EVERYONE knows that America’s tax code is a mess, yet despite considerable talk when elections come around, we’ve done nothing substantial to fix it. What is odd is that there is broad agreement on what should be done. We should strive to get the “lowest possible tax rates on the broadest base,” as five well-known conservative economists put it recently.

In a nutshell, the fewer deductions and other “tax expenditures” we have, the lower the rates can be. That part is simple.

The problem is that cutting rates is more popular than closing loopholes, especially those like the mortgage-interest deduction that are used by millions of taxpayers. But there is a possible solution.

I call it the modified Reagan 28 plan, or just the “28 plan” for short. It is a simple framework for thinking about tax policy. Though I’ve named it in honor of Ronald Reagan, it is similar in many ways to the ideas proposed by the Bowles-Simpson commission, which is a good starting point for any serious discussion of tax reform.

My first premise is that we should devise tax policy from the top down. As everyone now knows, nearly half of American households do not pay any income tax, though they do pay Social Security taxes, sales taxes and so forth. And many households that earn enough to start paying some income tax are essentially on a flat-tax system, because few itemize
their deductions. That means they mostly just pay a percentage of their income above the threshold where taxes kick in. So let’s think about how to tax the rich, then work our way down the income ladder.

For this discussion, let’s define a household as rich if its income exceeds $1 million a year. In fact, my plan applies only to the income such households earn above that threshold. And I can state my idea in just one sentence: All income above $1 million a year for a household will be taxed at 28 percent. There are no deductions, and all income, including capital gains and dividends, is included. President Reagan favored something like this approach. His 1986 tax plan also taxed dividends and capital gains at the same 28 percent rate, as would the Bowles-Simpson proposal.

While we’re at it, let’s make the corporate tax rate 28 percent, too, because our current rate is high by international standards. Oh, and the estate tax exemption? On amounts above $3.5 million for individuals, the rate would be, of course, 28 percent.

What would this plan accomplish? First, by establishing the same marginal rate on all income sources, the incentives disappear for shifting from one source of income to another. Although there is much discussion about how taxes affect people’s willingness to work, most people don’t have much flexibility about how many hours they’re employed. For the rich, however, it can be relatively easy to switch income from a highly taxed category to one that is taxed at a lower rate. One reason that Mitt Romney’s taxes have been so low — he paid an effective federal income tax rate of only 14 percent in the two years for which he has disclosed his returns — is that venture capitalists have figured out a legal way for the incentive fees they receive to be treated as capital gains income, currently taxed at a rate of only 15 percent. If we tax all income at the same rate, these games will end.

But what about the argument that taxing capital gains and dividends at the same rate as ordinary income will discourage investment? I don’t find this claim convincing. People are willing to buy bonds issued by corporations even though the interest is taxed as ordinary income, and I don’t see why investors need a special tax break to induce them to put money in the stock market, which has historically paid high returns. One bonus from adopting this plan would be a short-term windfall to the Treasury from investors realizing their capital gains now, in order to pay the current, lower rate. (Also, I do think that capital gains taxes should be adjusted for inflation.)

Wouldn’t nonprofit organizations suffer if we eliminated the charitable deduction for the wealthy? There might be some effect, but notice that by reducing the marginal rate to 28
percent, the tax incentive to donate would already be quite a bit lower than at current rates of 35 percent or more. And if this political season has taught us anything, it’s that rich people don’t need a tax deduction to contribute to causes they believe in. (Political contributions are not deductible.)

We could pay for the reduction in the corporation income tax by broadening that base as well. There are many special deals — like subsidies to oil companies — that could be eliminated.

Of course, I haven’t said what would happen to the households in the middle, or what the taxes would be on the first $1 million for the rich, but the Bowles-Simpson commission offers a comprehensive plan that is in the spirit of my suggestion. One possibility is to scale back deductions smoothly, starting at household incomes above $250,000, and completely eliminate them for incomes above $1 million. That would leave the popular deductions fully in place for those earning less than $250,000. A more radical plan, curtailing deductions for this large group, is probably politically infeasible, at least for now.

And what if the resulting revenue falls a bit short of what we need to start trimming the deficit? I suggest that we get our gasoline tax more in line with those of the rest of the world. Gradually raising it to something like $1 a gallon would both bring in revenue and help reduce emissions. In the long term, we could set the rate as a percentage of the price at the pump. Maybe 28 percent?

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