Financing Options for Progressive Reform

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Introduction

The work of the Kerner commission and the Milton S. Eisenhower Foundation has recognized the potential for the federal government to put in place policies that can make a real improvement in peoples' lives, and in the fabric of society. They have also recognized that real change means a real national commitment to finance policies that will bring about those changes.

But can we afford to increase our national commitments to achieve a more equitable society? The answer is clearly "yes" – as one of the richest nations we have the means – we only need the will. Poverty and racial inequalities have real costs to society as a whole, not just those living in poverty. Thus reductions in poverty will benefit the nation and the economy—thus federal programs to reduce poverty can be seen as needed national investments, not just as targeted individual benefits. So in many ways, we cannot afford not to address these concerns.

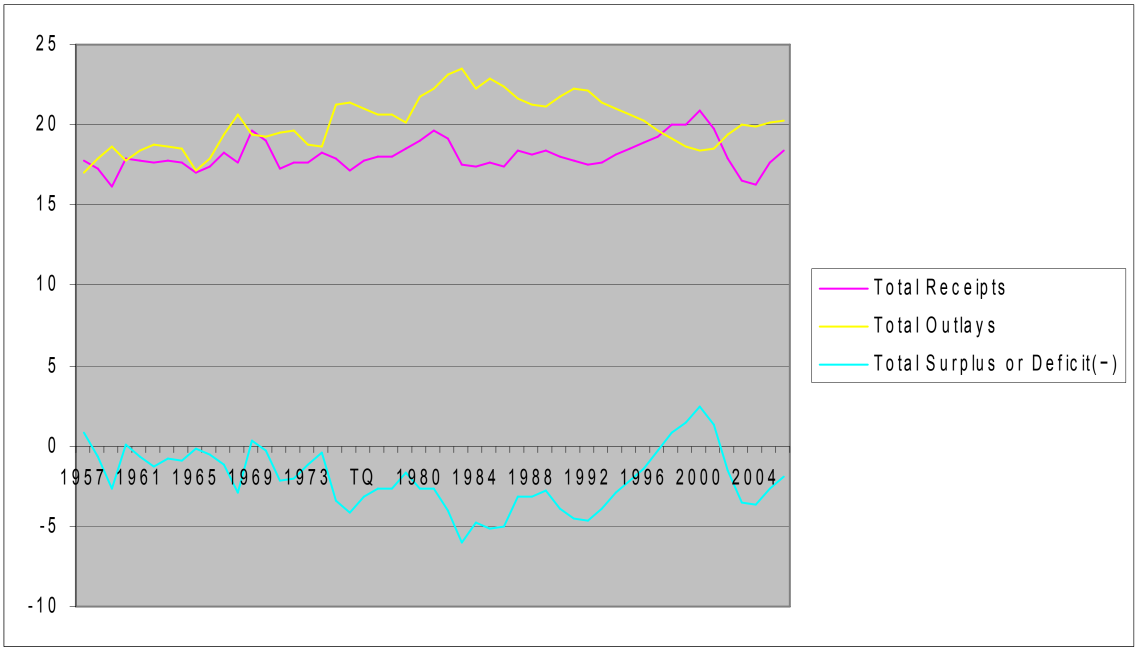
Several areas of the tax code can be revised to make the tax code fairer while also increasing federal revenues, which could be used to finance the proposals included elsewhere in this series. This paper will put our national budget into context first by looking at historic levels of revenue and spending in the U.S. The following section will look at specific changes to the tax code that would yield additional revenue in a progressive manner. The final section looks at two options to diversify our overall revenue sources, a value added tax and revenues from a limit to carbon emission.

Sources of revenue

To put revenue options in context, we first look at the big picture of tax revenue and spending over the last half century. While we have seen some variation over time both federal revenue and spending have represented about a fifth of the economy over this period.

Over the last 50 years, revenue as a share of the economy has fluctuated between 16 percent and 21 percent of GDP, averaging 18.1 percent over this time (Figure 1). Rarely have these revenues been sufficient to cover expenditures, resulting in deficits that have averaged 2.0 percent of GDP over this period. The late 1990s was a notable exception with revenues exceeding spending for several years.

Figure 1. Federal Receipts and Outlays as a share of Gross Domestic Product, 1957-2007



The composition of federal revenues has changed over this time as well (Figure 2). Individual income taxes are the largest contributor averaging about 46 percent of total revenues (Figure 3). Corporate income taxes have declined in importance and represent about 15 percent of revenues. Social Insurance revenue, primarily from the social security payroll tax, has seen an increase in importance, and now represents over a third of revenues.

For the near future, we can expect deficit levels to remain largely unchanged. Under current law, deficits are expected to decline; however, likely changes to the alternative minimum tax and the extension of (at least some of) the bush tax changes means that deficits on the order of 1.5 to 2 percent are likely under current policy.

While deficits of this level are likely sustainable – they leave little room to expand federal poverty programs, to overhaul the nations health system, or to expand work supports. The next section thus looks at areas of the tax code that could be used to expand the revenue base.[1]

Figure 2. Composition of Federal Revenue, 1957-2010

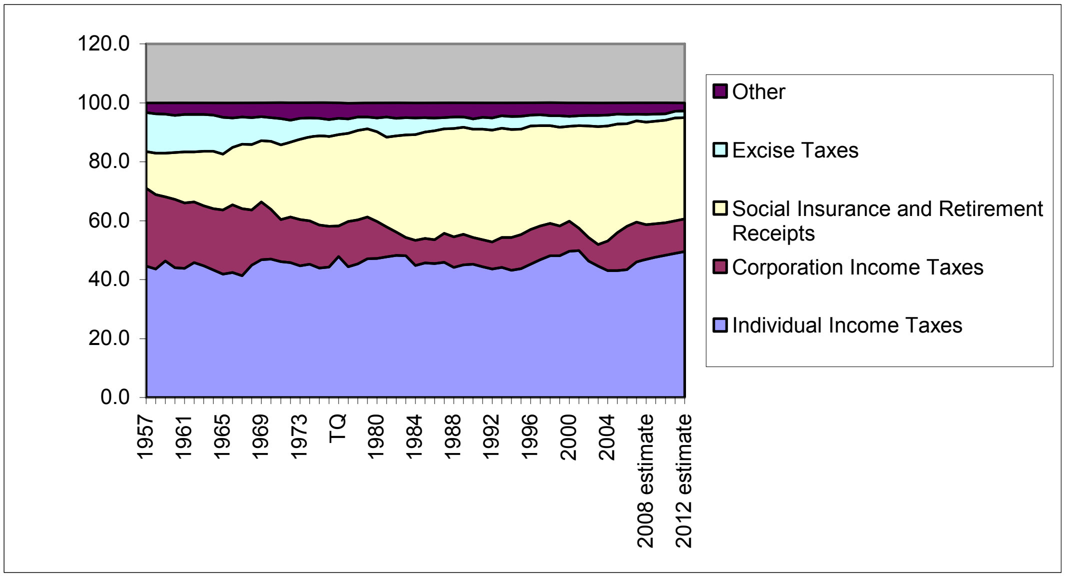
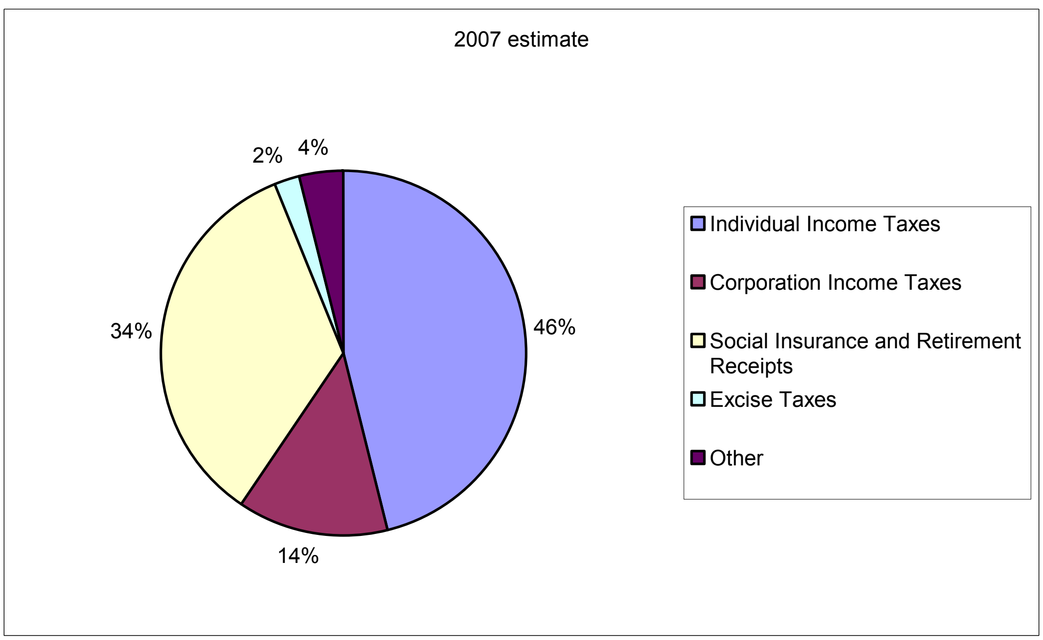


Figure 3. Composition of Federal Revenue, 2007



[1] Program expansion could be financed by spending reductions; however, this paper focuses exclusively on the revenue side of the ledger.

Revenue enhancements

Objections to progressive reforms all too often come from a claim that they are "too expensive" or that they would lead to higher deficits. As noted above, in many cases, progressive reforms should be considered investments, and thus deficit financing may be appropriate. In other cases, we may wish to couple progressive spending with changes to the tax code that would yield more revenue.

There are many changes to the tax code that would represent not just revenue enhancements, but also progressive tax policy. Many of these changes are listed below, (and summarized in Table 1.)

Table 1. Summary of Revenue Options

[NOTE: NEED TO REVISE TO CORRESPOND w/FINAL TEXT]

Tax Change	Revenue	Horizon	Source
Tax Capital Gains and Dividends at Ordinary Tax Rates:	$901 over '	2008-2017	TPC, Table T07-0212
Enforcement	as much as $290 billion/year		
Capital Gains Basis	$11 billion/'	2001	
Loopholes and tax expenditures	as much as $911 billion/year		
Offshore avoidance	$40 to $70 billion/year		
Carried Interest	$26 billion/10 years		
Corporate tax expenditures	At least $350 billion / 10 years		
Bush Tax Changes: Reversal			
Cost of all changes	$3.5 trillion/10 years		
Increase Top 2 marginal tax rates by 1 percenta	$100.9 billion / 10 years		
Limits to deductions and Exemptions	$28.6 billion / 10		
Estate tax			
Make permanent 2009 law			
Payroll Tax			
Raise Cap to cover 90%	$524.4 billi	2008-2017	

Capital gains and dividends

The tax code currently provides preferences for income generated from wealth relative to income from work. The top marginal tax rate capital gains and dividends is just 15 percent, while the tax rate on labor income for middle-income taxpayers can easily soar to twice that once the payroll tax is included.

This preference for capital also leads high-income taxpayers to attempt to reclassify labor income as capital income. Many private equity and hedge fund managers have done exactly this by taking income as "carried interest" and paying just 15 percent rather than a marginal tax rate of 35 percent that other high-income taxpayers must pay.

This preference for capital income has two important implications. First, it provides an incentive for high-income individuals to reclassify their income to better avoid their tax obligations. Recent revelations by hedge fund managers and private equity executives[2] taking income as "carried interest" shows that this is real concern.[3]

Second, reductions in the preferential rates for capital income are a windfall for those that have significant wealth. More than half of all capital gains and dividends subject to preferential rates are realized by those making over $1 million per year.[4]

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[2] *See* Sarah Lueck, Jesse Drucker, and Brody Mullins, "Congress Hunts For Tax Targets Among the Rich: Revenue Search Looks Beyond Private Equity" *The Wall Street Journal*, June 22, 2007. http://online.wsj.com/article/SB118247664712544353.html.

[3] Former Treasury Secretary Robert Rubin was quoted as saying: "It seems to me what is happening is people are performing a service, managing peoples' money in a private equity form, and fees for that service would ordinarily be thought of as ordinary income," at New York Times DealBook: "Rubin Urges Scrutiny of Private-Equity Tax Treatment" June 13, 2007. http://dealbook.blogs.nytimes.com/2007/06/13/scrutiny-on-tax-rates-that-fund-managers-pay/. See also Peter Orszag, "The Taxation of Carried Interest", Statement before the Committee on Finance, U.S. Senate, July 11, 2007. http://www.cbo.gov/ftpdocs/83xx/doc8306/07-11-CarriedInterest_Testimony.pdf

[4] Joel Friedman and Katharine Richards, "Capital Gains and Dividend Tax Cuts: Data Make Clear That High-Income Households Benefit The Most," Center on Budget and Policy Priorities, January 30, 2006. http://www.cbpp.org/1-30-06tax2.htm.

Reversal of Bush Tax Changes

The tax changes enacted by President Bush have been costly. Extending the 2001 and 2003 tax changes (together with a patch to the AMT) would cost $3.5 trillion over the next decade from 2008-2017 (or 2.0% of GDP over this period).[5]

The tax changes from 2001-2006 have been skewed towards those with high incomes.[6] Those with annual incomes above $1 million received an annual tax reduction averaging over $119,000 in 2007, while those in the middle quintile received only about $750 on average. These tax changes have added to growing income inequality.[7]

These changes have not resulted in a strong economy. Economic performance in the current expansion has fallen below past expansions by virtually every measure[8] including GDP growth, investment growth, employment growth, and wage and salary growth. Corporate profits are the one bright spot where the current expansion has surpassed prior booms.

Specific items that could be addressed include:

> *Increase Top marginal tax rates*
> Given the skewed distribution of these changes and the tremendous cost, a reversal of some of there most regressive components should be reexamined. For example, increasing the top two marginal tax rates by 1 percentage point would yield $101 billion in revenues over the next 10 years.[9]

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[5] Author's calculations based on Congressional Budget Office projections, see The Budget and Economic Outlook, An Update, August 2007, at http://www.cbo.gov/ftpdoc.cfm?index=8565&type=1 .
[6] Greg Leiserson, and Jeffrey Rohaly, "The Distribution of the 2001-2006 Tax Cuts: Updated Projections, November 2006." Tax Policy Center..http://www.taxpolicycenter.org/UploadedPDF/411378_tax_cuts.pdf.
[7] See T. Piketty and E. Saez analysis of income data at http://elsa.berkeley.edu/~saez/TabFig2005prel.xls
[8] Aviva Aron-Dine, Chad Stone, and Richard Kogan, "How Robust is the Current Economic Expansion?" Center on Budget and Policy Priorities, October 16, 2007, at http://www.cbpp.org/8-9-05bud.htm.
[9] *See* Congressional Budget Office "Budget Options." February 2007. http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf.

Restore Limits to itemized deductions and personal exemptions.

Provisions of the 2001 tax law repealed limits to itemized deductions and personal exemptions for very-high income taxpayers. Restoring these provisions would yield $28.5 billion over 10 years.[10]

Enforcement and loopholes – individual and corporate

The tax code is full of holes—both legal and illegal—that allow individuals and corporations to avoid paying taxes. In 2006, there were a total of $911 billion in tax expenditures included in the tax code.[11] While some of these provisions contain valuable incentives to businesses and individuals, there are also many provisions that are simply used to reduce tax obligations.

In addition to this legal avoidance, billions of dollars are owed to the federal government, but are never collected. Under-reporting (and non-reporting) of income and other forms of illegal evasion cost compliant taxpayers billions. This amount of uncollected revenue, the so called "tax gap," was estimated by the Internal Revenue Service to be approximately $345 billion in 2001.[12] While the IRS expects to recover a portion of this—around $55 billion—it is still estimated that nearly $290 billion will go uncollected. The non-collection of this amount of revenue essentially means that the tax rate necessary fund the government is higher than it need be.

Closing the entire gap would be difficult, but there are some simple steps that could be taken to collect more of the revenue.

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[10] *See* H.R. 3970, Tax Reduction and Reform Act of 2007, Committee Description, October 29, 2007. http://waysandmeans.house.gov/media/pdf/110/Summary%20for%20Distribution.pdf.

[11] Jason Furman, Lawrence H. Summers, and Jason Bordoff, "Achieving Progressive Tax Reform in an Increasingly Global Economy" Brookings, June 2007. http://www3.brookings.edu/views/papers/furman/200706bordoff_summers.pdf.

[12] Government Accountability Office. "Tax Compliance, Multiple Approaches Are Needed to Reduce the Tax Gap." Statement of Michael Brostek, Director, Tax Issues Strategic Issues, February 2007. http://www.gao.gov/new.items/d07488t.pdf

- Requiring the reporting of stock purchase prices to be used in the calculation of capital gains revenue. While financial firms are already required to report stock sales, dividends, and interest payments, they are not currently required to report the purchase price, which is essential to calculate capital gains tax liability. The tax gap for capital gains underreporting was estimated to be least $11 billion in 2001, and is likely to be greater today.[13] Enacting this requirement for just new stock and security purchases would yield over $4 billion over 10 years.[14]

Closing loopholes and eliminating tax expenditures for individuals and corporations could also yield billions while at the same time leveling the playing field for businesses and making the code fairer.[15]

- Individuals:
    - It is estimated that individual taxpayers use offshore tax schemes to evade between $40 and $70 billion in taxes every year.[16]
    - As noted above, private equity and hedge fund managers can reclassify their income so as to receive preferential treatment of their income. Eliminating this "carried interest" loophole alone would yield an estimated $26 billion over the next 10 years.[17]
    - Depending upon the health care reform proposed, there may be additional savings through the associated repeal of tax expenditures for health related items. For example, a national health care system could eliminate the need

[13] Government Accountability Office. "Requiring brokers to report securities cost basis would improve compliance if related challenges are addressed." Washington, DC, June 2006. www.gao.gov/new.items/d06603.pdf.
[14] Joint Committee on Taxation. "Estimates of federal tax expenditures for fiscal year 2007-2011" September 24, 2007. http://www.house.gov/jct/s-3-07.pdf
[15] A full description of tax expenditures and cost estimates put forth by the Joint Committee on Taxation can be found at http://www.house.gov/jct/s-3-07.pdf .
[16] *See* Minority and Majority Staff Report, Permanent Subcommittee on Investigations, "Tax Haven Abuses: The Enablers, The Tools and Secrecy." August 2001, at http://www.senate.gov/~levin/newsroom/supporting/2006/PSI.taxhavenabuses.080106.pdf, and Joe Guttentag and Reuven Avi-Yonah, "Closing the International Tax Gap," in Max B. Sawicky, ed., Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration. Economic Policy Institute, 2006.
[17] Joint Committee on Taxation. "Estimates of federal tax expenditures for fiscal year 2007-2011" September 24, 2007. http://www.house.gov/jct/s-3-07.pdf

for tax incentives for employer provided health insurance, saving $628.5 billion from 2007-2011. Even more limited changes could eliminate the role tax preferences for health savings accounts, saving $4.6 billion from 2007-2011.

- Corporate:

Currently, the U.S. has one of the world's highest statutory corporate tax rates, but one of the lowest effective tax rates. Analyst Jason Furman of the Brookings institution notes: "The United States has the second highest corporate tax rate of the 30 countries in the Organization of Economic Cooperation and Development (OECD). But because the United States has so many generous special tax preferences for businesses, it collects the fourth lowest corporate tax revenues as a share of GDP among all OECD countries."[18] Closing many of these holes in the tax code would yield revenue to fund other priorities, lower the statutory rate, or both.

In total, corporate tax expenditures total tens of billions per year.[19] Recent legislation introduced by House Ways and Means chair Charlie Rangel proposes to eliminate many of these tax expenditures, which combined raise $350 billion in revenue.[20] The proposal uses this revenue to reduce corporate marginal tax rates from 35% to 30.5%; however, some of the savings could be used for other priorities as well.

Estate tax

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[18] Jason Furman, "Corporate Taxes, in Need of Reform" *Think Tank Town at Washingtonpost.com*. Saturday, October 27, 2007, at http://www.washingtonpost.com/wp-dyn/content/article/2007/10/26/AR2007102601860.html

[19] Joint Committee on Taxation. "Estimates of federal tax expenditures for fiscal year 2007-2011" September 24, 2007, at http://www.house.gov/jct/s-3-07.pdf

[20] See H.R. 3970: Tax Reduction and Reform Act of 2007, at http://waysandmeans.house.gov/media/pdf/110/Summary%20for%20Distribution.pdf

The estate tax as currently enacted impact on a handful of very wealthy decedents. Individuals can exempt up to $2 million, and married couples can exempt up to $4 million from taxation, meaning that more than 99 percent of all decedents are completely exempt. At the same time, the estate tax is valuable in ensuring that the very wealthy pay their fair share.

Under current law, the estate tax is set to phase out, with the exemption set to increase to a $3.5 million (or $7 million per couple) in 2009. In 2010 the estate tax is scheduled to be fully repealed, while in 2011 it returns at $1 million per couple. Retaining the estate tax would yield additional revenue relative to the no-repeal option currently favored by President Bush and many conservatives.[21] For example, making the exemption and tax rates permanent at 2009 levels in 2010 and beyond would raise $266.9 billion additional revenue relative to making the 2010 repeal permanent.[22]

Payroll tax

Approximately two-thirds of the population pays more money in federal payroll taxes than in federal income taxes.[23] As shown above, the payroll tax has become an increasingly important part of overall revenue. However, the payroll tax is regressive: since taxes are collected on the first dollar earned, the tax rate is a flat 15.3 percent (including Medicare), and since the amount subject to the Social Security tax is capped at 97,500 (for 2007) and rises slightly each year. Those making more than the cap are thus taxed at lower effective rates than those earning below the cap.

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[21] Maintaining the estate tax with exemptions above $1 million and at rates below 55 percent past 2011 would be a revenue loser with respect to current law.

[22] CBO, "Budget Options" and authors calculations. February 2007, http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf

[23] *See* Burman and Leiserson, "Two-Thirds of Tax Units Pay More Payroll Tax Than Income Tax," *Tax Notes*, April 9, 2007. http://www.taxpolicycenter.org/UploadedPDF/1001065_Tax_Units.pdf

In addition, wealthier taxpayers also receive a greater share of their income outside of payrolls (through, for example, capital gains or dividends). Thus a greater share of their income is not subject to the social security payroll tax at all.[24]

Raising or eliminating the cap on the amount of taxable income subject to the social security payroll tax would yield additional revenue to the federal government, and make the overall tax less regressive.[25] For example, increasing the maximum taxable earnings to 90 percent of all earnings (or about $186,000 in 2007) would yield an additional $524 billion over the next 10 years.[26] This additional revenue could go a long way towards reducing the long-run actuarial shortfall in social security or even make additional room to improve benefits, and would also reduce the overall budget deficit.

Revenue dedication and diversification

As noted above the current tax code raises revenue from three main sources, the individual income tax, payroll taxes, and corporate income taxes. Many have suggested that alternative revenue sources would be able to provide additional resources for either general usage, or to be dedicated to a specific program. For example, a major overhaul of the nation's health care system—one that would provide universal coverage—would likely require significant revenue increases to prevent deficits from rising to unsustainable levels. Two often cited new sources of revenue – a value added tax (VAT) and a carbon tax (or permit auction) are discussed briefly below.

Value Added Tax

A value added tax is imposed at the firm level, and is a tax based on the difference between a firm's final sales and their purchases of inputs, such as raw materials, from other firms. Such a tax would behave much like a national sales tax in that the tax would generally result in higher (after-tax) prices for consumers, who would then bear most of

[24] There is no cap on the Medicare portion.
[25] The 2.9 percent Medicare tax is already applied to all payroll income with no limit.
[26] Congressional Budget Office, "Budget Options" February 2007.
http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf

the burden on the tax. The revenue potential of a VAT is significant: A 1% VAT in the U.S. would raise approximately $50 billion per year, with some variance depending upon implementation.[27]

Because the VAT is a tax on consumption, it is typically viewed as a regressive tax—that is, a tax for which lower-income taxpayers pay a greater share of their income than upper-income taxpayers. Since lower-income consumers tend to spend a greater share of their income on consumption, they will pay a greater percentage of their income on the VAT than would a high-income consumer.

Some remedies have been proposed to lessen the degree of regressivity including providing a rebate to low-income taxpayers or adjusting the tax base to exclude items, such as food, that represent a greater share of low-income household's consumption basket. However, since a VAT can be applied only at a single rate, it is more difficult to make the tax progressive for higher-earners. As such, a VAT that replaces a more progressive tax (such as the federal income tax or a corporate income tax) in a revenue neutral way would mean a less progressive tax code overall, and would likely result in a tax increase for low- and middle-income taxpayers, with upper-income individuals seeing a windfall gain.

The appeal of a VAT, however, may be restored if the revenues are dedicated to a program with wide-spread progressive benefits.[28] The VAT, for example, is sometimes discussed as possible dedicated revenue source for universal health insurance. Also, implementing a VAT with other tax changes – such as an enhancement to the earned income tax credit and reductions in marginal income tax rates for the middle-class – could maintain overall progressivity in the code.

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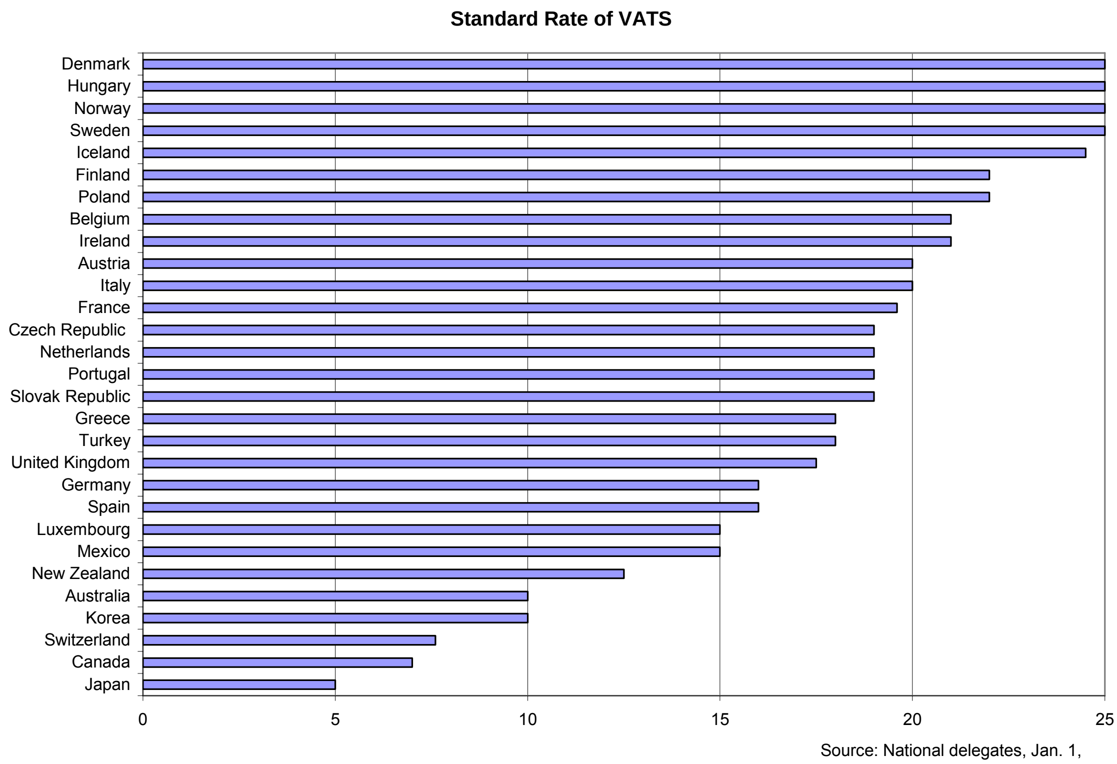
[27] See James Bickley, "Value added tax: A new revenue source?" Congressional Research Service, August 2002. http://assets.opencrs.com/rpts/RL33619_20060822.pdf.

[28] VATs also have other potential benefits—including increased reporting and compliance in the case of a credit-invoice VAT, and increased returns to savings—that are not addressed here.

Other observers have also noted that most other advanced countries rely more heavily on consumption taxes, including the VAT, and that they also have more expansive social services, including health care.[29] In fact, the U.S. is the only OECD country to not have a VAT—a VAT is a requirement for membership in the EU. Figure x shows tax rates in the OECD nations,[30] with VAT rates ranging from 5 percent to 25 percent. Clearly, other nations believe that a VAT is a valuable complement to other parts of their tax code.



Carbon Limits

A second prominent example comes from the growing desire to seriously address the causes of global warming. Limiting emissions of carbon into the atmosphere through either a carbon tax or the auctioning of permits could also yield tens of billions (or more) annually. A carbon tax would level a charge on energy consumption based upon the

[29] Obviously, the direction of causality can be disputed.
[30] OECD, “Consumption Tax Trends: 2006 Edition” http://www.oecd.org/document/20/0,3343,en_2649_33739_36891284_1_1_1_1,00.html

carbon content of the fuel. A cap and trade program would either allocate or auction permits to "upstream" energy produces (such as electrical power plants or oil refineries).[31] The Congressional Budget Office in a review of the literature suggested that the revenue potential is in the range of $50 to $300 billion annually.[32]

However, without other changes, a carbon tax (or the revenue from cap-and-trade permit auction) would be regressive since low-income consumers spend a greater share of their income on carbon-intensive energy such as gasoline. A 15 percent reduction in carbon emissions would cost an additional $750-950 per year for the bottom fifth of the population.[33] To correct for higher energy prices, some of the revenue from carbon abatement would need to be reserved to compensate low- and middle-income households.[34]

In this context, it is important to note that economic theory suggests that a cap-and-trade program would have the same price impact if carbon permits were allocated (that is, given away), or auctioned to energy companies. Under the auction scenario (unlike the allocation method), the government would have additional revenue that could be used to compensate low-income consumers for the higher prices, to ease the transition to a low-carbon economy for workers that might be displaced by this change, and also to invest in new energy R&D that would assist is lowering energy bills across the country.[35]

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[31] The limits could be applied more "downstream" at the consumer level, but most believe that upstream caps are more desirable.

[32] See CBO, "Trade-Offs in Allocating Allowances for CO2 Emissions" April 25, 2007. http://www.cbo.gov/ftpdocs/80xx/doc8027/04-25-Cap_Trade.pdf.

[33] *See* Center on Budget and Policy Priorities, "Climate Change" at http://www.cbpp.org/pubs/climate.htm.

[34] Designing a mechanism to assist low-income households is not a simple matter. *See* Robert Greenstein, Sharon Parrott, and Arloc Sherman, "Designing Climate-Change Legislation that Shields Low-Income Households from Increased Poverty and Hardship," Center on Budget and Policy Priorities, Revised November 8, 2007. http://www.cbpp.org/10-25-07climate.htm.

[35] The allocate vs. auction decision need not be all or none – some fraction of the permits could be allocated to companies in any given year. This decision also has implications for who would benefit or lose from the cap-and-trade regime. Under allocation, firms would receive valuable permits for free which could be used or sold on the open market, thus shareholders of these companies would come out net gainers under an allocation scheme. The CBO estimates that a system that allocates just 15 percent of permits would hold shareholders harmless.

Conclusion

All too often, policy reforms that would improve the lives of low- and moderate income Americans are halted in the political process because they are seen as too expensive or because they would add to the nation's budget deficit. This paper illustrates that there are changes to the tax code that would bring in significant revenue to not just adequately fund what works, but to also pay for new proposals and new directions. At the same time, these changes would make the tax code fairer and easier to understand.