Think FRED: Tax Cuts Just Add to Complexity

Commentary

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Why is the tax code so complicated?

Because whenever politicians face important tax policy choices, they always compromise with more complexity. That way they can avoid painful trade-offs.

Consider the story of a tax rule called FRED.

To those few brave souls who still fill in their tax forms by hand, it's just another damn worksheet. But to tax gurus many of the most odious and complex provisions in the code have cute pet names. There's the personal exemption phase-out, nicknamed PEP, and the phase out for itemized deductions, called Pease.

My personal favorite is FRED—Full Refundability for Excess Dependents. If you don't earn much money and have three or more children, FRED lets you convert those "excess dependents" into cash at tax time. (My youngest children, Kent and Liz, always bristle when I refer to them as excess dependents.)

FRED shows how bipartisan compromise can lead to bad policy. It was enacted in 1997 as part of the new $500 per child tax credit. It's the misbegotten brainchild of Republicans who thought the child credit should benefit only those who pay income taxes, and Democrats who thought that the child credit should benefit everyone with children. The Democrats wanted the credit to be refundable so that even families who didn't owe any taxes would get it. The Republicans wanted the credit to be nonrefundable—so that if you only owed, say, $300 in taxes, that's all the credit would be worth.

The compromise was FRED. Under FRED, a family with three or more children gets a refundable child credit to the extent that the employee share of Social Security taxes plus individual income taxes exceeds its earned income tax credit up to the amount of the full child credit. (Alas, that is the simplest explanation!)

FRED is one reason why most low-income families have to pay others to prepare their tax returns. Of course, the 754,000 families who qualified for FRED in 1998 did get some tax benefit as a reward for puzzling out the complex provision—worth about $675 per return. But there has to be an easier way to cut their tax bill.

The bipartisan leadership of the Senate tax-writing committee recently came up with a simpler approach. It proposed a new refundable tax credit for all low-income families who earn more than $10,000 per year. They could claim a refundable credit up to 15 percent of earnings over that threshold. That is still not simple, but limiting the credit to those with earnings does make matters simpler for the IRS. And anything is simpler than FRED.

The new refundable credit would cut taxes for more than 90 percent of those who benefit from FRED—and for millions more who don't. It would help millions more low-income families. It would make the tax system fairer and simpler.

It was, of course, too good to be true.

Congress' number crunchers at the Joint Committee on Taxation pointed out that some taxpayers would end up paying more in taxes under the new proposal than they do under the current rules. The unspoken assumption here is that no one can pay higher taxes, even if 100 people gain for every one who loses and the tax system as a whole would be better.

So Congress hammered out a compromise: complexity plus complexity. Under the proposal that passed the Congress last month as part of the big tax cut package, taxpayers could calculate their refundable credit under the new rules and compare that credit to the amount that they could claim under the old rules (FRED) and take the larger credit. In other words, they get the complexity of FRED *plus* the complexity of the new proposal. Maybe they will call the new provision Barney.

Of course, Barney is simply a symptom of a far larger problem: politicians' rank hypocrisy when it comes to the complexity that makes tax-time such a misery for most Americans. On the stump, everyone is for simplification. In congressional committee rooms and in the Oval Office, simplicity nearly always loses out to other objectives.

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