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What Real Tax Reform Should Look Like

Federal Tax Reform Should Raise Revenue, Enhance Fairness

Regardless of party affiliation, most politicians will concede that the middle-class is hollowing out, good jobs are too few, and ordinary Americans are financially standing still. Yet policy prescriptions from the Trump Administration and Congress pay lip service to these realities while recycling old hat policy proposals that would cut taxes primarily for the wealthy and corporations. This drive to use the tax code to redistribute money to corporate shareholders and the wealthy does not comport with the idea of economic populism, nor is it the will of the people.

If lawmakers truly want to create an environment in which economic mobility is possible for more working people, budget-busting tax cuts are the wrong way to achieve this goal. Dramatic tax giveaways would force cuts to programs that provide early education, health care, job training, affordable housing, nutrition assistance, and other vital services that promote economic mobility. Further, current tax proposals from Congress and the Trump Administration defy what most Americans would consider true reform and, instead, embrace supply-side economic theories. This policy brief outlines two sensible, broad objectives for meaningful federal tax reform and discusses six tax policies that can help achieve these objectives.

Goals for Federal Tax Reform

1. Tax reform should raise revenue.

The most basic task of any tax system is to raise enough revenue to fund needed public investments, but the federal tax system has consistently failed to achieve this minimal goal. In 36 of the past 40 years, the federal government has run a budget deficit. These continual deficits are not driven by federal spending growth. The Congressional Budget Office (CBO) estimates that in 2016, federal spending as a percentage of the nation's Gross Domestic Product was lower than in any year of Ronald Reagan's presidency. Since 2010, discretionary spending has fallen by 30 percent as a share of the economy.[1]

The main driver in the nation's ongoing budget deficits is declining federal tax revenues, driven by sweeping tax cuts enacted more than a decade ago.[2] From 2009-2012, federal revenues were lower as a share of the economy than at any time since the early 1970s.[3] While revenue has bounced back somewhat, U.S. tax collections are still well below those of most other nations. In 2015, the U.S. collected less tax revenue as a percentage of its economy than did almost any other economically developed country.[4]

Looking forward, the main driver of long-term spending will be demographic shifts requiring significant increases in spending on Social Security, Medicare, and Medicaid.[5] The nation needs additional revenue to continue to ensure these programs provide robust services to a wide swath of Americans. In addition, more public investment in healthcare, infrastructure and research is needed to keep the nation's economy competitive. For these reasons, the primary goal of tax reform should be to raise federal revenues substantially.

Changes to the federal tax code must strengthen the federal tax system in both the short run and the long term. But President Trump's proposed tax plan and the House Republicans' plans would cut taxes substantially. In fact, ITEP analyses show President Trump's campaign tax plan (which includes many of the ideas in the sketch plan he released on April 26) would lose \$4.8 trillion[6] in tax revenue, while the House Republican plan would lose \$4.0 trillion,[7] over ten years.

Unfortunately, even some current Congressional proposals that emphasize raising revenue in the short run do so at the expense of sustainable long-term tax revenue. For example, proposals to enact a "tax holiday" for trillions of dollars in cash that American corporations are currently holding offshore would provide a small short-term revenue boost, but at the same time would mean forgoing a much larger long-term revenue stream if these companies paid their fair share of the corporate tax when they eventually repatriated these profits. [8]

A sensible litmus test for any proposed tax reform or major change to the tax code is whether it would help provide sustainable long-term tax revenue or undercut this goal. At a minimum, any tax reform proposal should be revenue neutral, meaning that it will not make the revenue gap worse.

2. Tax reform should increase the progressivity of the tax code.

Fairness is in the eye of the beholder, but Americans generally agree that a fair tax system is a progressive tax system. Contrary to the "skin in the game" rhetoric used by some politicians, Americans at all income levels pay a significant share of their income in taxes to support public services.

Compared to state tax systems, the federal income tax is progressive. The Earned Income Tax Credit, Child Tax Credit and progressive tax bracket structure enable lower-income people to pay a smaller share of their income in federal income taxes than upper-income and wealthy taxpayers. State tax systems, however, capture a far greater share of income from lower-income people than their very richest residents.[9] So, when our collective local, state and federal tax systems are collectively examined, the nation has an overall nearly proportional or flat tax system. This means total taxes paid by each income group are roughly equal to the share of total income received by that group. For example, the poorest 20 percent of taxpayers will pay only 2.0 percent of total taxes this year, which is roughly on par with their share (3.3 percent) of total income. Meanwhile, the richest 1 percent of Americans will pay 23.8 percent of total taxes and receive 21.7 percent of total income in 2017.[10] Even though the lowest-income Americans contribute 2 percent of all local, state and federal tax revenue, the sum accounts for 19.1 percent of their income on average. The average annual income in this group is about $15,700, so even families living significantly below the federal poverty threshold pay one of every five dollars of their income in local, state and federal taxes.[11]

Mitigating poverty and creating conditions in which more citizens can contribute to our nation's economy is a worthwhile public policy goal. Requiring the poorest Americans to spend a fifth of their income on taxes is tantamount to making the poor poorer. For this reason, a minimal goal of revenue-raising federal tax reform should be to avoid increasing taxes on the most vulnerable Americans beyond their current level. A more ambitious goal would be to make the federal income tax more progressive. The nation's federal tax system is not as progressive as it could be because the code is riddled with special carve-outs that allow the wealthiest Americans to avoid paying their fair share. According to the CBO, the major tax expenditures in the code go disproportionately to the wealthy, with 16.6 percent of the benefits of these breaks going to just the top 1 percent of taxpayers.[12] Taken together, tax expenditures make the income tax system substantially less progressive. Any serious tax reform effort should start with eliminating and reforming tax expenditures that disproportionately benefit the wealthy.

Yet the tax plans proposed by congressional leaders and President Trump would move in the wrong direction. As much as 44 percent[13] of the tax cuts in President Trump's tax plan released during the campaign and 60 percent[14] of the House Republican's "A Better Way" tax plan would go to the top 1 percent of taxpayers. The key problem is that the cuts to the top marginal personal and corporate income tax rates in both plans are so large that they overwhelm the size of any base-broadening aimed at wealthier taxpayers in the rest of the plans. In fact, an ITEP analysis of the House Republican tax plan found that if implemented, it would take our overall tax system from flat or barely progressive to outright regressive.[15]

Six Proposals for Tax Reform

1. End Offshore Tax Avoidance.

Many of the biggest Fortune 500 corporations find ways to shelter their U.S. income from taxes altogether. A 2017 ITEP report found that 100 profitable Fortune 500 companies were able to avoid all federal income taxes in at least one year between 2008 and 2015.[16] In many cases, these zero-tax corporations are simply claiming generous tax breaks that have been enacted by Congress (at the behest of corporate lobbyists) over the years. All too often, these tax provisions lavish huge tax cuts on the most profitable corporations while offering little to smaller businesses with less lobbying clout.

Many of the same big multinational corporations are aggressively seeking to avoid taxes by claiming, for tax purposes, that their U.S. profits are earned in offshore tax havens.[17] This practice results in an estimated loss to the U.S. Treasury of more than $100 billion annually.[18] This practice has gotten so bad that Fortune 500 companies now report having accumulated more than $2.6 trillion in earnings that they claim is offshore.[19] This widespread income-shifting stems largely from an arcane feature of the U.S. corporate tax law: American multinational corporations are allowed to "defer" paying U.S. taxes owed on the profits of their offshore subsidiary companies until those profits are officially brought to the United States.

The most straightforward way to stop this sham is to end deferral. This would mean that all profits of American corporations are subject to the U.S. corporate income tax whether they are domestic profits or foreign profits generated by offshore subsidiaries. This change would eliminate the incentive for an American corporation to move its operations offshore or to make its U.S. profits appear to be generated in an offshore tax haven. Based on the amount of revenue lost to the deferral loophole, ending deferral could raise as much as a trillion dollars over 10 years.[20]

As for the existing earnings being held offshore, companies should have to immediately pay what they owe, meaning that they should pay the full 35 percent rate minus foreign tax credits. This move alone could raise $767 billion,[21] an amount that is significantly higher than what is in a variety of proposals that would give companies a significant tax break on these offshore earnings.[22]

As a complement to ending deferral, a series of anti-inversion measures should be included to prevent U.S. companies from using expatriation as a back door to escape paying their fair share. Anti-inversion legislation should curb earnings stripping and better define what constitutes an American company (based on where a company is managed and controlled and its stock ownership).[23]

One final needed reform to end offshore tax avoidance is requiring companies to report financial information on a country-by-country basis. Such a reform would give the media, government, and public a clear picture of just how much companies are paying or not paying and enable them to ensure that companies are paying their fair share.[24]

2. Clean Up the Corporate Tax Code.

The problems with the corporate tax code go well beyond issues with offshore tax avoidance. The corporate tax code is riddled with a variety of ineffective tax breaks that cost the U.S. Treasury billions of dollars each year.

Besides the deferral loophole, the next largest corporate tax expenditure is accelerated depreciation, with a price tag of $225 billion over 10 years.[25] This break allows companies to deduct their capital purchases at a rate faster than those assets depreciate. The size of this break has expanded in recent years with the inclusion of so-called "Bonus Depreciation," which allows companies to immediately deduct 50 percent of the cost of capital investments.[26] There is ample evidence that despite claims of its proponents, this costly tax break does very little to stimulate investment[27] and thus would be ideal for reform or repeal.

Also ripe for reform—or elimination— is the research credit. While well-intentioned, the credit is undermined by the fact that the research eligible for subsidies is too broadly defined. For example, the research credit has gone to help research fast food packaging, fashion designs, and hair styles, which are not exactly the scientific breakthroughs that lawmakers intended to subsidize.[28] In addition, the credit can be taken retroactively, which means that in many cases it is not incentivizing new research. The research credit should either be significantly reformed or eliminated.[29]

Another egregious giveaway is the stock option loophole, which allows companies to deduct millions or sometimes billions from their tax liability for the compensation of executives through the granting of stock options that cost the company nothing. A recent report found that Fortune 500 companies managed to avoid $64.6 billion in taxes over the last five years using this loophole.[30]

There are numerous other corporate tax breaks that should be curtailed or eliminated entirely. These include special breaks for oil and gas drilling, building NASCAR tracks, domestic manufacturing (also not well defined), and a slew of others.[31]

3. Tax Wealth Like Work.

The single most egregious loophole in the individual income tax code is the preferential rate for capital gains and dividend income. The tax code treats income derived from wealth more favorably than income derived from work. This explains why, for years, billionaire investor Warren Buffett was able to make the startling claim that his secretary paid a higher tax rate than he did.[32]

The top tax rate on capital gains and dividends income is currently 23.8 percent, well below the 39.6 percent top tax rate on salaries and wages. Two-thirds of all capital gains and 38 percent of dividends are enjoyed by the top 1 percent of Americans.[33] More so than virtually any other feature of the tax code, this preferential tax rate exacerbates widening economic inequality.

The solution to this loophole is simple: capital gains and dividend income should be taxed at the same rate as wage income. Such a reform would raise a substantial amount of revenue, over $613 billion from capital gains and over $231 billion from dividends over 10 years.[34] This reform would also ensure that the Warren Buffets of the world will pay a higher, rather than lower, tax rate than middle-income workers.

4. Reform, Limit, or Eliminate Tax Expenditures.

On the individual side, there are a variety of tax loopholes that both complicate the tax code and make it less progressive.[35] Even popular deductions like the mortgage interest deduction or the deduction for charitable giving are skewed toward the top and in need of substantial reform to make them more targeted and progressive. Any serious tax reform effort should go through the individual tax expenditures in the code one-by-one and eliminate or reform those that are not achieving the goals set out for them or are making our tax code more unfair.

For example, numerous overlapping tax breaks exist for higher education which add complexity to the code while lavishing tax breaks unnecessarily on the best-off Americans.[36] The best approach, short of scrapping the tax credit entirely and providing better funding for Pell grants, would be to replace the numerous credits with a single, better-targeted refundable credit for higher education.

Rather than taking on each individual tax expenditure, a second-best approach would be to strengthen the alternative minimum tax, which disallows the use of most tax expenditures at higher income levels. A more direct approach to reducing the harm created by the slew of deductions in the code would be to enact a broader limit on the size and regressivity of itemized deductions. One way to do this would be to limit the rate at which deductions can be taken, which is the approach proposed by former President Barack Obama, who would have limited deductions to 28 percent for each dollar deducted.[37] Another approach would be to put a total dollar limit on the deductions that can be taken, which was the approach taken in President Trump's campaign tax plan when he proposed to limit the total deductions to $100,000 for a single person or to $200,000 for joint filers.[38] Either approach would limit the cost and unfairness of itemized deductions.

5. Reform the Estate Tax.

The estate tax has long been a bulwark in the tax code against the unearned accumulation of wealth. In recent years, however, the robustness of the estate tax has dwindled as lawmakers have increased the exemption level, reaching $5.5 million in 2017. In addition, wealthy individuals have taken advantage of legal loopholes to avoid paying a significant amount of the tax. According to the Joint Committee on Taxation, the estate tax applied to only the richest 0.18 percent (or less than 1 in 500 estates) in 2013, well below the historic average of 1 to 2 percent of estates.[39] For those owing any estate tax, the average rate was just 20.5 percent, substantially less than the marginal tax rate.

To raise critically needed revenue and counter wealth inequality, the estate tax should be substantially reformed. First, this would mean restoring the exemption level closer to historic norms such that it applies to around 1 to 2 percent of estates and potentially increasing the tax rate, which at 40 percent is significantly lower than the 55 percent level it was set at during the 1990s. One specific proposal along these lines would have lowered the exemption to $3.5 million and raised the top rate to 45 percent.[40] Estate tax reform should also include closing loopholes in the code such as the Grantor Retained Annuity Trust (GRAT), which allows wealthy people to use trusts to reduce or eliminate a substantial amount of taxes on gifts to their children.[41]

An important related reform would no longer allow capital gains income to escape taxation at death. Currently, heirs receive a "stepped-up" basis on any assets they inherit, meaning that they do not owe any tax on unrealized capital gains. The best way to fix this would be to require that capital gains be realized and then taxed at death, ending the lock-in effect on capital gains and also ensuring that huge swaths of capital income face at least a single layer of taxation.[42]

6. Expand the EITC for Workers Without Children in the Home.

Unlike most tax expenditures, the Earned Income Tax Credit (EITC) has proven to be highly effective at making the tax code more progressive, reducing poverty, and increasing employment.[43] Along with the Child Tax Credit (CTC), the EITC lifted 9.2 million people out of poverty in 2015 according to the latest Census data.[44] The EITC has proven to be that rare tax credit that is both effective and has garnered bipartisan support since its inception.

But the EITC can be strengthened in one important area. Historically, it has provided little to no benefit to workers without children in the home (sometimes labeled childless workers). These workers are the only group of people that the federal income tax pushes deeper into poverty. The best way to prevent this would be to expand the maximum benefit for workers without children in the home from $503 to $1,400. In addition, lowering the eligibility age of these workers from 25 to 21 would also provide a boost to young people just starting out in the workforce. Taken together, these policies would provide 10.6 million individuals and families with an additional $6.4 billion in annual benefits or an average additional benefit of $604 each.[45]

Putting It All Together

Our tax system chronically underfunds the public investments the American people support and want, and it does so in a way that pushes low-income families further into poverty while allowing huge corporations and the wealthy to avoid paying their fair share. True tax reform should raise revenue in the short run to help meet the country's pressing budgetary needs, while simultaneously creating a sustainable long-term revenue stream to meet tomorrow's needs. Tax reform should also avoid making inequality and poverty greater problems than they already are. Each of these goals can be achieved by closing unwarranted loopholes, while preserving and expanding valuable low-income tax credits.

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