income—pensions, returns from housing, stock dividends, tax shelters, partnerships, under-reported income, or employee benefits such as health insurance. In fact, many of the tax reform efforts of the early and mid-'80s did touch in one way or another on these many sources and uses of income. To be consistent, it was often necessary to measure each source of income and the value of each tax preference so that if its tax treatment were changed, the attribution of the change would be made to the right people.

If all this is true, then what is the issue? Well, today's protestors argue that people with, say, $80,000 of real income only see, say, $60,000 in AGI. The other $20,000 comes in the form of such things as employee benefits or unrealized capital gains or returns from owner-occupied housing or some other source. Therefore, when Treasury reports that a particular tax bill increases taxes by $2,000 for those with $80,000 of income, it appears that the tax increase is only 2.5 percent of comprehensive income when it is 3.3 percent of AGI.

Or suppose the administration is objecting to a tax cut that it says favors the rich. It would show tax cuts in the $80,000 class that reflected what was happening to people with AGIs of $60,000. Depending on the tax increase or cut in question, this differential in classifications may make it look better or worse politically.

No doubt for some purposes, a measure such as AGI should be used. If a family wants to look at its return to guess how some simple tax rate reduction will affect it, then a less comprehensive measure such as AGI sometimes is informative because it is recognized. Thus, there are a number of possibilities for legitimately classifying taxpayers.

But there are problems with using classifiers that in the end are inaccurate in measuring income. As case 1, return to our tax shelter issue. It's not the mid-1980s anymore; do we really want to return to a period where those investing in tax shelters looked as if they were poor? The narrow classifier effectively becomes a political way to help tax shelters thrive.

Case 2 is very current. A number of conservatives, as well as liberals, today are considering a market-based health reform that would cut back on the tax subsidies for higher-income individuals for unlimited amounts of health insurance coverage. Instead, the tax break would be converted to a credit that would be distributed more equally and would not be so open-ended. If Treasury were asked to run distributional tables that included such a reform, wouldn't it make sense to attribute to individuals the value of the health insurance that might be capped or that might be subsidized through a credit? Of course it would.

Case 3 involves social security reform. Most people don't include social security in their AGI. Does anyone really advocate using a distributional table that excluded social security altogether when social security was being reformed?

Or take as case 4, proposals to increase corporate taxes. A comprehensive measure of income would include returns to capital and would show a corporate tax increase as an increase on individuals. Of course, we could always exclude attributions of corporate income on the grounds that it isn't reflected in AGI except to the extent of dividends. And, indeed, some distributional tables do exclude consideration of corporate taxes. That might be a good way to help make corporate tax increases appear as if they had no effect on individuals, but it's funny to hear some self-styled conservatives favor a system that would imply that when corporations pay taxes, people don't.

Or consider as case 5, proposals to deal with provisions for low- and moderate-income individuals such as those receiving food stamps or the earned income tax credit. Families with $15,000 of income plus benefits might only have $5,000 or $6,000 of AGI. If we don't count all their income because it doesn't appear in AGI, then many proposals might look like they helped or attacked the truly poor when they did not.

Of course, one can always play the game of arguing that the definition of income will change from one proposal to the next depending on what sources and uses of income are at stake. But that is a dangerous game.

First, some people will make comparisons across distributional tables for different proposals, not knowing that in one case Treasury was compelled to try to count all income, in another it was compelled only to count AGI, and in another it counted AGI plus or minus some item at stake. Second, the classifier might have to change from day to day as members of the tax writing committees or other lawmakers add amendments to a bill. Not only would this present a difficult management issue—all of a sudden, the distribution of the tax burden would change within income classes—but it could be the consequence of a change in classifier rather than the change in the proposed law. Finally, even if Treasury made these decisions on some reasonable basis, it would appear to almost everyone that it was manipulating the tables for political purposes.

It's one thing to argue that alternative tables are useful for different purposes, or that there are better measures of income and tax burdens. It's another to argue that incomplete accounting and inconsistency are good things in and of themselves.

Coming up with a proper classifier for taxpayers involves the kind of judgment over which people of good spirit and commitment to rigorous thinking may disagree. But trying to solve a legitimate technical debate through politics is another matter. When it comes to attacks on more comprehensive measures of income, those who are pointing the gun unwittingly are aiming it at themselves and many of the causes they espouse.

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