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Tax Reform Might Start With a Look Back to ’86

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“A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income.”

— Tax Reform report of the Treasury Department to President Ronald Reagan, November 1984

As Washington grapples with the budget, it might be worth asking a simple question: What would Ronald Reagan do?

He was the last president to preside over a significant tax reform, one that did exactly what both candidates in this year’s presidential election said they want to do: lower tax rates and close loopholes.

And a critical part of that reform was to end the historical system of taxing capital gains at lower rates than ordinary income.

In the name of fairness, the Tax Reform Act of 1986 raised the maximum tax rate on long-term capital gains to 28 percent from 20 percent at the same time it reduced the maximum rate on ordinary income to 28 percent from 50 percent.

Doing that again in a tax reform act of 2013 would do more than raise revenue and increase fairness. It would bring an abrupt end to the “carried interest” tax dodge, in which managers in the private equity business are able to define their compensation as capital gains and thus pay far lower income tax rates than do ordinary people with far less income.

Ideally, there will be two tax reform efforts in the next 18 months.

The first, going on now, is a simple patch-up, aimed at dealing with the pending increases in taxes brought on largely by the expiration of the Bush “temporary” tax cuts. If the lame duck Congress and President Obama can avert disaster, raising some revenue while not devastating the economy, they will have succeeded.

But the next move should be aimed at comprehensive tax reform. The Obama administration should look to President Reagan’s second term for inspiration. The Reagan method included a comprehensive, well-thought-out proposal that dealt with

the myriad details that can rise up to frustrate any efforts at change, put together painstakingly by the Treasury Department.

Then there was a bipartisan effort to get it through Congress, with inevitable compromises but with clear goals in mind.

The proper way to approach that proposal is to accept that the government needs to raise a certain amount of money. There can be differences over spending, obviously, but there should be consensus that whatever decisions are reached, the tax system adopted should be expected to finance those expenditures over an economic cycle, with deficits in difficult economic times and surpluses in good years.

With an agreement that taxes should raise a certain amount of revenue — presumably expressed as a percentage of G.D.P. — then the debate on actual tax policies can take place in an atmosphere very different from the ones we have had in the past. Every tax deduction and every tax exemption should be viewed not just as giving a break to whatever deserving group has hired a good lobbyist but as forcing the rest of us to pay more.

One way to do that would be to calculate a system, based on a simple progression of tax rates, without any deductions or exclusions, that would produce the needed revenue. Then the debate over each tax break would include a discussion of just how much the rates would have to rise if that break were granted for those who can take advantage of it.

Do you want to preserve the deduction for interest on home mortgages, in the name of encouraging homeownership? Fine. Just understand that it would raise the marginal tax rate for every one of us by a certain number of percentage points. The same goes for charitable deductions, or not taxing certain fringe benefits like the cost of health insurance premiums.

With that in mind, we come to the capital gains tax break. It is defended as critical to economic growth and prosperity, on the theory that without it money will not be invested. But the empirical data to back that up is lacking, to say the least. Over the last 30 years, the economy and the stock market has tended to do better when the capital gains rate was high.

That does not prove causation, of course. But if the data went the other way you can be sure supporters of low capital gains rates would be citing it.

It also needs to be understood that the current system ends up discriminating against many who own stocks and mutual funds and thus receive capital gains and dividends.

If your investments are in retirement plans, like 401(k) accounts, the profits are not taxed until the money is taken out. And then the money is taxed at ordinary income tax rates, regardless of whether it originated as capital gains.

As a result, most of the money earned by the highest-income taxpayers comes from tax-advantaged dividends and capital gains. In most years, more than half the capital gains reported to the Internal Revenue Service are received by people with annual incomes of more than $1 million.

The 1985 Reagan plan did propose one break for capital gains. It called for indexing profits to inflation. So if total inflation was 10 percent from the time you bought until you sold, the first 10 percent of profits would be tax-exempt. Congress dropped that idea when it passed the Tax Reform Act of 1986, but it could be revived.

Much of the credit for the 1986 bill went to Senator Bill Bradley, the New Jersey Democrat who had pushed for lower rates and fewer deductions. He had three fundamental principles — ones that should inform any serious effort at tax reform. The first was that markets allocate capital better than politicians do, so we risk distortions with tax provisions aimed at encouraging investment in one part or another of the economy. The second was that equal incomes should pay equal taxes, and the third was that those who make more should pay more.

The 1986 law was devised to be revenue-neutral. Any new reform bill will have to raise revenue, which Mr. Bradley said in an interview this week would make the task harder than it was in 1986. He said one approach might be to reduce but not eliminate the value of some deductions for those in the highest tax brackets.

The important issue now is not such details but the development by the administration of a comprehensive plan that can be the basis for legislation, as the Reagan administration did in 1985 and then revised in 1986 after receiving a lot of reaction. That will require a Treasury secretary committed to providing the resources to produce such a report.

That should be a priority for President Obama in picking a new Treasury secretary. Mr. Bradley deserves consideration.

The alternative way to handle a tax proposal is to make one without thinking through the details. The George W. Bush administration tried that in 2003, when it proposed ending the "double taxation" of dividends, a worthy goal.

Until then, dividends had been taxable as ordinary income, even though — theoretically at least — they came from profits on which companies had already paid

corporate income tax. The Bush proposal called for ending the tax on dividends, but only if the company had actually paid federal income taxes on the profits.

Imagine what would have happened if that became the law. All or most of the dividends of a company like General Electric, which manages to pay very little in the way of federal income taxes, would be fully taxable to shareholders. A company that actually paid taxes would have tax-exempt dividends, which might mean a higher stock price.

Unfortunately, the Bush Treasury Department had not worked out all the details, and officials were soon buffeted with questions they could not handle. In the end, the dividend rate was cut to 15 percent, regardless of whether the companies actually paid taxes. A great opportunity for reform was missed.