Center for American Progress

1333 H Street, NW, 10th Floor
Washington, DC 20005
Tel: 202 682.1611 • Fax: 202 682.1867

www.americanprogress.org

Michael Linden
Managing Director for Economic Policy
Center for American Progress

Testimony on "Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform"

United States Senate Committee on the Budget
624 Dirksen Senate Office Building
Washington, D.C.

May 22, 2013

Tax reform should strengthen the economy by strengthening the middle class

For all the disagreements among policymakers, economists generally agree on the ingredients that make an economy grow: human capital, demand, strong institutions and governance, innovation, and financial capital. While all of these are important, since the late 1970s some tax policymakers have lost sight of the big picture, focusing on financial capital and the activities of the wealthy few. That focus produced supply-side economics and the belief that the government should focus its efforts on wealthy “job creators,” and that if those “job creators” were released from the burdens of high taxation and regulation, prosperity for all would trickle down.

But trickle-down economic policies have been a failure. Over the past several decades, the United States has undergone a remarkable transformation, with income growth stalling for the middle class while the incomes of those at the top continued to rise dramatically compared to the rest of the working population. Between 1979 and 2007, the last year before the Great Recession, median family income rose by 35 percent, while incomes for those at the 99th percentile rose by 278 percent.[1] Families in the middle class have also pulled away from those at the bottom, but have achieved these modest income gains only by working longer hours, increasing their labor supply—particularly among wives and mothers—and increasing household debts to maintain consumption as wages failed to keep pace with inflation.

The supply-siders had it backward—a strong middle class is the driver of economic growth, not merely an outcome. When one examines the factors that produce a growing economy, the strength of the middle class is critically important to them:

- A strong middle class promotes the development of human capital and a well-educated population.
- A strong middle class creates a stable source of demand for goods and services.
- A strong middle class incubates the next generation of entrepreneurs.
- A strong middle class supports inclusive political and economic institutions, which underpin economic growth.

Given that the middle class is key to economic growth, and given the mounting stress placed on the middle class over the last 30 years due to stagnant wage growth and rising costs, the question then becomes: What policies will grow and strengthen the middle class?

Tax reform should make the code *fairer* to the middle class

Fairness to the middle class means doing more to reduce America's staggering inequality

Over the past 30 years, our nation's income distribution has grown increasingly unequal. In 1979 the average income for a household in the richest 1 percent was about 10 times higher than the average income for a household in the middle 20 percent. By 2007 that ratio had almost tripled. The average household in the richest 1 percent was now earning nearly 30 times as much as those in the middle. Yet even as income inequality increased dramatically, the effect of the federal tax code on income distribution declined substantially.[2]

Between the early 1990s and the financial collapse, the effective federal tax rate of the richest 1 percent of Americans has plummeted even while their incomes skyrocketed. Households in the top 1 percent more than doubled their incomes from an average of more than $800,000 in 1993 to nearly $1.9 million in 2007. During that same period, their effective federal tax rate dropped from 35 percent to 30 percent.

The Great Recession hit hard the income for those at the top, mostly due to a dramatic drop in capital-gains realizations during the stock-market turmoil of the past few years. Average real income for the top 1 percent dropped 36.3 percent from 2007 to 2009, while the bottom 99 percent saw their income decline by 11.6 percent, shrinking the share of income flowing to the top 1 percent dramatically. It is already clear, however, that this is a temporary effect. Income growth during the recovery has so far favored those at the top. In fact, from 2009 to 2011, the top 1 percent saw their incomes grow by 11.2 percent, while the other 99 percent *lost* 0.4 percent of their income; 99 percent of Americans were worse off two years into the recovery than during the recession, while 121 percent of the economy's growth flowed to the richest 1 percent. As this pattern continues, and capital-gains realizations rebound with the stock market, America's inequality is likely to be worse after the Great Recession than before it.[3]

The American Taxpayer Relief Act of 2012, or ATRA, allowed some Bush-era tax cuts to expire for the very wealthiest Americans—those making more than $400,000 per year. The Tax Policy Center now estimates that the top 1 percent of income earners will face a 35.7 percent effective federal tax rate in 2013.[4] But with top incomes continuing to grow at a tremendous rate, this will do little to affect underlying inequality. As economists Thomas Picketty and Emanuel Saez explain:

> Looking further ahead, based on the US historical record, falls in income concentration due to economic downturns are temporary unless drastic regulation and tax policy changes are implemented and prevent income concentration from bouncing back. Such policy changes took place after the Great Depression during the New Deal and permanently reduced income concentration until the 1970's. In contrast, recent

> downturns, such as the 2001 recession, lead to only very temporary drops in income concentration.
>
> The policy changes that are taking place coming out of the Great Recession (financial regulation and top tax rate increase in 2013) are not negligible but they are modest relative to the policy changes that took place coming out of the Great Depression. Therefore, it seems unlikely that US income concentration will fall much in the coming years.[5]

Over the past several years, America has faced a historic economic challenge not seen since the Great Depression, yet we are stuck in the same tired fiscal and economic policy debates we were having before the financial crisis. Inequality keeps rising over time, and our policy responses have, so far, been inadequate.

America fares very poorly in international comparisons as well. A recent OECD report shows how little the entire system of revenues and investments in the United States does to redress inequality. When the authors look only at the most progressive part of the U.S. tax system, federal income taxes, it appears as if the United States has a reasonably progressive system.[6] But this result is driven by the low levels of revenue the U.S. income tax collects compared to other rich countries, the high underlying inequality in U.S. income, and the American propensity for tax expenditures, which categorize things that other countries call social spending and transfers—subsidies for health care, retirement savings, and homeownership, for example—as "tax cuts." Once the total revenue and transfer system is taken into account, the only OECD country that does less to ameliorate inequality is Korea.[7]

Even looking only at income taxes, America's richest taxpayers pay substantially less than the wealthy pay in other countries. An independent analysis[8] ranked the United States 53rd among nations for the effective income and payroll tax rate paid by a household making $300,000 per year; in the top 2 percent of the U.S. income distribution. According to the study, these households in the United States pay a similar tax rate to similar households in Sri Lanka and Malawi. The effective tax rate for rich households in the United Kingdom and Canada is almost 40 percent higher than in the United States—in some wealthy European countries it's more than 75 percent higher.

Fairness to the middle class means demanding that America's wealthiest pay their fair share

Other rich countries raise *substantially* more revenue from their wealthiest citizens than we do in the United States. This revenue allows them to invest in middle-class benefits and services—like world-class education starting in preschool, universal health care, and robust public pension and safety-net programs. Meanwhile, some of America's wealthiest families pay less in taxes than the middle class.

According to Congressional Research Service data, one in four households making more than $1 million *per year* faces a lower federal tax rate than middle-class families.[9] In fact, according to the Tax Policy Center, in 2011, 7,000 millionaires paid nothing in federal income taxes.[10]

Given that the top marginal income tax rate was 35 percent in 2011 and is now 39.6 percent—still substantially lower than the top rate in the United States in the early 1980s or in other wealthy countries—how is it that so many wealthy people avoid paying their fair share? Because the individual income tax code is riddled with exemptions, deductions, special preferences, and loopholes that disproportionately benefit high-income taxpayers.

Most tax benefits and incentives come in the form of deductions or exclusions. Both are provisions that reduce one's taxable income and include many of the most important—and most costly—tax breaks, such as those for mortgage interest, charitable giving, employer-provided health insurance, and retirement savings. One of the unfortunate and largely unintended effects of structuring tax benefits as deductions or exclusions is that they tend to provide much bigger tax benefits to those in the highest tax brackets.

For a wealthy taxpayer in the highest tax bracket—now 39.6 percent—a $10,000 itemized deduction, such as one for mortgage interest, results in $3,960 in tax savings. For a taxpayer in the 15 percent bracket, however, that same deduction is worth only $1,500.

This "upside-down" effect is not only unfair, but it's also inefficient from a budgetary point of view: It gives the largest tax break to the people who are least likely to need it and also least likely to respond to the incentive. High-income people, for example, are already likely to be homeowners, and they would therefore likely use disposable income to save for retirement even without a tax incentive. We would not tolerate it if a federal spending program distributed benefits in such an inefficient way—and we should be equally cost conscious with programs and subsidies that operate through the tax code.

The Center for American Progress has put forward a proposal to eliminate this inefficient "upside-down" effect by converting many deductions and exemptions into uniform credits that provide an equal value to all taxpayers.[11] The president has proposed partially addressing the problem by limiting tax breaks for the highest-income Americans: People whose high incomes place them in the top tax brackets would be able to claim the same value from deductions that a middle-class taxpayer in the 28 percent bracket gets, but not more. This proposal would make tax breaks fairer and more efficient while raising substantial revenue. The Congressional Budget Office estimates that such a proposal would raise $493 billion over 10 years.[12]

In addition to deductions and exemptions that disproportionately benefit the well off, there are some tax preferences that flow almost *entirely* to the wealthy, and tax loopholes that can only be taken advantage of by particularly sophisticated tax avoiders.

For example, the different treatment of income from investments and income from work is the largest reason that many wealthy households pay lower taxes than the middle class. Under the current code, long-term capital gains and qualified dividends are taxed at a maximum rate of 20 percent, well below the top statutory rate on labor income. The Tax Policy Center has estimated that in 2013, 96 percent of the benefit from low rates on capital gains and dividends went to households in the top quintile, with nearly three-quarters going to the top 1 percent of income earners and nearly half going to the top 0.1 percent.[13]

These preferential rates are even taken advantage of by highly compensated noninvestors: The carried interest loophole allows people who manage investment funds—such as private equity funds and hedge funds—to convert their income into lower-taxed capital gains, driving down their tax bills and costing the federal government $21 billion in revenue over 10 years.[14] A similar loophole exists for derivatives traders, allowing them to convert the margins from their daily trades into “long-term” capital gains for purposes of the preferential rates.

Another loophole allows certain well-off professionals—most famously former Sen. John Edwards (D-NC)[15] and former House Speaker Newt Gingrich[16] during their private-sector careers—to avoid paying Medicare taxes on their income by turning themselves into S corporations and taking their salaries as dividends. The U.S. Treasury’s inspector general for tax enforcement has called the loophole a “multibillion dollar employment tax shelter.”[17]

Even some “middle-class” deductions have high-income loopholes built in. For example, taxpayers can claim the home mortgage interest deduction not only on their primary residences, but on second homes and even *yachts*; but only if they are big enough to live on.

Any serious effort to strengthen the middle class and address our long-term fiscal challenges must start by asking the country’s most privileged people to pay their fair share. The alternative is to raise taxes on the middle class and abandon crucial investments in our future—clearly something we should seek to avoid.

Tax reform should make the code *simpler* for the middle class

A core goal of comprehensive tax reform is to make the tax code simpler. But when we discuss simplification, it is crucial that we are clear about what the real drivers of complexity are. It's not the rate structure: Whether you are looking up your tax liability in a paper table or letting software calculate it for you, it's the same single step whether we have one rate or 20. What drives the ever-increasing complexity of the tax code is the proliferation of special deductions, exclusions, and tax breaks for particular activities.

Simplicity for the middle class means reforming tax expenditures and limiting opportunities and incentives for complicated tax-avoidance schemes

Some tax expenditures are worth the complexity they create, because they support the middle class, further important policy goals, and prevent millions of families from falling into poverty and extreme hardship. But some of the expenditures that most radically increase the need for regulation, tax planning, and litigation, are the very same tax breaks that allow the wealthy to avoid paying their fair share.

Tax expenditures and loopholes add extra calculations and documentation requirements. More importantly, they create incentives for individuals and businesses to engage in complicated schemes to reclassify income and reorient economic activity so as to take advantage of specialized tax breaks. As more taxpayers game the system, ever more regulations are required to curb abuses.

These are the real drivers of increased complexity and compliance costs, and tax simplification should focus on reducing the incentives and opportunities for wealthy, sophisticated taxpayers to push money around in ever more complicated ways to avoid paying taxes.

A perfect example of this dynamic at play is the complexity created by the preferential rates currently in effect for long-term capital gains and dividends. These special rates are a huge giveaway to the very wealthiest Americans, and they are also an enormous driver of complexity: One tax expert has estimated that fully one-third of the Internal Revenue Code and accompanying regulations would be unnecessary if income from labor and capital were taxed at the same rate.[18] This is because the differential creates enormous incentives to classify as much income as possible as tax-preferred capital gains or dividends—this incentive drives an arms race between tax lawyers and Congress/IRS that necessitates ballooning regulations, ever-more-creative accounting and recordkeeping, and extensive litigation.

This effect can be seen across the income tax code, as each special tax break introduced by Congress spawns more creative accounting requiring more detailed regulations. Legislation is then frequently needed to clamp down on the worst inequities and abuses created by special preferences—creating even more complexity. The current alternative minimum tax, legislation to close the carried interest loophole, and enactment of the Buffett Rule, which would assure that millionaires pay an effective tax rate above that of ordinary Americans, would be unnecessary if tax fairness were assured in the regular tax code.

These problems are even more pronounced on the business side, where the stakes are high and armies of lawyers and accountants stand at the ready to take advantage of any special breaks. One prominent example is "deferral": U.S. multinationals that do business overseas are allowed to put off paying taxes on their overseas profits indefinitely, until they "repatriate" these profits to the United States. This creates an incentive to move real economic activity—jobs and assets—overseas, but it also creates an *enormous* incentive to play accounting games that move book profits offshore. By designating profits as "overseas income," corporations can put off paying U.S. taxes indefinitely or until another "one-time only" repatriation holiday. Without the big tax preference for foreign profits created by deferral, there would be no reason for American corporations to set up shell subsidiaries in the Cayman Islands and contort their business and accounting practices to move money through those subsidiaries. Our business tax rules are full of special-interest breaks that increase complexity and compliance costs while allowing America's largest and most profitable corporations to avoid paying taxes.

Simplicity means making tax credit compliance easier for working families and students

Some beneficial tax credits for the poor and middle class are needlessly complicated and difficult to comply with. For example, Congress could make tax filing easier for families with children by simplifying and standardizing definitions used in child-related tax exemptions and credits. Currently, the child tax credit, earned income tax credit, and the head of household filing status have different definitions for a child, with different requirements for both qualified ages and levels of support.[19] By using a single definition, these provisions of the tax code can be administered in a more cost efficient manner. The earned income tax credit has additional complexity, with the Internal Revenue Service noting, "[t]he eligibility requirements and computations are complex, yet EITC recipients are relatively less able to understand complex rules and less likely to speak English as their primary language, creating a recipe for confusion."[20]

Middle-class taxpayers also face a variety of complex tax rules in the higher-education arena. With multiple tax programs to incentivize saving for college, reimburse costs while attending college, and provide support for loan repayment,[21] navigating the tax rules associated with college can become an exhausting task. Furthermore, the American Opportunity Tax Credit continues to be authorized on only a temporary basis and expires after 2017. Congress should make college incentives in the tax code easier to understand by streamlining all of these benefits into one vehicle, a permanent American Opportunity Tax Credit.

Congress should be wary of regressive policy masquerading as simplification

Regressive policies that would shift the tax burden from the rich to those below them on the income scale are of course very unpopular. And so they are often presented as something they are not: measures to simplify tax filing.

The budget outline released by House Budget Committee Chairman Paul Ryan (R-WI) is a case in point. The House budget bemoans the complexity of the tax code at length. But the actual policies proposed have little to do with making the tax code simpler and everything to do with making it less progressive. The talk of simplicity is a distraction from the budget's real-world effects, namely shifting the tax burden from the rich to the middle class.[22] In fact, this approach would keep or expand features of the tax code that add complexity and encourage gaming the system, while dramatically reducing the progressive rate structure in the name of "simplicity."

Simplification is a laudable goal, but Congress should focus on the kind of simplification that matters for middle-class families, while balancing the goal of simplification against distributional goals, revenue needs, and other important policy concerns.

Tax reform should raise revenue for investments in the middle class

We have a revenue problem. Repeated tax cuts played an outsized role in creating the budget deficits of the last decade, and setting the stage for the current drive for austerity that is holding back the recovery and damaging the middle class.

As Oliver Wendell Holmes said, "Taxes are what we pay for civilized society." They pay for the foundational public investments that are critical to a modern prosperous society, such as infrastructure, education, and basic scientific research. They pay for services that only the government can effectively perform, such as national defense and ensuring clean food, safe consumer products, and clean water. Taxes make it possible for us to meet our societal obligation to care for our veterans, our aged, and our impoverished. And taxation allows us to overcome national challenges and achieve extraordinary feats. Apollo 11, the Hoover Dam, and the Internet were all financed with tax revenues.

Current federal revenue levels are at their lowest levels since the 1950s, a time before Medicare and Medicaid, federal aid to education, and a host of other federal programs that are now viewed as core responsibilities of the federal government. Some of this is driven by the recession, but even once incomes begin to rebound, our federal tax code will not raise enough revenue to meet the challenges America will face in the coming decades.

In the long run, the tax code must raise adequate revenue to meet our nation's needs

According to Congressional Budget Office projections, maintaining today's tax code will result in revenues averaging about 18.5 percent of gross domestic product over the next decade.[23] From 1998 to 2001—the last years in which we had balanced budgets—revenues averaged about 20 percent of GDP. And in the intervening years, our population has aged, baby boomers have started to retire, health care costs have risen, and our national security needs have changed dramatically. Clearly, generating additional revenue is a necessary component of any practical plan to address our budget challenges.

In "Reforming Our Tax System, Reducing Our Deficit," the Center for American Progress proposed a plan to overhaul the federal income tax code that will raise increased revenues progressively while making the tax system more efficient, simple, fair, and comprehensible.[24] Under our plan, by the middle to the end of this decade federal revenues will match those revenue levels recommended by the bipartisan "Simpson-Bowles" plan. These revenue levels have been agreed to by Democrats and Republicans, and are sufficient to put the budget on a sustainable path while dealing with sequestration and investing in the recovery. But it is likely that more revenues will be necessary over the long term if America is going to adequately invest in education, infrastructure, science and technology, energy, and the other investments in the middle class that will determine future growth and prosperity.

All of the bipartisan plans, including Simpson-Bowles, have proposed raising revenue levels above that of the historical average. And there are many good reasons to be skeptical that averages from the last 60 years are appropriate benchmarks for the next 60. First and foremost, these averages are highly misleading—they obscure a clear rise in tax revenues, decade by decade, as the federal government took on more responsibility for the health care of senior citizens and as health care costs rose more generally.

More importantly, it's simply wrong to try and budget for the future by looking backwards and trying to shoehorn future needs into whatever the past levels have been. Instead, we should be trying to determine broadly how much public investment will be required as we move deeper into the 21st century, and then how do we pay for those investments in the most efficient way possible. Why should we even consider the average from the past 60 years as an appropriate constraint until 2070? Certainly everyone agrees that times and circumstances have changed, and that the federal government should, presumably, change with them.

The United States raises far less in tax revenue, at all levels of government, than other first world countries. In 2010 only two OECD countries, Mexico and Chile, had lower government revenues as a share of GDP than the United States.[25] Revenue as a share of GDP in the United States was more than 25 percent lower than the OECD average.[26] That difference amounted to nearly $1.3 trillion in revenue in that year alone.[27] The United States has historically been a low-tax country, and can remain a low-tax country even while substantially increasing federal revenues to provide needed services to the middle class.

Because U.S. taxes are so much lower than the OECD average, many services provided to the middle class in other developed countries are not available in the United States. In Denmark, the OECD country with the highest tax revenue as a percentage of GDP,[28] the government pays for higher education, universal health care, and care for the sick and elderly,[29]—costs that many middle-class American families struggle to pay out of their own pockets. Similarly, other countries, including Mexico, are able to invest vastly more in preschool than the United States, increasing student achievement and allowing middle-class families to participate in the workforce without worrying about what to do with their preschoolers while they work.[30] When low taxes on the rich translate to reduced services and increased costs for the middle class, the American economy suffers.

Even the most progressive revenue proposals currently on the table are largely geared toward stabilizing U.S. debt as a share of GDP, replacing the misguided and damaging spending cuts required by “sequestration,” and paying for some relatively small investments to help speed the recovery. These are important short-term revenue goals that should not be held up by a longer tax-reform process; ensuring that the government takes in enough revenue to meet current basic funding needs, and raises that revenue in a progressive way, should be seen as a crucial prerequisite to any broader tax reform. But in the context of comprehensive reform, Congress should ensure that the tax code reflects the revenue needs of a growing economy with a vibrant middle class. The coming decades will present challenges and opportunities that we have not yet imagined, and we need a tax code capable of raising the revenue we will need to confront these changing circumstances efficiently and progressively.

Endnotes

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