progressive policy institute

To: The Next President

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Re: From Tax Cuts to Tax Reform

Memos to the Next PRESIDENT

As the next president, your first priority must be to get our economy going again. This means using federal resources to stimulate growth, promote job creation, and re-establish confidence in the global financial system.

Obviously, these challenges—along with obligations to expand access to health care and college—will cost money. They will also threaten your efforts to restore fiscal discipline, at least in the short term.

One way to address our economic troubles, reduce our deficits, and invest in our future is to get serious about tax policy.

And this does not just mean cutting taxes. Sure, when you were on the campaign trail, you and your opponent got into all kinds of arguments over who would cut taxes more deeply and for more people. That is an American political tradition that goes all the way back to the Boston Tea Party.

But we need something more fundamental now, something rather revolutionary in its own right. Now that the campaign is over and you are getting down to the hard business of governing at a time of grave economic uncertainty, you need to think not merely of cutting taxes, but of reforming our entire tax system.

This memo outlines three concrete ways for you to do just that. It is important to make clear at the outset that these suggestions would be, at worst, revenue-neutral (and, if you are able to constrain spending increases, they would actually help restore fiscal sanity). That is a major consideration as you inherit the Bush deficit.

The three tax-reform policies are as follows:

- Slash through the thicket of current tax breaks and winnow them down to four core incentives that focus on the true economic priorities of the middle class, such as owning a home and paying for college.

- Enact a meaningful middle-class tax cut that remedies the current imbalance between labor income and investment income.

- Simplify business taxation so that our nation's entrepreneurs do not have to waste their time, money, and creative energy on figuring out our convoluted system of shelters and loopholes.

Before we dig into those three points in greater detail, let's start with some basic truths about our tax system. The federal tax code, as presently constituted, is a mess. It does not raise enough revenue to meet our nation's financial needs. Its complexity is a drag on economic growth and innovation. It fails to adequately promote savings and work. It is so confusing that it takes the average taxpayer 31 hours to navigate. And each year it gets worse, as lawyers, accountants, and financial planners identify new loopholes that cost the treasury hundreds of billions of dollars.

Things have gotten so bad that one poll—conducted for the Associated Press by Ipsos-Public Affairs—actually found that a slim majority of Americans would rather go to the dentist than prepare their tax returns.

The good news is that the need for tax reform is so great that your administration will have an historic opportunity to not only simplify the code, but also use it to spur economic growth and help the middle class get back on its feet.

Unfortunately, the most widely-discussed reforms—replacing the current income tax with a consumption tax or a flat tax—are as bankrupt as Wall Street. While proponents of these ideas bill them as bold and innovative reform, the truth is that either one would be a raw deal. Both are horribly regressive and would leave most Americans worse off than they are now.

Consider this: Under a national sales tax, a family making $50,000 per year would pay the same amount in taxes for such basic items as food and clothing as a family earning $500,000. For the lower-income family, sales taxes would add up to a big chunk of the family budget. For the wealthier family, taxes would barely be a consideration. That is not fair.

And while some have argued that a national sales tax would eliminate the need for the IRS, they overlook the fact that we would need a new agency to collect tax revenues from businesses. Worst of all, a national sales tax would have to be much higher than its proponents admit. In fact, the Brookings Institution's William Gale estimates that it would take a sales-tax rate of approximately 60 percent to fund the federal government at its current levels, since taxable retail sales account for less than one-third of all U.S. economic activity.[1]

Advocates for a so-called flat tax call for collapsing the existing five marginal income-tax rates into one. That idea sounds simple, but it would not be cheap. Former Undersecretary of Commerce Robert J. Shapiro has estimated that maintaining current federal revenues would require a 21 percent flat tax, with an initial exemption so as to not tax low-wage families into poverty.[2]

That is cold comfort when you consider that less than one-quarter of all taxpayers are in the tax brackets above the 15 percent rate. If we were to keep the popular deductions such as the ones for mortgages and charitable contributions, the rate would likely have to rise to 29 percent. A flat tax would thus become a substantial tax hike for a large majority of taxpayers. America deserves a better approach to tax reform, one that simplifies the code and actually lowers taxes for middle-class families.

The plan we propose is designed to shore up the very pillars of middle-class aspiration. It would make the tax code work for ordinary American families by providing a tax cut to help pay for college, buy a home, raise children, and save for retirement. Those incentives will help families get into the middle class and stay there. Just as importantly, this plan is fiscally responsible. Coupled with sensible spending cuts and the restoration of budget accountability, it will help reduce our burgeoning federal debt.

Here is a more detailed description of the three basic policies outlined earlier:

1. Four Core Tax Incentives

Over the years, lawmakers have added tax breaks for retirement savings, home purchases, and myriad other hallmarks of middle-class attainment. While well-intentioned, this accrual of new incentives has created a system that is confusing and often at odds with itself. Furthermore, many of the existing tax breaks are not refundable, so they do not go to those who need them most.

To fix this mess, in 2004 PPI proposed eliminating or consolidating some 68 tax breaks that are redundant and sometimes at cross-purposes (including no fewer than 16 tax-favored retirement accounts). Our approach is to replace them with four core tax incentives that would be readily understandable, available to the vast majority of taxpayers, and consistent with the values of work and family. Because the four new incentives would replace existing tax breaks, this plan is budget-neutral. It need not add a single dime to the federal deficit.

The first new incentive would be a refundable College Tax Credit (CTC) similar to the $4,000 American Opportunity Tax Credit you proposed during your campaign.[3] The CTC will provide a fully refundable tax credit to ensure that college is affordable for all American families. This credit will cover 100 percent of the first $4,000 of qualified tuition expenses, making community college essentially free and covering about two-thirds of the cost of tuition at a public four-year college. At a time when access to college loans from banks may shrink, such a credit is more vital than ever.[4]

The second major incentive would be to extend the home-mortgage deduction to non-itemizing homeowners by creating a 10 percent Mortgage Interest Credit (MIC). This refundable credit (also included among your campaign proposals) would offset mortgage-interest payments and make homeownership more affordable for lower- and middle-income families. This universal credit would provide an average tax cut of $500 to 10 million homeowners who do not currently itemize.[5]

Third, a new Family Tax Credit (FTC) would replace and augment three existing tax incentives—the Earned Income Tax Credit, the Child Credit, and the Child and Dependent Care Credit. Qualifying families would receive $1 in a refundable credit for every $2 earned, with a maximum credit of $3,500 for a family with one child, $5,200 for two children, and $7,000 for three children.

Fourth, a Universal Pension (UP) would replace those 16 existing IRA-type accounts with a single portable retirement account for all workers. This proposal would help ensure every American has the option of saving in an easy, automatic pension account. To encourage Americans to open a UP, each worker would receive a $500 stake upon taking his or her first job.

Unlike traditional defined-benefit plans and 401(k)s, a Universal Pension would move with workers from job to job—a necessity in today's fluid labor market. When workers change jobs, their 401(k) accounts would seamlessly transfer to their Universal Pensions, without any cumbersome paperwork or the need to open an IRA. Finally, the UP would expand the existing Savers Credit to match 50 percent of the first $1,000 of savings for families that earn under $75,000 per year, and make the credit fully refundable.

2. A Middle-Class Tax Cut That Rewards Work

During the campaign, you championed a middle-class tax cut to help overburdened families make ends meet. Now, with our country facing a recession, getting middle-class tax relief enacted in the first few months of your administration is even more necessary.

You are right that the top rates of the Bush tax cut should be allowed to expire. Yet with the government bailouts of the financial and housing sectors (along with a possible second stimulus package), that extra revenue alone will not be enough to pay for both a middle-class tax cut and reductions in a fiscal year 2009 deficit—a deficit that some believe may reach an astronomical $1 trillion. That is why we are proposing an additional offset to pay for a middle-class tax cut: a securities-transaction tax.

Currently, the United Kingdom imposes a modest stock-transfer tax of 0.25 percent on every purchase or sale of a share of stock. Despite the existence of this tax, London has gained on New York City as a center of the financial world. A share-transfer tax also appears in some of Asia's most dynamic economies, and does not exactly seem to have hindered their upward trajectory. Malaysia and Singapore each have financial-turnover taxes of at least 0.10 percent. India introduced a securities-transactions tax in 2004, and Japan, Korea, Taiwan, and Hong Kong did so earlier. In each of these cases there were no significant reductions in either price volatility or market turnover. Other countries that have had financial turnover taxes of at least 0.10 percent include Australia, Austria, Finland, and Germany.

In the United States, we had a securities fee from 1914 to 1966—a half-century that, with the obvious exception of the Great Depression, featured an extraordinary rise in wealth and living standards across a broad range of income levels.[6] Indeed, this sort of tax would have almost no impact on typical middle-class shareholders.

A tax of this size, with comparable taxes on various other financial instruments, like options and futures, would help reduce the excessive speculation that has contributed to our current financial crisis. A transaction tax of 0.25 percent on the trading of securities, derivatives, and credit swaps could raise anywhere from $100 billion to $150 billion annually, enough to cover the cost of your middle-class tax plan and then some. Alternately, you could use some of the revenues from the transaction tax to cut the highly regressive payroll tax (thus restoring some balance between how we tax income from work and capital) and apply the rest to extend the life of the Social Security Trust Fund.

For example, you could provide every taxpayer with a $500 refund at a cost of $69 billion annually. That would leave $31 billion to $81 billion for deficit reduction or to help pay for the retirement of the baby boomers, many of whom lost substantial sums in the recent market collapse.[7]

With the financial markets still in a delicate state, you should wait to institute the tax until 2010, at which time the bailout and stimulus packages should have taken full effect. In addition, a time limit could be placed on the transaction tax after the full cost of the bailout has been repaid to American taxpayers (this is expected to occur within 15 years to 20 years).

3. Simplified Business Taxation

Perhaps no section of the code is more convoluted and inefficient than the corporate-income tax. With a federal rate of 35 percent (39 percent if you add in state and local taxes), the United States has one of highest nominal rates in the world. Yet, according to the General Accounting Office, 60 percent of U.S. firms did not pay income taxes from 1996 to 2000. Further, as a percentage of GDP, revenues from the corporate-income tax have dropped from 5 percent to between 1.5 percent to 2 percent in recent years.

With one of the highest rates in the world, why are U.S. corporate-tax revenues declining? The reason is twofold. First, the 35 percent rate only applies to income above $10 million; lower levels of corporate income are taxed at lower rates.

Second, corporations receive a large number of deductions, credits, and other tax benefits that dramatically reduce the income on which they owe. As a result, the Congressional Research Service estimates that the effective corporate tax rate—the share of profits actually paid to the IRS—averages approximately 26.3 percent.[8]

Furthermore, in recent years the use of tax shelters—efforts to actually hide income from taxation—has exploded. While every American business owner has the right to seek ways to save money on taxes, it is hard to see how the profusion of tax refuges available primarily to the very wealthy are good for our Republic at a time of acute budget shortfalls, crumbling physical infrastructure, two wars abroad, a failing healthcare system, and numerous other urgent public needs.

One way to create an environment favorable to all businesses is to reduce the disparities created by the tax code. That is why we recommend you seek legislation to create a loophole-closing commission (comparable to the commissions that have handled the similarly thorny political task of closing military bases), with a mandate to cut the corporate tax structure down to a single low rate. Such a proposal would help eliminate inefficiencies, promote fairness, and reduce the tax burden on the majority of firms. Over the long term, it would also save businesses billions in compliance costs.

In return for reducing the corporate rate, you could consider asking American businesses to contribute to expanding health-care coverage or require every firm to offer its workers a 401(k). To ensure that Congress does not go back and undo tax reform, you could promise to veto any legislation that includes new tax loopholes.

In conclusion, Mr. President, you should make tax reform the leading item on your reform and economic agenda for this reason: Simplifying the code and making it more pro-work and pro-family is key to getting the U.S. economy growing again—for all Americans.

Endnotes

1. Gale, William, "The National Retail Sales Tax: What Would the Rate Have To Be?" The Brookings Institution/Tax Notes, May 16, 2005.
2. Shapiro, Robert J., "The Flat Tax, Flat-Lined: Republicans usually love tax reform. Now that they control Washington, why are they scared of it?" Slate, November, 26, 2002.
3. *http://www.barackobama.com/issues/education/#higher-education*.
4. The average tuition cost of tuition at a public university was $6,185 during the 2007-2008 academic year according to the College Board.
5. *http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf.*
6. Hu, Shing-yang, "The effects of the stock transaction tax on the stock market - Experiences from Asian markets," Department of Finance, National Taiwan University, December 1998.
7. The Internal Revenue Service calculates that in 2007 there were 138 million taxpayers.
8. Maguire, Steve, "Average Effective Corporate Tax Rates: 1959-2002," Congressional Research Service. The CRS estimates apply only to domestic non-financial corporations.

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