Can We Bring More Fairness to the Tax System AND Make Revenues Match Spending?

A Primer on Taxes and Other Sources of Federal Revenue

For a lot of Americans, the very thought of taxes produces a headache. Partly it's the complication of filing and partly it's the fear of having to make out a check to the "U.S. Treasury" on April 15. While it may not be the most fun topic, any discussion of how to address America's growing federal debt and threats to the nation's fiscal future must examine not just how we spend money, but also how we collect money. Is it fair? Is it efficient? Does it raise enough money to pay for our national priorities?

Most Americans, including experts and leaders from across the political spectrum, agree that significant reforms are needed. The system is complex and cumbersome, with the average American spending 26 1/2 hours a year filing his or her taxes[1]. The total cost of complying with tax laws has been estimated to be $265 billion a year[2]. And while complaints about the unfairness and complexity of the tax system have been with us for a long time, the mismatch between the revenue generated by federal taxes and the cost of the government programs makes tax reform especially urgent. Unfortunately, there is little agreement on what reforms should be instituted.

In recent decades, there have been many efforts to cut, increase, and change how we pay taxes and collect other revenues. The U.S. tax code is now more than 66,000 pages long[3], and contained in those pages is a living history of competing priorities and beliefs about the economy and how various tax policies would affect the actions of the people and corporations who must abide by it.

If getting the federal budget closer to being in balance is a simple matter of bringing spending and revenues into closer alignment, then we owe it to ourselves to have a clear understanding of the revenue side of the equation. The Students Face Up to the Nation's Finances discussion guides on Government Accountability, Social Security, Medicare/Medicaid, and other major areas of federal spending and setting national priorities are designed to help advance discussion on how to attain both fiscal responsibility and a government that is fairly financed and provides for our nation's needs. This primer aims to provide some background and begin asking some questions about how we raise the revenue that pays for whatever federal programs Americans believe are important.[4]

Ultimately, the goal of tax reform is to raise sufficient government revenues in the most fair, simple, and efficient manner.

What Are the Sources of Federal Revenue?

"Taxes are the price we pay for a civilized society."

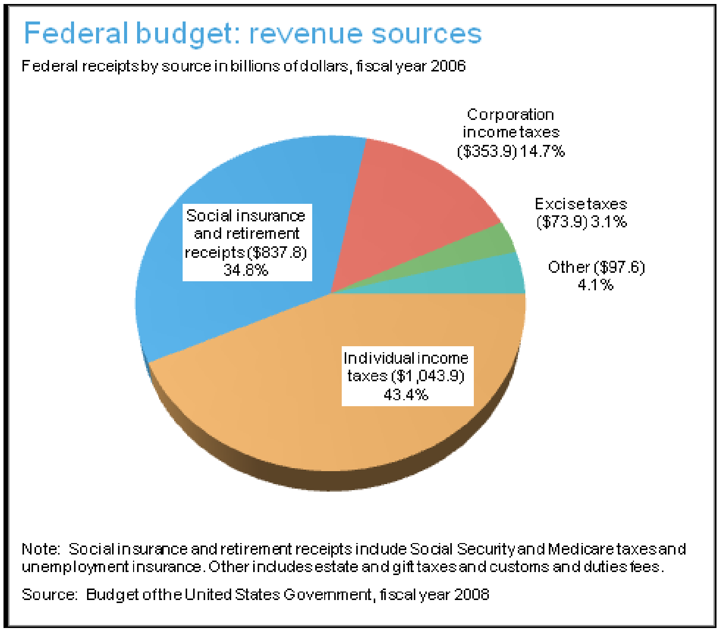
—Justice Oliver Wendell Holmes

On one level, understanding the federal debt is simple: the government consistently spends more than it takes in. If we don't want to continue paying huge sums to service interest on the debt (The United States is currently paying about $260 billion a year of the federal budget on interest

[1] National Taxpayers Union, "Tax-Filing Burdens Worsen, with Little Respite in Sight, Citizen Group's Annual Study Finds" April 15, 2008, available at www.ntu.org/main/press_release.php?PressID=1004&org_name=NTU.
[2] Tax Foundation "The Rising Cost of Complying with the Federal Income Tax," January 10, 2006, available at www.taxfoundation.org/publications/show/1281.html.
[3] Cato Institute, "The Simple (Tax) Life," April 17, 2006, available at www.cato.org/pub_display.php?pub_id=6345
[4] The authors of this primer would like to thank the authors of "Where Does the Money Go? Your Guided Tour to the Federal Budget Crisis" (HarperCollins, 2008). That book's chapter on taxes helped shape the structure of this primer and greatly informed the content.

on the debt[5]), we need to either cut spending, raise more revenue or both. Most experts believe that, even if we dramatically cut spending – which has no historical precedent anyway – the U.S. government would still need to raise *more* in revenues to meet the growing fiscal demands posed by the retirement of the baby boom generation.

The federal government collects about $2.6 trillion in tax revenues[6]. For most of the past half century, tax revenues have averaged about 18.25 percent of GDP (Gross Domestic Product – the grand total of our nation's financial output). But that percentage fell during the Bush Administration[7].



Individual Income Taxes

Nearly half of the federal budget comes from individual income taxes. Income tax rates have fallen fairly dramatically since World War II when the top tax bracket was 94 percent, meaning that if you earned over $200,000 (which was a lot of money back then), the government took 94 percent of what you received above that. By 1981, the top rate was 70 percent. President Reagan's tax cuts brought the top bracket down to 50 percent. President George W. Bush cut taxes in 2001 and 2003, and the top tax bracket is now 35 percent.[8] Some 18 million Americans earn so little that they don't even need to file a tax return (less than $15,650 for married couples), while another 33 million end up paying nothing at all.[9] With certain tax credits for children for example, some receive money back even though they are too poor to owe income taxes. The tax changes enacted under President Bush are set to expire December 31, 2010, so the battle over whether to keep them is already underway.

Social Security and Medicare Taxes

Social Security and Medicare take nice little chunks out of your take-home pay – those dreaded FICA (Federal Insurance Contributions Act) deductions on your pay stub. About a third of the money the government spends comes from Social Security and Medicare taxes, unemployment taxes, and retirement payments made by federal employees. Individuals who earn over a certain amount ($102,000 in 2008) pay no Social Security taxes on income over that level. Because of this, Social Security taxes are often considered "regressive" since they tend to hit nearly everyone on the lower end of the income scale while letting the people who earn the big bucks off the hook at a certain point. Corporations also pay FICA (see below).

Corporate Taxes

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[5] "Table 3.2 — Outlays by Function and Subfunction: 1962–2013", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
or
"Table 15.4 — Total Government Expenditures by Major Category of Expenditure: 1948–2007", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
[6] "Table 2.1 — Receipts by Source: 1934–2013", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
[7] "Table 2.3 — Receipts by Source as Percentages of GDP: 1934–2013", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
[8] Tax Policy Center, Individual Income Tax Brackets, 1945-2007, www.taxpolicycenter.org/TaxFacts/Tfdb/Content/PDF/individual_rates.pdf, accessed May 20, 2007.
[9] Tax Policy Center, Nonfilers and Filers With Modest Tax Liabilities, 2003, www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=283, accessed May 20, 2007.

Taxes paid by corporations have fallen from about 30 percent of federal revenues in 1946 to about 14 percent today.[10] According to a recent study by the Government Accountability Office, two-thirds of U.S. businesses paid no federal income taxes between 1998 and 2005. And about 68 percent of foreign companies doing business in the United States avoided corporate taxes over the same period.[11]

There are two big reasons fewer and fewer corporations are paying taxes to the federal government. One is that corporations quite logically take full advantage of the current tax laws that allow them to take deductions for expenses like R&D, capital investments and untold other legal incentives; and also to minimize taxable income by claiming no profit or having incurred losses from prior years and tax credits that eliminated any tax liability. A second reason why corporations are paying fewer taxes is that more and more corporations are being registered as "S" corporations, which do not pay any income taxes (or FICA taxes). Instead, the corporation's income or losses are divided among and passed through to its shareholders (the shareholders must then report the income or loss on their own individual income tax returns).

Since revenues from corporations constitute a far smaller percentage of federal revenue than 50 years ago, many suggest that corporate taxes are ripe for increasing.

On the other hand, corporate tax rates for normal "C" corporations in the United States – which, unlike "S" corporations, pay FICA taxes and have their profits taxed both when it is produced by the corporation and when it is received by the shareholder as dividend – remain among the highest in the developed world (Corporate income tax rates for annual taxable income over $75,000 ranges from 34 percent to a high of 39 percent, depending on the amount of annual taxable income).[12] Some argue that corporate income that is taxed both when the corporation produces it and when it is distributed through dividends constitutes "double taxation," while others say that our high corporate tax rate compared to other countries hurts U.S. competitiveness, and therefore corporate taxes should be lower or abolished.

Excise Taxes

About 2.5 percent of the money the government spends comes from excise taxes, mainly on alcohol, tobacco, airline tickets and gas. That little 2.5 percent added up to $65 billion in 2007.[13] In this area, many people try to advance more far-flung ideas, such as legalizing drugs and heavily taxing their profits. Or less radical ideas like a carbon tax on corporations emitting greenhouse gasses, which would both increase revenues and have the effect of decreasing carbon-emitting pollution. So-called "sin taxes" are an often-popular idea in discussions on raising revenues, partly because they can discourage people from smoking, drinking and other things that are bad for their health. But these kinds of taxes also run into a great deal of resistance in the legislative process since the corporations that profit from these legitimate businesses lobby hard against higher taxes that decrease sales.

Other Revenue

Government also earns about a quarter-trillion dollars by providing goods and services to the public at a price, ranging from the Postal Service to power from the Tennessee Valley Authority.[14]

The rest of what government spends is obtained by borrowing – nearly $500 billion in 2008 by selling Treasury securities, plus another $200 billion or so borrowed from other government accounts, most notably the Social Security Trust Fund.

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[10] "Table 2.1 — Receipts by Source: 1934–2013", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
[11] United States Government Accountability Office, "Comparison of the Reported Tax Liabilities of Foreign-and U.S.-Controlled Corporations, 1998-2005," July 2008.
[12] Internal Revenue Service, Publication 542 (Rev. February 2006).
[13] "Table 2.1 — Receipts by Source: 1934–2013", Budget of the United States Government FY 2009, available at http://www.gpoaccess.gov/usbudget/fy09/hist.html
[14] Ibid.

Gaining Clarity on the Goals of Tax Reform

Conservatives and liberals alike believe that tax reform is necessary. Bringing the federal budget into balance with spending cuts alone is extremely unlikely for both economic and political reasons, and so significant changes to our tax system – increasing taxes, expanding the tax base, strengthening tax-collection enforcement, and/or adding new taxes – must be discussed as an important option to secure the nation's fiscal future.

As noted in the introduction, the basic goal of reform is to raise sufficient government revenues in the most fair, simple, and efficient manner. While any tax reform would likely mean higher taxes for some families or on certain kinds of economic transactions and less for others, most tax reformers aim to keep the overall level of taxation "neutral" – that is not increasing or decreasing the amount of taxes in the United States.

Beliefs about whether to raise taxes to deal with budget problems often depend largely on whether we believe government programs and services are useful and helpful. Essentially, we ask ourselves whether what we're getting is worth paying for. But people also argue about whether taxes pay for themselves, whether they harm or benefit the economy, and whether who pays what is fair.

> **"The nation should have a tax system that looks like someone designed it on purpose."**
>
> —former Treasury Secretary William Simon

Does Cutting Taxes Actually Generate More Tax Revenue?

Some prominent leaders argue that tax cuts actually bring more money into the U.S. Treasury. Vice President Cheney has said lower taxes are "a powerful driver of investment, growth, and new jobs for America's workers," which in turn produce more tax revenue.[15] But well-respected economists like N. Gregory Mankiw, who chaired President Bush's Council of Economic Advisers, estimates that cuts in capital gains taxes (paid on profits from selling property or stocks) generate revenue only covering about half their costs. And Douglas Holtz-Eakin, who worked in the Bush White House and for Congress, puts the "replacement value" for cutting personal taxes at 22 percent for the first five years and 32 percent in the following five.[16]

Will tax increases harm the economy?

Many fear that raising taxes too much may upset the stock market and lead investors to look for opportunities in other countries. This line of thinking has it that excessive taxes sap the enthusiasm of entrepreneurs, inventors and others who take risks. But others argue that federal income taxes were significantly higher in the 1950s and 60s and the U.S. economy had plenty of very good years back then. Some economists and policymakers point out that when the government uses tax money to invest in education, research, highways, air traffic control and other services, this can help the economy. There's also the argument that the government itself buys goods and services, which is also good for the economy. Others question whether strong economic growth, spurred by low taxes, really means anything if the benefits aren't shared broadly.

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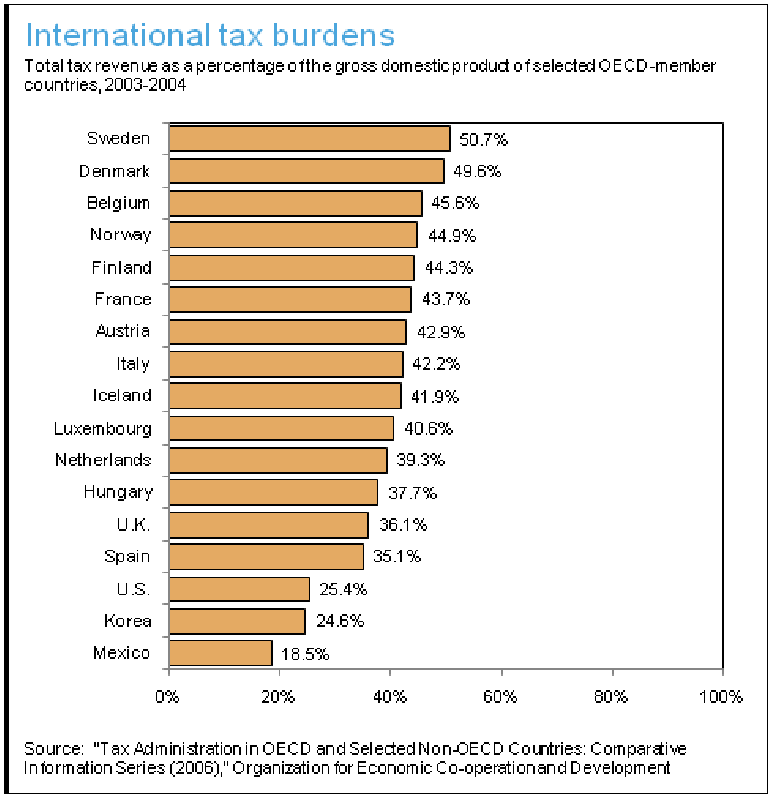
[15] Vice President Dick Cheney, speech to the Conservative Political Action Conference, Omni Shorham Hotel, Washington, D.C., March 1, 2007.

[16] Douglas Holtz-Eakin, Congressional Budget Office, "Analyzing Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," December 1, 2005, and Gregory Mankiw's analysis at http://economics.harvard.edu/faculty/mankiw/files/dynamicscoring_05-1212.pdf.

Another big wrinkle in the tax issue is whether, if we raise taxes, we can do it in ways that are fair. We all bring our own values to the table on this one. Conservatives typically believe that individuals should be able to keep as much of what they earn as possible, and that government's call on our tax dollars should be very, very limited. Liberals typically believe that government has done many good things with taxes (Social Security is a favorite example), and that wealthier Americans who have benefited the most from our economic system should help pay for services that not only help and protect the poor and middle-class but also build a better economy for the future.



Hardly anyone wants to pay taxes, and most of us think there is someone else somewhere who should be paying more, so we don't have to pay as much. But when Americans engage in discussion on this topic, most say that they want a system that allows for robust economic growth that rewards hard work and creativity, and one that also helps disadvantaged individuals and families achieve.

What Are the Major Tax Reforms Being Advocated?

These are some of the major areas of tax reform discussed most often among government leaders and policy experts:

Letting the 2001 Tax Cuts Expire

Letting the tax cuts enacted in 2001 expire in 2011 and returning to the tax rates of 2000 would yield about 2 percent of GDP a year – that's $250 billion dollars – for the federal government. Ending the 2001 tax cuts only for those earning more than $200,000 annually would yield somewhat less, but would reduce deficits by as much as $1.1 trillion over a decade.[17] Neither of these would bridge the gap between current spending and revenues necessary to cover that spending.

Raising Income Taxes Across the Board

This is one of the simplest and probably least palatable options to the majority of Americans. Just increasing income taxes by about 50 percent – without changing spending on Medicare/Medicaid, Social Security, national defense and domestic discretionary spending – would bring the budget into balance in the next 15-20 years. But keeping up with ballooning Medicare and Social Security costs associated with America's aging population would require even greater revenue generation after the 15-20 year mark.

[17] Robert Rubin, "Attention Deficit Disorder," New York Times, May 13, 2005; International Monetary Fund, "Fiscal Policies and Priorities for Long-Run Sustainability," IMF, Jan 7, 2004.

Increasing Payroll Taxes on Some or All Workers

There are a number of options being discussed in this area. The Social Security payroll tax, including the small portion allocated to Medicare, could be increased by 1 or 2 percentage points, a new Medicare tax could be added, and the payroll tax cap could be eliminated, to bring more revenues to both programs. This option would more directly and disproportionately affect lower- and middle-income earners in comparison to increasing revenues from corporations and estates, discussed below. Currently, workers who earn more than $102,000 are not assessed payroll taxes on income over that amount. Simply assessing payroll taxes on income over $102,000 at the same rate as all other income could close between half and all of Social Security's long-range imbalance.

Raising Taxes on Corporations or Particular Types of Corporations

Raising corporate taxes could hurt U.S. competitiveness in the global economy. The official U.S. corporate tax rate of 35% is higher than in many countries and is arguably double taxation of some income. However, (as discussed in detail above) the federal government receives a far smaller percentage of its revenues from corporations than it did 50 years ago and many of America's largest corporations avoid paying any taxes. That is something that small businesses often are unable to do. Many corporations actually benefit from the tax code through what some call "tax expenditures" and others call "corporate welfare." Some argue that such tax expenditures are a way of encouraging economic growth by helping business, whereas others say these are unnecessary handouts to business and violate free-market principles.

Returning to Higher Taxes on Estates

Even though the estate tax continues to be hotly debated, it currently only affects only the wealthiest few thousand of the two million Americans who die each year. There is a vast array of financial instruments that help wealthy families avoid estate taxes – the most common being a "living trust." Relatively few estates will be subject to the estate tax even if it returns to the 55 percent level for estates over $1 million upon the expiration of the Bush Administration tax cuts in 2011, although most experts believe the threshold will be set higher.

When property values were rapidly increasing, the estate tax began to hit more Americans. Some have called for completely abolishing the estate tax, which would cost about $1 trillion in lost revenues over a decade.[18] Those in favor of maintaining or increasing the estate tax say it mitigates the accumulation of wealth by inheritance and encourages hard work in every generation, and helps contribute to a more progressive taxation system. Those against the estate tax say that it constitutes a double taxation (already taxed when earned and then taxed again when inherited) and that it is a disincentive to those who work hard and want to leave money to their children and grandchildren.

Ditch the Current Tax System and Move to a National Sales Tax

Getting rid of most of the current tax code and completely starting over is an option. However, raising several trillion dollars in revenues from several hundred million Americans inevitably is going to involve a fair degree of complexity. One of the most frequently discussed alternatives to the current income tax system is a national sales tax, otherwise known as a consumption tax.

The federal government could impose a tax on what individuals and businesses buy instead of what they earn – like state and local governments do with sales taxes and like nearly 100 other countries do with consumption or "value-added taxes" (VATs). Under a national retail sales tax, a single tax rate would apply to all businesses or households. Under a VAT, each business would pay tax on the difference between its sales and purchases, thus capturing the incremental value at each stage of production. A consumption tax could be regressive and disproportionately affect lower- and middle-income Americans.

[18] Congressional Budget Office, Budget Options, February 2007 , available at http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf

However, it is much more efficient to collect and difficult to avoid. Advocates say it would encourage savings and it would better reflect people's ability to pay (the rationale being that a person who is unable to pay the tax on a sale will simply not buy the product, whereas a tax on income levies the tax regardless of the person's life circumstances and competing financial demands).

Whereas today's income tax raises about $1.25 trillion a year, a 10 percent consumption tax could raise $750 billion dollars, with far fewer administrative and compliance costs than the income tax. A VAT or national sales tax of 15 to 23 percent could bring in the amount currently raised through income and payroll taxes and would enable us to eliminate those taxes. It should be noted, however, that the consumption tax rate would have to rise to meet the rising costs associated with rapidly growing Medicare, Medicaid, and Social Security expenditures if spending reforms do not take place.

To address the regressive nature of consumption taxes, some have proposed a consumption tax exempting those earning below a certain inflation-indexed amount, such as $100,000, from paying income tax, eliminating 90 percent of tax returns, with the wealthy still paying an income tax in addition. Certain goods, such as groceries, education, and basic health care, could be exempt, or a refundable low-income tax credit could cushion the burden.

Manufacturers and retailers, who want to encourage consumption, generally oppose consumption tax plans.

Ditch the Current Tax System and Move to a Flat Tax

The current income tax system has a graduated rate of taxes so that the more you earn, the higher percentage of your income you pay in taxes. Many are now advocating to simplify tax collection with a "flat tax." One much-discussed flat tax plan, called the Hall-Rabushka tax, would have a single tax rate of 19 percent for all workers.

Opponents say that a flat tax would benefit the wealthy and be regressive. But some advocates say a flat tax could be made more progressive and fairer to lower-income Americans by expanding the Earned Income Tax Credit. (Currently, a tax filer who earns under a certain amount of money each year and has a child can qualify to receive a "credit" of up to $2,853, or up to $4,716 for multiple children. This makes the EITC one of the largest anti-poverty programs in the United States.) However, just to replace existing revenues, experts have estimated that a flat tax would have to be set at between 21 and 30 percent. In order to bring in more revenue to pay for the growing costs of the aging population, a flat tax rate would have to be higher than 30 percent – and the highest rate in the current graduated tax system is only 35 percent.

End "loopholes," Incentives and Deductions in the Tax Code

The more than 100 special deductions, exemptions and credits in the tax code are popularly referred to as "loopholes," and amount to about $1 trillion in lost revenues for the federal government each year. Many argue that treating all forms of income equally and not giving deductions and exceptions for all kinds of activities that the government tries to encourage could not only go a long way toward simplifying the process of collecting taxes but also make tax avoidance much more difficult.

But these loopholes, deductions and incentives – broadly categorized as "tax expenditures" – have vocal constituencies and many are very popular, making reform potentially difficult. They include the exclusion for employer-based health care that exempts corporations and individuals from paying taxes on the value of employer-provided health insurance; the exclusion of pension contributions and savings; and the deductions for mortgage interest and state and local taxes. Others range from what many call "corporate welfare," or tax subsidies to corporations and farmers, and offshore tax havens, which alone cost $100 billion a year, to individuals' deductions for mortgage interest and charitable contributions. While tax expenditures mostly benefit wealthier Americans, parts of popular deductions could be retained by capping the mortgage interest deduction at, say, $250,000 to benefit middle-class and lower-income home-owners.

Strengthen Enforcement and Tax Collection

About a decade ago, the IRS had earned a reputation of heavy-handedness and several measures were enacted that decreased the agency's aggressiveness. Studies indicate that strengthening tax enforcement could net a significant portion of the $300 billion in owed taxes that are lost each year because of "noncompliance." With many Americans admitting to cheating on taxes, and with IRS budgets and audits cut in recent years, experts believe that if enforcement were beefed up, at a modest cost of a few billion dollars, the IRS could collect $100 billion more.

Miscellaneous New Taxes

Efforts to increase federal revenue could include various new taxes. There are lots of ideas floating around from far corners of the political universe. We could increase "user fees," such as tolls on highways, fees to pay for air-traffic control and our air-transportation system, admission fees for national parks, and charges for use of national lands. Environmentalists, among others, favor introducing a carbon tax, a BTU tax, or higher gas taxes that could reduce greenhouse gases and other pollution, and fuel consumption and dependence on foreign oil, while raising new revenues. "Sin" taxes, despite their potential to raise only limited levels of revenues – could be raised and broadened to include more goods and services. Beyond taxes on tobacco and alcohol, we could tax junk foods and soft drinks (helping to reduce obesity), as well as some "luxury" consumption. And then there is the idea of legalizing and taxing drugs like marijuana, a fringe proposal, but one that is very popular in certain circles. Other ideas in this realm include "luxury taxes" on items like very expensive cars, boats, furs, etc. A luxury tax is basically a large sales tax leveled on certain items that are somewhat arbitrarily determined to be nonessential.

Addressing the Alternative Minimum Tax

One of the biggest tax issues being discussed these days is the Alternative Minimum Tax. The AMT was designed to ensure that all high income earners pay taxes regardless of their eligibility for deductions or other creative tax shelters. The AMT was not indexed to inflation when it was created in 1969 (expanded in 1986 and set at 26-28%), eliminating many deductions and credits for those with incomes between $150,000 and $415,000. More and more upper-middle class families are finding themselves having to pay the AMT. There is broad political support for increasing the income threshold below which taxpayers would be exempt from the AMT and reduce its rate. These changes, however, would greatly reduce the amount of revenues coming into the federal government. But without changes to the AMT laws, the burden of the AMT will increase from a few million taxpayers to an estimated 33 million by 2010 and 42 million by 2015.[19] A total repeal of AMT would mean a loss of revenue for the federal government estimated to be between $800 billion and $1.5 trillion over 10 years. A recent Brookings Institution-Urban Institute Tax Policy Center study said that it would cost the Treasury considerably less to repeal the ordinary income tax system than the Alternative Minimum Tax.[20]

Questions to Consider

Given the current system that relies primarily on income tax revenue, does a "progressive" tax system – where those who earn more pay higher rates of taxes – make sense?

Would a system that relies on taxes on consumption make more sense or be more fair?

Should tax reform efforts focus on trying to make the system fairer or to bring in more revenue? Or must both happen at the same time to make reform worthwhile?

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[19] Leonard E. Burman, William G. Gale and Jeffrey Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax." *Journal of Economic Perspectives, updated May 2005.*
[20] Leonard E. Burman, William G. Gale and Jeffrey Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax." *Journal of Economic Perspectives, updated May 2005.*

While experts say that the realities of economics and politics dictate that getting the federal budget closer to balance will require both cuts in spending and increased revenue generation, which do you think would be the most productive and fair for the whole of American society? Or do you agree with the experts that both need to happen?

If corporations are really made up of people, do taxes on corporate income and the dividends those corporations distribute to shareholders constitute double taxation?

Certain taxes are designed to encourage or discourage specific activities. Are you in favor of efforts to try to use the tax system to encourage or discourage certain activities? If so, what are your priorities? And would those taxes significantly change the amount of revenue coming in to the federal government?