

INTRODUCTION

The Center for American Progress is pleased to host a full-day conference with academic and policy experts from around the country who will highlight options for reforming the tax code. Many experts agree that the tax code is in need of repair. Yet it has been 20 years since the landmark 1986 reform. Given the growing complexity of the tax code, increased revenue pressures, and a changing economy; tax reform will likely be a central issue for 2006 and beyond. This conference will provide a forum for sharing proposals—both quick fixes and broad overhaul—and for open and engaged discussion.

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Many of the papers included are preliminary and subject to revision - please contact the author before quoting or citing.

AN INNOVATIVE TAX PLAN FOR THE 21ST CENTURY

By Maya C. MacGuineas¹

The tax code is backwards in many ways. It discourages saving, job creation, and economic growth while encouraging consumption, energy dependence, and environmental degradation. It has become less progressive at a time when income inequality is growing and it bestows the largest targeted tax breaks on those who need them least. It has failed to keep up with changes in the global economic environment, harming U.S. competitiveness. It is highly complex, non-transparent, and it does not raise enough money to pay for government spending. Overall, the tax code is ill suited to meet the needs and opportunities of the 21st century.

The New America Foundation's comprehensive tax plan is structured to address these shortcomings by dramatically altering how we raise federal revenues. The plan consists of five major components:

- 1) Replace the payroll tax with a progressive consumption tax
- 2) Integrate the individual and corporate income taxes in exchange for taxing all forms of income the same
- 3) Reduce and reform tax expenditures
- 4) Replace the estate tax with an inheritance tax
- 5) Create a new revenue stream from environmental taxes

1) REPLACE THE PAYROLL TAX WITH A PROGRESSIVE CONSUMPTION TAX

The payroll tax is regressive, inefficient, and insufficient to meet the future needs of the programs it supports. The tax is levied only on wages, kicks in at the first dollar of earnings, and is capped at \$90,000 for most earnings. Interest, dividends, and capital gains, as well as many forms of non-wage compensation such as healthcare and pension benefits—all of which go disproportionately to upper income earners—are not taxed. Unlike the individual income tax, the payroll tax makes no adjustments for family size or situation. Furthermore, the

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payroll tax is a tax on labor, creating disincentives for businesses to make new hires, which can be particularly problematic during periods of slow economic growth. Finally, the payroll tax is insufficient to meet the future needs of Social Security and Medicare.

Replacing the payroll tax with a progressive consumption tax would combine the economic benefits of a consumption tax with the fairer tax structure available from progressive rates. Under a progressive consumption tax money that is saved would be exempt from taxation while money that is spent would be taxed, creating a strong incentive for individuals to save. Each year a taxpayer's consumption base would be calculated by totaling their income from all sources, and subtracting the amount they saved. Higher levels of spending would be taxed at higher rates. The effect would be not only to increase national saving, thereby strengthening the economy, but also to increase in the overall progressivity of the tax code.

2) INTEGRATE THE INDIVIDUAL AND CORPORATE INCOME TAXES IN EXCHANGE FOR TAXING ALL FORMS OF INCOME THE SAME

In an era of highly integrated global markets and heightened international competition, the corporate income tax has become detrimental to U.S. competitiveness. The tax is so complex that many companies pay more in accounting fees than they do in taxes and by some estimates, the corporate tax drains as much from the economy as it collects. Globalization has made it easier for multinational corporations to follow not just lower labor costs, but lower tax rates, around the world so countries that keep their corporate tax burdens low have a competitive advantage. Ultimately, the corporate tax burden is passed along to individuals—either through lower wages, higher prices, or lower returns, so while collecting the tax at the corporate level makes actual tax burdens less transparent, it does not, as many people mistakenly believe, reduce them.

In order to simplify and streamline the income tax, the corporate tax should be eliminated or fully integrated with the individual portion of the tax. This change would end the punitive double taxation of capital income, while closing the many loopholes that allow much of capital income to escape taxation completely. In exchange, while all capital income would be taxed once and only once, all forms of income—from wages, dividends, capital gains, and inheritances—would be taxed at the same progressive rates.

3) REDUCE AND REFORM TAX EXPENDITURES

Tax expenditures—or targeted tax breaks—have grown significantly since the landmark reforms of 1986 broadened the income tax base. In many years, tax expenditures cost the government more than the entire discretionary budget. Such targeted tax breaks, which include the home mortgage interest deduction, deductions for many employer-based benefits and state and local taxes, and a slew of other deductions and credits, are popular with both taxpayers and businesses. They are also politically popular since they provide a way to provide benefits for things such as education, saving, and housing, while simultaneously cutting taxes.

However, targeted tax cuts are generally bad tax policy. They tend to be complicated, regressive, non-transparent and inefficient. Tax expenditures regularly pay people to do what they would do anyway—as in the case of buying a home or saving for retirement—creating little positive behavioral or economic effect, while draining significant funds from the Treasury. Because many of the breaks are done through exemptions and deductions, they are generally more regressive than other forms of spending. In many cases, only taxpayers who itemize realize the savings, and those in higher marginal tax brackets save more. The current maze of complicated and overlapping tax breaks accounts for many of the payment errors in any given year and compliance costs are a significant drain on the economy. Creating tax expenditures rarely involves the type of thoroughness or thoughtfulness that should go into instituting a new government initiative and once a tax break is implemented, it is unlikely to receive sufficient oversight.

Tax expenditures should be dramatically reduced and reformed. Multiple breaks for things such as dependents, education and saving should be consolidated. Other tax breaks should be capped and/or turned into credits—a change that would potentially save hundreds of billions of dollars a year while increasing the progressivity of the tax code. Those tax expenditures that are not achieving their purpose or have become outdated should be eliminated. Finally, scoring certain tax expenditures as government outlays would better reflect the size of government and the cost of each policy, while helping to end the bias towards running spending programs through the tax code.

4) REPLACE THE ESTATE TAX WITH AN INHERITANCE TAX

The discussion over reforming the estate tax has focused on the benefits of eliminating the tax completely versus reforming it by drastically increasing the exemption and lowering the rates. Both of these approaches are not only

extremely costly, they ignore the basic inequity in exempting inherited income from an individual's income tax base. Why should a minimum wage worker pay taxes on the very first dollar he earns while a trust funder can receive millions tax-free? In a society that values work, the punitive treatment of earned versus inherited income is the opposite of what it should be.

Instead, we should treat all forms of income—including inheritances—the same by repealing the estate tax and replacing it with an income tax on inheritances. Under this system, when a beneficiary receives an inheritance, it would be taxed the same as the rest of their income. The tax base on inherited money would be broader and the rates would be lower, with larger inheritances taxed at progressive rates just like other forms of income.

5) CREATE A NEW REVENUE STREAM FROM ENVIRONMENTAL TAXES

The United States is dependent on foreign oil and engages in many policies that harm the environment. Perversely, the tax code subsidizes numerous environmentally harmful policies but does little to encourage conservation or energy independence. At the same time, the federal government raises far less than is needed to cover government costs and structural deficits are only likely to widen in coming decades as the Baby Boomers move into retirement.

Adopting a new revenue stream in the form of an environmental tax—such as a gas tax or a system of tradable carbon permits—would bring with it many benefits. Such a tax is consistent with the basic principles of taxing more of what you want less of. It would help curb energy consumption and dependency and lead to reductions in pollution and environmental degradation, while at the same time, providing a much-needed new revenue stream with which to finance federal government operations.