Tax Reform for Progressivity: A Pragmatic Approach

Natasha Sarin, *University of Pennsylvania Carey Law School and Wharton School of Business*
Lawrence H. Summers, *Harvard University*
Joe Kupferberg, *Harvard University and University of Pennsylvania*

Abstract

Trends in demographics, national security, economic inequality, and the public debt suggest an urgent need for progressive approaches to raising additional revenue. We propose a suite of tax reforms targeted at improving tax compliance, rationalizing the taxation of corporate profits earned domestically and abroad, eliminating preferential treatment of capital gains, and closing tax loopholes and shelters of which wealthy individuals disproportionately avail themselves. We estimate that these proposals have the potential to raise over $4 trillion in the coming decade. These proposals are comparable on the basis of both potential revenue raised and progressivity with newer and more radical proposals, like wealth taxation and mark-to-market reforms, that have been the focus of much recent attention. Importantly, our agenda is likely to enhance rather than reduce efficiency, is far less costly in terms of political capital, and hews more closely to basic notions of fairness than alternative approaches.

Introduction

In the coming decades, federal spending will need to grow just to enable the government to continue to provide the services it does today (Summers 2017). This is the result of a confluence of economic forces: an aging society; price increases in the goods the government purchases, like education and health services; potential increases in national security expenditure to keep pace with adversaries; and the growth in inequality, which will require increased spending to ameliorate. Given these realities as well as issues of avoiding excessive federal debt accumulation, progressive tax reform is and should be high on progressives' agenda.

Our belief is that the best path forward is through a combination of deterring illegal tax evasion—by investing more in an underfunded Internal

Revenue Service (IRS)—and reducing legal tax avoidance by broadening the tax base and closing loopholes that enable the wealthy to decrease their tax liabilities. The combination of policies described in this chapter will increase both the efficiency and progressivity of the U.S. tax system. Our rough estimates in table 1 suggest that these approaches could raise $4 trillion over the course of a decade, more revenue than more extreme alternatives advocated recently, including calls for a 70 percent marginal rate on top earners and wealth tax proposals.

Once revenue is raised by progressively broadening the tax base as we propose, more tax revenue may still need to be raised from the wealthy,

TABLE 1.

Revenue Potential of Proposed Programs

Program	Revenue potential 2020–29 (billions of dollars)
Compliance	
Adequate enforcement resources	715
Information reporting	350
Information technology investment	100
Corporate taxes	
Per-country accrual of GILTI credits	170
Corporate tax rate increase to 25 percent	400
Minimum book income tax	200
Capital gains taxation	
Tax at ordinary income levels	350
Eliminate stepped-up basis	250
Eliminate carried interest loophole	20
Capping like-kind exchanges	50
End charitable giving tax advantage	150
Closing individual loopholes and shelters	
Eliminating payroll tax loophole	300
Capping tax deductions	250
Ending pass-through deduction	430
Broadening estate tax base	320
Total	**4,055**

Source: Authors' calculations.

Note: "GILTI" refers to global intangible low-taxed income.

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requiring the consideration of alternative approaches. However, we believe that our proposals are the right place to start. Practically, closing loopholes will increase the efficiency of increases in top rates, or wealth taxes, by making it more difficult for individuals and firms to shelter income from tax liability.

The remainder of this chapter proceeds as follows. In the first section, we try to estimate what a progressive tax reform can reasonably expect to collect from those at the very top. We base this exercise on effective tax rates paid by the rich and large corporations, today and historically. In the second section, we discuss the substantial magnitude of the tax gap, propose means of shrinking it, and illustrate that an increased focus on tax compliance is a substantially progressive reform. Next, we make the case for other progressive base broadeners, including closing corporate and individual tax shelters, overhauling capital gains taxation, and capping tax deductions for the wealthy. We then compare our approaches to more radical alternatives, like wealth taxation, before concluding the chapter.

How Much Can Be Raised from Those at the Top?

In recent months, progressives have debated how best to raise tax revenue from high-income individuals to fund necessary government expenditure and investment (Batchelder and Kamin 2019; Saez and Zucman 2019a; Sarin and Summers 2019). A first-order question is how much can be collected by tax reform focused on raising revenue from those at the very top.

In 2017, the total adjusted gross income (AGI) of those in the top 1 percent (making $500,000 or more annually) was $2.3 trillion. Total tax collection from this group—through federal income taxes, state and local taxes, and payroll taxes—was $790 billion.[1] This constitutes an effective tax rate of 34 percent, with $1.5 trillion in AGI that remains untaxed.

Auten and Splinter (2019) provide historical data on average effective tax rates by fractile from 1960 to 2015.[2] The Auten and Splinter series sheds light on the important difference between maximum marginal tax rates and effective tax rates historically. Top marginal federal income tax rates peaked at 91 percent in 1960, when the effective income tax rate was under 20 percent. Including other tax categories—like payroll and state and local taxes—the maximum effective tax rate on the top 1 percent was 47.4 percent in 2000. Raising the effective tax rate on the top 1 percent from its current 34 percent by 13.4 percentage points to return to this peak would result in an additional $4.3 trillion in tax collection between 2020 and 2029, as shown in table 2. Similarly, raising the tax rate on those making $1 million

or more annually from the 2017 level (36 percent) to the historical peak (49 percent) would increase taxes collected from this group by $3 trillion from 2020–29.

Increasing corporate income tax liability is another progressive means of raising revenue. In 2017, corporations made $1.4 trillion in taxable income, of which $340 billion was collected through income taxation (a 24 percent effective tax rate after accounting for corporate tax credits). Since then, the Tax Cuts and Jobs Act of 2017 (TCJA) decreased the corporate tax rate from 35 percent to 21 percent, and corporate tax revenue fell by 0.5 percent of GDP (Office of Management and Budget 2019). The Congressional Budget Office (CBO) estimates that a 1 percentage point increase in the corporate tax rate would raise almost $100 billion in a decade (CBO 2018). Extrapolating from this estimate suggests that returning to the 35 percent corporate tax rate would raise $1.4 trillion in additional revenue over a decade. To validate this revenue estimate, note that in 2018 U.S. corporations paid $90 billion less in taxes than they had in 2017 (IRS 2018a). Adjusting for growth and inflation, an extra $90 billion in 2018 would translate to an extra $1.16 trillion between 2020 and 2029.

TABLE 2.

Revenue-Raising Potential of Increases in Individual Tax Rates, by Income Category (in Billions of Dollars)

	Income category			
	Over $500,000	Over $1 million	Over $5 million	Over $10 million
Total adjusted gross income	$2,339	$1,659	$848	$632
Total taxes	$791	$596	$292	$213
Total after-tax income	$1,548	$1,063	$556	$419
Auten-Splinter maximum rate[a]	47.4%	49.2%	52.8%	54.1%
Extra revenue in 2017 if maximum rate	$317	$219	$156	$129
Extra revenue in 2020–29 if maximum rate	$4,286	$2,964	$2,100	$1,742

Source: IRS 2019b, Auten and Splinter 2019, CBO 2019.

[a] Auten and Splinter (2019) report the average tax rate for the top 1 percent, top 0.5 percent, top 0.1 percent, and top 0.01 percent. These do not exactly correspond to our AGI buckets, but they are fairly close. Those making $500,000 or more annually correspond to the top 1 percent, those making $1 million or more annually correspond to the top 0.3 percent, those making $5 million or more annually correspond to the top 0.03 percent, and those making $10 million or more annually correspond to the top 0.01 percent.

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We estimate that when this change in corporate tax liability is combined with a significant increase in top individual tax rates, more than $4 trillion could be generated from increasing taxes on the individuals at the very top of the income distribution and on the corporations they own (table 3).

Returning top individual and corporate tax liability to historical peak levels would raise over 2 percent of U.S. GDP annually. By way of comparison, such an approach would increase tax collection by a larger amount (as a percentage of GDP) than any changes to the tax code enacted since 1950 (Committee for a Responsible Federal Budget 2016). The Clinton administration's 1993 tax increases were similarly focused at raising revenue from high-income earners: they increased the top income tax bracket to 39.6 percent, raised corporate taxes, and made permanent the highest estate and gift tax rates. Combined, these changes—at that time, among the largest tax increases in U.S. history—were estimated to raise 0.7 percent of GDP (Rosenbaum 1993). Raising $4 trillion from high-income earners and corporations represents a tax hike three times as large and is at the upper edge of what we think is feasible.

In recent months, some presidential candidates have argued that the government's revenue needs can be met by even larger tax increases borne only by the very wealthy. Senator Elizabeth Warren, for example, proposes funding progressive programs like Medicare for All and debt-free college by means of tax increases on the very top, through a broad program that includes wealth taxation, mark-to-market taxation of capital gains, an increase in top tax rates, and payroll tax hikes. The cumulative result of these changes would be confiscatory: tax rates over 100 percent on those

TABLE 3.

Revenue Raised in 2020–29 from Returning Income Tax Rates to Historical Levels

Tax source	Revenue (trillions)
Individual	
Tax hikes for those making $1 million or more, or	$3.0
Tax hikes for those making $500,000 or more	$4.3
Corporate	$1.2
Total	$4.2–5.5

Source: Authors' calculations; IRS 2018a, 2019b; Auten and Splinter 2019; CBO 2019.

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at the top of the wealth distribution (Rubin 2019; Stankiewicz 2019). Even a main academic proponent of the Warren proposals concedes that their impact would place them on the wrong side of the Laffer curve (Frank 2019; Saez and Zucman 2019b), that is, a lower tax rate might actually raise more revenue than the rate proposed.

Our estimates show that returning top individual income tax and corporate tax rates to their historical peak would generate between $4.2 trillion and $5.5 trillion in a decade, depending on what share of high earners see tax increases. Senator Warren's campaign estimates that the proposed tax changes to be borne by this group will raise $13.2 trillion in a decade, more than twice as much. This would represent a tax increase nearly 10 times as large as the Clinton-era reforms and the Obama administration's tax proposals pursued in this vein, which at the time were not successfully legislated. In light of historical experience, it seems unlikely to expect to generate this much revenue from tax increases on the top alone.

The base-broadening approaches proposed in the next two sections of this chapter meet a stringent test: they make the tax code more efficient and raise substantial revenue in a very progressive way. But our revenue estimates are less optimistic and involve taxing a broader swath of the population than other approaches that have been advocated.

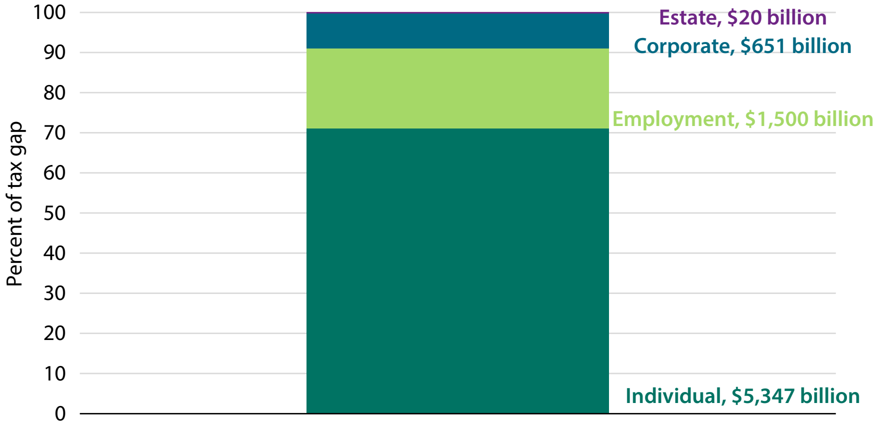
Investing in Compliance to Create a More Progressive Tax System

The IRS estimates that between 2011 and 2013, it failed to collect more than $380 billion in taxes per year—across all filing categories (individual income tax, corporate income tax, self-employment tax, estate tax, and excise tax).[3] Extrapolating this estimate to the present to allow for inflation and income growth, we find that in 2020 the IRS will fail to collect more than $630 billion, or nearly 15 percent of total tax liabilities. Figure 1 shows that the tax gap will total an estimated $7.5 trillion between 2020 and 2029. (See figure 2 for noncompliance rates by filing category.) Shrinking the tax gap by 15 percent would generate over $1 trillion in revenue in the next decade.

It is hard to imagine a more equitable tax proposal than substantial investment in compliance to make sure that individuals and firms pay the taxes they owe. Distortions are also limited because these efforts will not add new taxes to an already overly complex and sprawling Internal Revenue

FIGURE 1.

Projected Tax Gap in 2020–29 by Filing Category

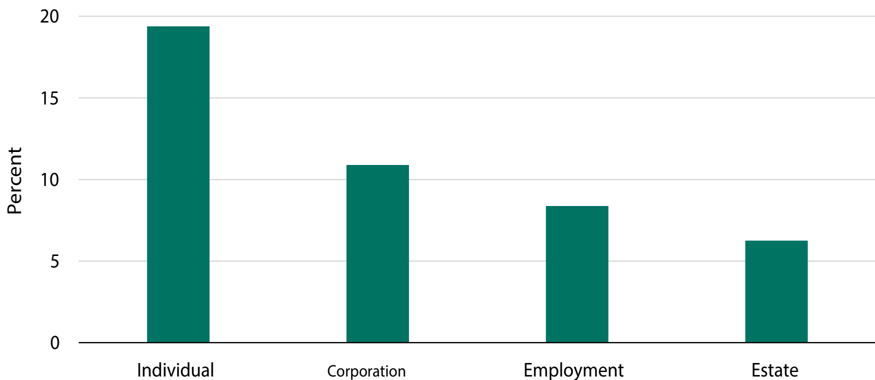


Source: Sarin and Summers 2019b; IRS 2019a.

Note: The employment tax gap includes both underpaid employment and self-employment taxes. To compute the tax gap for 2020–29, we first take the share of the gross tax gap for which the IRS reports each filing category was responsible in 2012. We apply those shares to our estimate of the overall net tax gap for 2020–29.

FIGURE 2.

Average Noncompliance Rate by Filing Category, 2011–13



Source: Sarin and Summers 2019b; IRS 2019a.

Note: The employment tax gap includes both underpaid employment and self-employment taxes. To compute the tax gap for 2020–29, we first take the share of the gross tax gap for which the IRS reports each filing category was responsible between 2011 and 2013. We apply these shares to our estimate of the overall net tax gap for 2020–29.

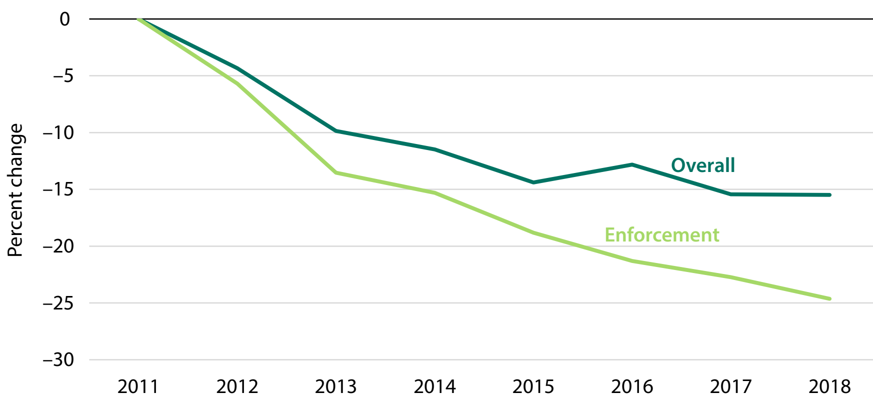
Code. Beyond being efficient and fair, these investments will also create a more progressive tax system.

Consideration of individual income tax filers illustrates this point clearly. Tax compliance decreases with wealth, because the categories of income that accrue to the richest Americans are the most opaque and thus least likely to be honestly reported and taxed: Over 80 percent of income that accrues to those who make under $200,000 annually is salary and wage income, subject to both cross-party reporting and withholding requirements, with a resulting compliance rate of 99 percent. Less than 20 percent of the income that accrues to those making $10 million or more is wage income. These high-income individuals are much more likely to report partnership income and rental income, with much higher rates of noncompliance.

While elimination of the tax gap is impossible, the magnitude of the gap is a function of the IRS's resources available to pursue and punish noncompliance. Today, these resources are at historic lows, as shown in figures 3 and 4. In the last decade, the IRS budget has declined (in real terms) by 15 percent (35 percent if measured as a share of collections reinvested into the IRS). This substantial decline is the consequence of a sustained attack on the IRS by special interest groups who benefit from a lax tax regime. The result is large direct revenue losses: as the rate of individual and corporate audits fell by half, additional tax revenue generated by these examinations fell by the same proportion.

FIGURE 3.

Percentage Change Relative to 2011 in Real IRS Budget



Source: Sarin and Summers 2019b; IRS 2012–18.

Note: All dollar figures were converted into 2018 dollars.

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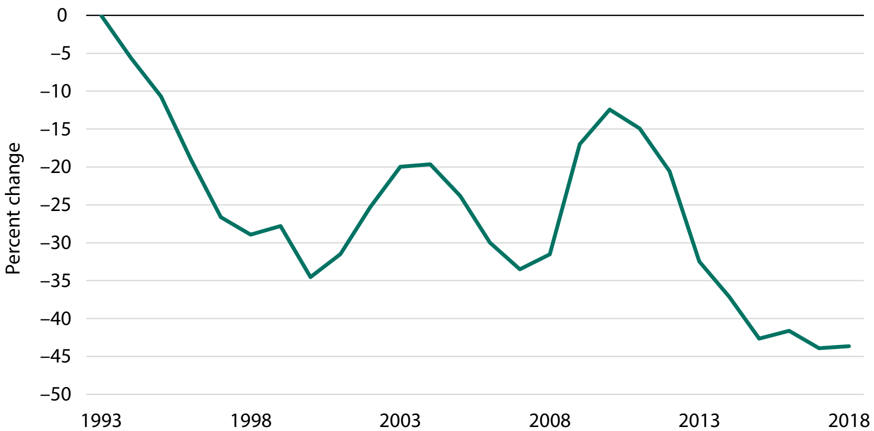
FIGURE 4.

Percentage Change Relative to 1993 in IRS Budget as a Share of Gross Collections



Source: Sarin and Summers 2019b; IRS 2018b.

Note: Calculated as the ratio of reported IRS operating costs to gross collections.

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Returning the IRS budget to past levels would, we believe, pay for itself many times over. By focusing these additional resources on collecting owed but unpaid taxes from high-income individuals, such investment would likely shrink the tax gap by around 15 percent (table 4).

Our compliance proposals focus on three main areas: increasing examination resources, investing in technology infrastructure, and encouraging more cross-party reporting to verify that income is reported accurately and tax liabilities are appropriately assessed.

INCREASE AND BETTER TARGET AUDIT EFFORTS

Our proposal involves both increasing the number of examinations—across filing categories—and focusing limited resources on audits that are most likely to generate substantial revenue: those of high-wealth individuals. The IRS enforcement budget has dropped by a quarter in real terms since the financial crisis, and as a result, the IRS today has fewer auditors than at any point since World War II. Tax enforcement efforts today are at their lowest level of the last four decades, despite the responsibilities of the IRS and the growing difficulty of ensuring tax compliance (Rubin 2020). See figures 5 and 6 for details.

TABLE 4.

Summary of Revenue-Raising Potential of Compliance Efforts

Tax gap	$7.5 trillion
Approaches to shrink tax gap	
Enhanced enforcement resources	$715 billion
Improved information reporting	$350 billion
Information technology investment	$100 billion
Approximate total revenue raised	$1.15 trillion
Percent decrease in tax gap, net of costs	15%

Source: Sarin and Summers 2019b.

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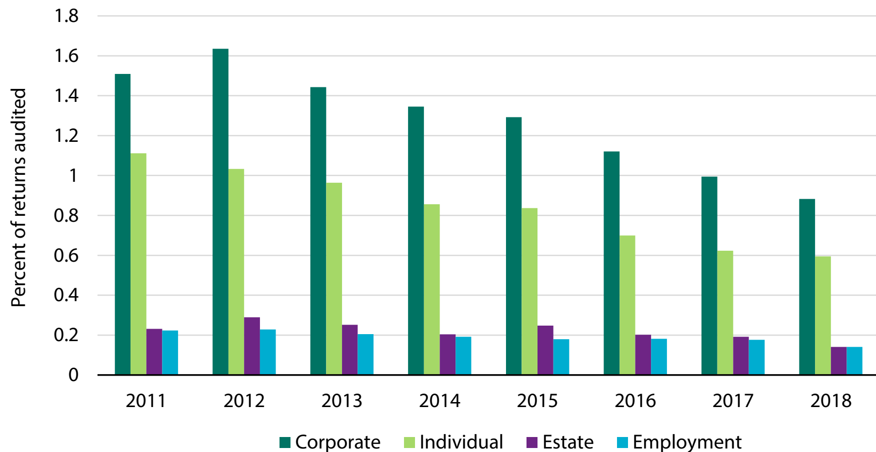
FIGURE 5.

Percent of Returns Audited by Filing Category



Source: Sarin and Summers 2019b; IRS 2011–18a.

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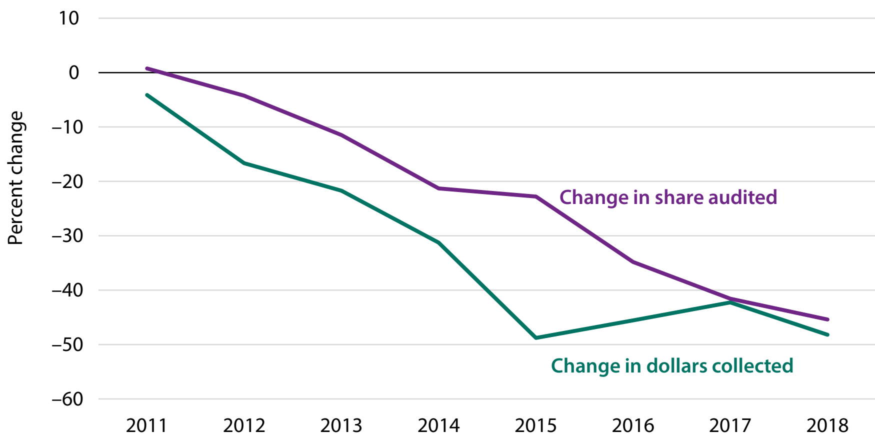
The decrease in enforcement expenditure means that the likelihood of an individual return being audited has fallen by 50 percent in the last decade. And the share of millionaires audited has decreased from over 12 percent to around 3 percent. Individual audit rates have dropped for the last eight consecutive years, and the IRS reported that audit rates fell by over 20 percent in fiscal year 2019 alone (Rubin 2020). It is challenging to estimate how significantly this impacts tax collection, but it is telling that, as the share of millionaire audits declined by around 75 percent over this period, the additional taxes collected, following examinations of this group decreased by a similar amount.

In related work, we estimate the returns to a substantial investment in IRS resources (Sarin and Summers 2019). Had the IRS been able to conduct audits in 2018 at 2011 rates, it would have conducted nearly 800,000 more individual audits, nearly doubling actual 2018 audit rates; nearly 12,000 more corporate audits, increasing audit rates by around 66 percent;[4] more than 3,200 more estate tax returns, more than doubling estate tax examinations; and nearly 25,000 more employment tax returns, almost doubling employment audits (Sarin and Summers 2019). The increase in revenue from these additional examinations would have totaled nearly $30 billion ($360 billion in a decade).

FIGURE 6.

Percentage Change Relative to 2010 in Audits and Additional Tax Liability Imposed



Source: Sarin and Summers 2019b; IRS 2011–18a.

Note: Yearly tax liability were converted to 2018 dollars. Estimates consist of additional tax liability imposed post-examination but do not include civil penalties assessed to tax evaders.

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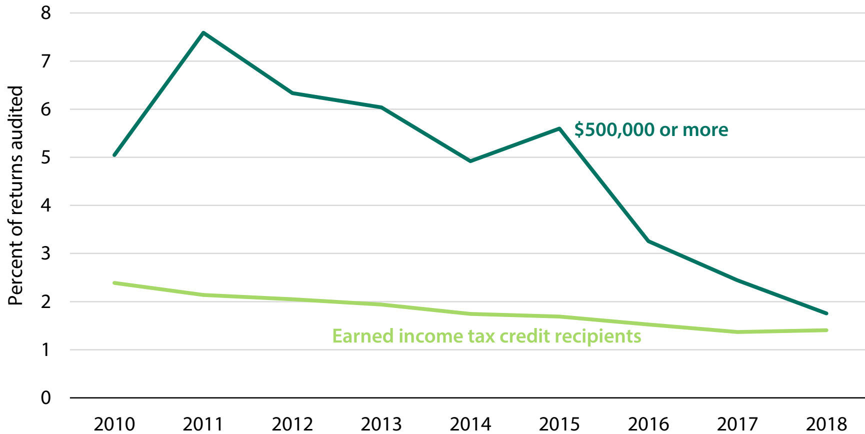
FIGURE 7.

Audit Rates for Those Earning $500,000 or More vs. Earned Income Tax Credit Recipients



Source: Sarin and Summers 2019b; IRS 2011–18a, 2011–18b.

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Investment in examinations could be made even more progressive by targeting the enforcement resources on high-wealth returns. Tilting audit resources toward the wealthy would be more efficient in addition to being more progressive: An extra hour spent auditing an individual filer who earns $200,000 annually generates only around $600. An extra hour spent auditing someone who makes $5 million or more a year generates nearly $4,500 (George 2019). From an efficiency perspective, it is hard to justify why individuals who receive the Earned Income Tax Credit are as likely to have their filings audited as those who make $500,000 or more annually (figure 7).

Our estimation suggests that by holding audit rates fixed for individuals who make $200,000 or less annually and instead focusing new enforcement resources on the examination primarily of high-income individual filers, corporations, and estate tax filers, it would be possible to increase the revenue raised from greater compliance resources to around $715 billion in a decade. This amount is perhaps an overestimate because our extrapolation ignores the fact that the average revenue generated from high-income audits is higher than the marginal revenue that would be generated from an additional audit. However, our estimate also ignores the indirect revenue generation that accrues from greater investment in tax compliance deterring errant filings, which according to U.S. Treasury estimates can be

more than three times the size of the direct benefits that are our focus (U.S. Department of the Treasury 2018a).

HOW PROGRESSIVE ARE TAX GAP EFFORTS?

These estimates of returns to a progressive increase in examination levels may well be optimistic, and proper scoring by professional scorekeepers is imperative. Several points are worth highlighting. First, to estimate the returns on additional audits of high-income individuals, we rely on IRS data that provide net misreporting percentages for different income types. Wage and salary income is essentially perfectly reported (net misreporting percentage of 1 percent), whereas more opaque categories like capital gains (net misreporting percentage of 23 percent) and proprietorship income (net misreporting percentage of 55 percent) are less likely to be reported properly. We use these averages to calculate net misreporting percentages by income category for individuals at different categories of AGI, based on their income shares in different categories. Based on this approach, net misreporting rates are more than 5 times as high for those who make $10 million or more annually as they are for those who make under $200,000 (table 5). These estimates suggest that a substantial portion of noncompliance accrues from those who are in the top 1 percent of the income distribution, suggesting that efforts to curb noncompliance will be borne primarily by top earners and thus these efforts will be progressive.

Our estimates suggest that tax gap reduction efforts are borne primarily by the wealthy because their income accrues less in wage and salary income and more in opaque categories with high misreporting percentages.

TABLE 5.

Average Underreporting Percentage by AGI Category

AGI category	Average share underreporting (percent)
Less than $200,000	2.6
$200,000 to $500,000	4.5
$500,000 to $1 million	6.7
$1 million to $5 million	9.1
$5 million to $10 million	11.1
$10 million or more	13.9

Source: Sarin and Summers 2019b, IRS 2019a, and authors' calculations.

Note: For each AGI bracket, the average share underreporting is calculated as the average of misreporting percentages by income category weighted by the share of income that the income category represents for that AGI bracket.

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However, we fail to account for differences in misreporting rates *within income type* that may differ by income category.

Johns and Slemrod (2010) study the distribution of tax noncompliance based on an audit study of the individual income tax gap performed in 2001. They find that for opaque categories of income—like Schedule C business income, partnership income, and capital gains—noncompliance rates peak between the 90th and 99th percentiles of the income distribution, before falling for the top 1 percent of earners. The overall trend they document is that for each income category, misreporting rises with income level, peaking in a high *but not the highest* income group. There are reasons to be skeptical of this conclusion. First, this audit study was based on 2001 tax returns, and composition of the tax gap has shifted significantly since then. For one, misreporting rates for capital gains have doubled in this period. It is not obvious how this change in composition impacts the misreporting rates by income level that Johns and Slemrod estimated. Second, it is possible that the audit study methodology is not well tailored to capturing misreporting by the highest income earners, which implies that underreporting at the top is higher than estimated.[5]

In prior work, we extrapolate from the overall net misreporting rates in table 5 to estimate that 70 percent of the tax gap accrues to the top 1 percent (Sarin and Summers 2019). Those estimates suggest that in 2001 the top 1 percent accounted for nearly 30 percent of the tax gap (expanding to the top 5 percent of earners brings the estimate to 70 percent of the tax gap). The Johns and Slemrod approach suggests that the share of the tax gap that accrues to the top 1 percent is around half this, and that 70 percent is a better estimate for the share accruing to the top 5 percent.

It is impossible to know with precision what the distribution of noncompliance is. However, the suggested reforms focus on increasing the tax compliance of high-income earners by increasing audit rates primarily for millionaires, corporations owned primarily by these individuals, and their estates. As such, the additional income generated from the greater tax enforcement efforts outlined would likely accrue from the top 1 percent of earners.

INVEST IN INFORMATION TECHNOLOGY

Beyond examinations, the outdated IRS technology offers substantial scope for a useful overhaul that will enable the IRS to better detect and address errant returns and will decrease costs of compliance efforts such as field audits. A few facts illustrate the extent to which the IRS has underinvested in technology: In 2018 the IRS spent only $2.5 billion on new information

technology investments. That number seems large until we compare it to Bank of America's outlays, which were around $16 billion—despite the company serving only 25 percent of American households (Sarin and Summers 2019).

One may believe that the IRS does not need substantial new technological investment because it has already developed state-of-the-art technology to address noncompliance. The magnitude of the tax gap suggests this is unlikely. Consider the following illustration of the deficiencies of the IRS's system: 97 percent of individual income tax filers receive at least one "information return" that contains information that can be used to identify misreported income. However, in 2010 (the last time these data were made available), the IRS identified five times as many mismatches as it was able to successfully resolve.[6] According to the U.S. Government Accountability Office (GAO), the IRS file systems date to 1960 and are among the oldest in the federal government (GAO 2018a), and the most recent Taxpayer Advocate report speculates that without an overhaul, there are "limitations on the functionality of a 60-year-old infrastructure, and at some point, the entire edifice is likely to collapse" (Office of the Taxpayer Advocate 2018, 351).

The IRS understands the substantial revenue benefits of investments in technology and has campaigned for additional resources that have allowed it to pilot programs that hint at the benefits of a technological overhaul. One success story is the return review program, which automates analysis of returns to prevent the issuance of invalid refunds. In 2017, this program saved the IRS $4.4 billion and cost only $90 million (GAO 2018b, U.S. Department of the Treasury 2018b). Greater investment in this and similar efforts have substantial potential to raise additional tax revenue in a progressive manner.

INCREASE INFORMATION REPORTING REQUIREMENTS

Better technology to help address discrepancies through information returns solves only a piece of the puzzle. Many income categories are subject to little or no cross-party reporting, which means there is no way to check the accuracy of these returns against information reported from another source. Unsurprisingly, income subject to little reporting—like proprietorship income and rental income—is also the category of income where compliance rates are lowest: 45 percent at last estimate. Increasing the visibility of more opaque sources of income is likely to raise substantial revenue. Like our other proposals in the compliance arena, this too is a progressive reform, because opaque income accrues primarily to individuals

at the tail end of the income distribution: less than 4 percent of individuals who make $200,000 or less a year report any rental or royalty income on their tax returns; over 40 percent of those who make $5 million or more annually do. In related work, we estimate that an increase in information reporting could generate $350 billion in additional revenue in a decade (Sarin and Summers 2019).

Increasing information reporting is generally regarded as an effective way to increase tax compliance. The GAO and the IRS suggest that reporting requirements are among the "few means of sizably increasing the compliance rate" (Herndon 2019, 3; see also McTigue 2019). Still, there are reasons to be skeptical about the promise of increased information reporting requirements. The most recent effort on this dimension was an expansion of reporting requirements for landlords and small businesses—requiring them to file 1099 forms for all purchases of goods and services over $600 annually. This effort was quickly repealed because of the burden imposed on small business owners, hinting at the political obstacles to successful reforms on this dimension. Without comprehensive information reporting, there is also significant room to game requirements and take advantage of holes in reporting regimes. Beginning in 2011, electronic payments received by businesses operating as sole proprietorships (e.g., credit card payments) were reported to the IRS and businesses on forms processing these payments, via Form 1099-K. This increase in information reporting made taxpayers more likely to file business income returns, and reported receipts rose by up to 24 percent (Slemrod et al. 2017). However, taxes paid did not increase by a similar magnitude, because taxpayers largely offset the increased receipts with an increase in reported expenses, with no corresponding information reporting requirements. This experience gives guidance on the appropriate design for information reporting requirements: excluding certain categories of income from information reporting will encourage income to shift into these excluded categories when reporting requirements rise. It will be important to anticipate gaming possibilities and increase information reporting across categories of income.

Other Progressive Tax Reforms

More can be done to rein in illegal tax evasion by the wealthy and the firms they control. But there is also a compelling case to be made to restrict the legal maneuvers that fortunate individuals, with the help of skilled tax advisors, avail themselves of to lower tax liabilities. As one of us has written elsewhere, "With respect to taxation, as so much else in life, the real scandal is not the illegal things people do—it is the things that are legal" (Summers

2014). Here, we make the case for some base-broadening and efficiency-enhancing reforms that will decrease opportunities for legal tax avoidance.

CLOSING CORPORATE TAX SHELTERS

Firms shift revenues to countries with lower tax rates to avoid corporate tax liability. Economist Kimberly Clausing (2016) estimates that the cost to the United States from corporate tax base erosion is more than $100 billion annually. Beyond revenue consequences here in the United States, the ability of firms to erode tax liability in this manner creates a destructive race to the bottom, as jurisdictions strive to attract large and mobile multinational firms by offering them the most attractive tax treatment. Corporate tax base erosion also adds to the regressivity of the tax system since empirical evidence suggests that corporate taxes accrue primarily to shareholders and not workers: the Joint Committee on Taxation and the U.S. Treasury estimate that 75 to 82 percent of the burden of the corporate tax falls on owners of capital (Cronin et al. 2013; Joint Committee on Taxation 2013).

A major tenet of the TCJA was its effort to reduce the incentives for and ability to engage in costly profit-shifting. As such, the legislation imposes a minimum tax on “global intangible low-taxed income” of foreign corporations. The basic idea is that foreign earnings are subject to a minimum tax rate of 10.5 percent (which will rise to 13.125 percent by 2025). Firms are provided tax credits for their foreign tax liabilities, but importantly, these credits accrue on a global (rather than per-country) basis. Paradoxically, the new regime incentivizes firms to locate investment in jurisdictions with both higher and lower corporate tax rates than the United States, because income can be blended from both groups of countries to decrease domestic tax liability. The result is an “America last” corporate tax regime.

Incremental changes can have a large impact: for example, transitioning to a regime where credits for corporations with investments abroad accrue on a per-country rather than a global basis will raise tax revenues by nearly $170 billion in a decade. But more must be done. Needed reforms include more robust international cooperation to deter profit-shifting incentives, harsher penalties for firms and tax advisors who facilitate dubious sheltering, and penalties on tax havens. These reforms would have the dual benefit of encouraging the location of economic activity in the United States and discouraging the use of vast intellectual resources to design clever tax avoidance strategies.

CLOSING INDIVIDUAL TAX SHELTERS

Individuals avail themselves of a number of legal tricks to lower individual tax liabilities. Many of these moves relate to the use of corporations and partnerships as shields to lower individual tax liability. Tax gaming opportunities based on using a corporation as a tax shelter are straightforward to understand: Since top individual tax rates are high (exceeding 40 percent in some cases), it pays to recharacterize one's income. The TCJA's changes increased the incentives for gaming on this margin by lowering corporate rates substantially and increasing the incentives to characterize income as earned through ownership of a corporation, rather than accruing to an individual employee. Although earning income through a corporation imposes a cost in the form of a "double tax" when that income is distributed, individuals can shield income from double taxation in a number of ways, such as by retaining the interest until death; holding corporate shares in retirement accounts that are tax-advantaged; or making use of loopholes that enable corporate distributions without tax, like Section 1202 of the Internal Revenue Code, which excludes from taxation the gains from small business stock (Kamin et al. 2018). In a world where the IRS's ability to enforce tax compliance has been diluted by budget cuts and the incentives to game these margins have increased with the decrease in the corporate tax rate, many of these loopholes, which have long been available to taxpayers, are increasingly attractive following the 2017 TCJA.

Individuals may also choose to organize their small businesses as S corporations for tax benefit. Most American workers have wages deducted to cover the cost of entitlement programs like Social Security and Medicare. However, payroll taxes apply only to income derived from wage labor, not to business profits, so small business owners and professionals who form S corporations can avoid payroll taxes by characterizing income as business profits rather than wage income (Hanlon 2012).[7] The Obama administration estimated that the gains from eliminating the payroll tax loophole alone would be around $300 billion over a decade (U.S. Department of the Treasury 2016).

REFORMING CAPITAL GAINS TAXATION

Reforms to capital gains taxation have received substantial academic and political attention. The central issue identified by reformers is that the current tax regime is ill equipped to collect revenue from the very wealthy, who earn and report income differently from the rest of the population. Wages and salaries constitute less than 10 percent of the income of the top 0.001 percent, while capital gains and dividends taxed at preferential rates

make up 71 percent, with business income (oft underreported and thus undertaxed) accounting for the remainder (Batchelder and Kamin 2019).

Capital gains are taxed at preferential rates, lower than ordinary income levels. Often, capital gains escape taxation altogether. For example, gains passed to an heir receive a "step-up" in basis and are thus untaxed. Additionally, when capital gains are donated to charity, the gains are untaxed and the donor receives an income tax deduction for the fully appreciated value of the asset.

We propose an overhaul of capital gains taxation. In our system, the death of the owner of a capital asset will be a realization event for tax purposes. Thus, the rationale for mark-to-market accrual of capital gains is substantially decreased, because the government will eventually be able to collect tax revenue on all gains. Although in many instances tax collection will not occur until death, in a world where long-term interest rates are currently near zero, the present value of annual tax collection and that of an end-of-life tax are comparable. Further, our proposal is administratively much less cumbersome, requires valuation only once in life, and does not require the IRS to deal with complexities around periods of capital losses. Our proposal has five components.

Taxing Capital Gains at Ordinary Income Levels

Raising rates on capital gains and dividends to the same level as ordinary income would end the tax advantage that accrues to financial relative to labor income. But without more comprehensive changes (outlined later in this chapter), this approach is unlikely to reach its full revenue potential. The Joint Committee on Taxation and the U.S. Treasury assume that the capital gains rate that maximizes revenue is around 30 percent, because of the "lock-in" effect (Batchelder and Kamin 2019). This is because increasing the tax rate on capital gains would influence investment decisions and encourage people to defer the sale of capital assets until death, when they can be passed tax-free to heirs.

The CBO (2018) estimates that raising capital gains rates by 2 percentage points would generate $70 billion in additional revenue in a decade, and thus it follows that raising capital gains rates such that the top tax bracket is taxed at the "revenue-maximizing" level would generate an additional $350 billion in revenue over a decade.

But as part of a more comprehensive reform package, the revenue potential of higher rates for capital gains increases substantially. The Urban–Brookings Tax Policy Center estimates that the revenue-maximizing capital gains

rate rises to 50 percent if the stepped-up basis is repealed (Rubin 2019). For those in the top ordinary income tax bracket, taxing capital gains at ordinary income levels would increase the current rate by 17 percentage points; naïve extrapolation from the CBO estimate suggests that this would raise nearly $600 billion in a decade.

Eliminating Stepped-Up Basis for Capital Gains

Wealth tax advocates are right to point out that the current tax regime facilitates growing wealth inequality. This is because our tax laws allow substantial wealth to be passed down across generations without taxes ever being collected. To understand how this happens in practice, consider an entrepreneur who starts a highly successful company. She pays herself a small salary, and the company does not pay dividends, so it can invest in growth. Her tax liability is thus very low, despite her becoming substantially wealthy, as she does not pay taxes on the growing value of her ownership stake. These unrealized capital gains are only taxed upon a realization event, like their sale.

However, no capital gains tax is ever collected on appreciation of capital assets if they are passed down to heirs. When the entrepreneur dies and leaves the stock of her company to her beneficiary, the cost basis is "stepped up" so that the gain in value during the entrepreneur's life is never taxed.

The beneficiaries of stepped-up basis are the wealthy: nearly 40 percent of the wealth of the top 1 percent is in the form of accrued but unrealized capital gains, and the top 1 percent holds around half of all such unrealized gains (Batchelder and Kamin 2019). In addition to decreasing government revenue, stepped-up basis is distortionary since it creates an incentive to hold on to underperforming assets purely for tax reasons, or to fail to sell these assets to be used in more productive ways while one is alive—because doing so would constitute a realization event.

Eliminating stepped-up basis would thus improve the productivity of the economy and be desirable even if it did not raise any revenue. However, the revenue benefits turn out to be substantial: implementing the Obama administration's proposals for constructive realization of capital gains at death would raise nearly $250 billion in a decade, and 99 percent of this revenue would be collected from the top 1 percent of filers (White House 2015).

Eliminating the Carried Interest Loophole

Similarly, many wealthy individuals shelter income from taxation by taking advantage of the lower tax rates for partners of investment firms. Because income that flows through partnerships is often treated as capital gains and taxed at lower rates, private equity and hedge fund managers have an incentive to minimize the share of their compensation that is ordinary income and to maximize payouts received in the form of "carried interest." The Joint Committee on Taxation estimates that taxing carried profits as ordinary income would generate $20 billion in a decade (Joint Committee on Taxation 2016).

Eliminating Like-Kind Exchanges

A Section 1031 like-kind exchange allows for the disposal of investment property and the purchase of a replacement, without tax liability generated from the sale of the asset. The initial objective of like-kind exchanges was to exempt from taxation small-scale transactions (e.g., livestock purchases by farmers), but today, like-kind exchanges help the wealthy avoid taxation on significant commercial real estate purchases, among other large transactions (Marr 2016). Wealthy investors can combine the tax exemption for like-kind exchanges with stepped-up basis at death to make highly profitable investments that avoid tax liability entirely. Like-kind exchanges average at least 6 percent of all commercial real estate sales based on dollar volume, which rises to 10–20 percent in high-tax jurisdictions (Ling and Petrova 2015). The Tax Reform Act of 2014 proposed the repeal of like-kind exchanges, which at the time were ranked by the Joint Committee on Taxation as the second-largest tax expenditure (Joint Committee on Taxation 2015), and estimated that this would raise $40.9 billion between 2014 and 2023, which, adjusted for growth and inflation, translates to around $50 billion today (Joint Committee on Taxation 2014). Outright elimination of like-kind exchanges would raise five times as much as the Obama administration's more limited proposal to limit real estate and personal property exchanges to $1 million annual gain deferral and to exclude art and collectibles exchanges.

Under the TCJA, Section 1031 now applies only to exchanges of real property and not to exchanges of personal or intangible property (e.g., machinery, equipment, vehicles, artwork, patents, and other intellectual property). We propose the repeal of Section 1031 entirely, which may generate less revenue than previously estimated due to the TCJA's scaling back of this tax expenditure. It will be important to consider the behavioral effects of repeal in the context of the broader program around capital gains we propose and factor this analysis into official revenue scores. The Joint Committee on

Taxation's estimate of tax revenue loss from like-kind exchanges is only 9 percent of its corresponding tax expenditure estimate because it factors in such behavioral responses—specifically, that in the absence of like-kind exchanges, taxpayers would delay transactions, which would substantially diminish the potential revenue gains from repeal (Ling and Petrova 2015). This lock-in effect is muted by our broader set of reforms.

End Tax Advantages for Charitable Giving of Long-Term Appreciated Assets

The tax code incentivizes charitable giving through the donation of long-term appreciated assets. This is because when an individual donates an asset—like a share of stock—that has appreciated in value, capital gains on that asset generally go untaxed and the individual receives a credit equivalent to the full value of the share, despite not paying any tax on the gains.[8] From the taxpayer's perspective, this approach is preferable to selling the asset (and paying capital gains) and making a monetary charitable donation, with a smaller deduction. It is also preferable to the charity, which receives the entire asset—rather than the cash that remains after paying capital gains taxes.

To understand the differences between these approaches for the individual and for the charity, consider a taxpayer in the top tax bracket who plans to make a $10,000 donation to charity (table 6). This taxpayer has a 40 percent combined federal and state income tax rate and a combined 20 percent tax rate on capital gains. The stock has a cost basis of $2,000.

We propose eliminating individuals' ability to use charity to escape capital gains liability. Practically, this means constructive realization of

TABLE 6.

Tax Effects of Stock vs. Cash Charitable Contribution

	Stock donation	Cash donation
Combined federal and state income taxes	40%	40%
Tax rate and amount for selling stock	Not applicable	$1,600 (20% tax rate on $8,000)
Net amount to donate	$10,000	$8,400
Tax savings	$4,000	$3,360

Source: Authors' calculations. Note: Calculations assume a $10,000 donation of an asset with a $2,000 cost basis, which is either donated as stock or as cash.

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capital gains when individuals give to charity. This will mean that that tax preferences for charitable gains will be equivalent whether individuals choose to donate assets or the cash that is generated from the sale of those assets. To our knowledge, the CBO has not scored this proposal directly, but it estimates the revenue gains from eliminating deductions for noncash charitable contributions at around $150 billion over a decade (CBO 2018).

From both a behavioral and scoring perspective, it will be imperative to think about the interaction between the tenets of the proposed program, rather than to evaluate its components in isolation. Our naïve revenue estimation fails to account for the interaction effects of the various prongs of our proposal, but they are likely to be important. For example, taxing capital gains at ordinary income levels will have a lock-in effect that discourages the realization of capital gains. This lowers the revenue that the CBO estimates will be raised by the change. But the CBO estimate is independent of simultaneous changes to the tax code: combining an increase in capital gains tax rates with constructive realization of capital gains at death disincentivizes lock-in because taxes will eventually have to be paid on appreciated capital gains. Our elimination of the use of charitable giving to avoid taxes on capital gains further strengthens this effect.

Overall, we believe we have designed a program that eliminates the incentive to lock in capital gains because it eliminates loopholes to avoid eventual taxation on these assets. This change should mitigate concerns about illiquidity and distortions that arise from under-realization of capital gains. It also makes a program of mark-to-market capital gains taxation less attractive, especially given the administrative complexity. In today's world, with long-term interest rates near zero, there is little reason to insist on immediate realization of capital gains if we create a system requiring taxes eventually to be paid on these gains.

CAPPING TAX DEDUCTIONS AND EXCLUSIONS FOR THE WEALTHY

A homeowner in the top tax bracket who makes a $1,000 mortgage payment saves $370 in taxes (37 percent top-rate deduction). Under an Obama administration proposal to cap these deductions at 28 percent across earners, this same write-off would save this wealthy taxpayer just $280. Importantly, this change would raise tax burdens only for the rich who benefit from a deduction at top-rate levels. The change would apply to itemized deductions such as mortgage interest, charitable giving, and medical expenses. Those with marginal rates under the cap would still be able to claim the full value of their itemized deductions, making this reform progressive.

Our proposal would also apply to certain types of income currently exempt from any tax liability, such as municipal bond interest, workplace health insurance, and retirement savings contributions, as proposed in the fiscal year 2017 Obama budget (U.S. Department of the Treasury 2016).[9]

The TCJA decreased the deductibility of home mortgages, such as by allowing homeowners to claim a deduction for the interest on up to only $750,000 of mortgage debt (previously, the limit was $1 million) and by capping the deductibility of state and local real property taxes at $10,000. Despite these changes, the Obama-era proposal to cap itemized deductions would still generate significant additional tax revenues, though exactly how much can be raised is unclear. At the time it was proposed, it was estimated to raise nearly $650 billion in a decade (Sperling and Furman 2012). In earlier work, we speculate that following the TCJA, additional cuts in this vein are likely to raise $250 billion in a decade (Sarin and Summers 2019).

ENDING THE 20 PERCENT PASS-THROUGH DEDUCTION

Arguably the most distortionary of the changes brought about by the TCJA is the newly introduced 20 percent deduction for qualified business income. This deduction exacerbates the already significant problems that arise from a tax system that preferences noncorporate business income over individual earnings.

It is hard to identify any defensible policy rationale for this deduction. Perhaps it was a misguided attempt to decrease the incentives to shift business income into corporate structures following the decrease of the corporate rate to 21 percent (Kamin et al. 2018). But the structure of the deduction creates a complex framework with innumerable gaming opportunities. For example, certain lines of business are ineligible for the deduction, including professionals in health, law, athletics, and any trade or business in which the principal asset is the reputation or skill of owners or employees. There is no rationale for why some categories of income are favored with a tax break and others disfavored—indeed, some categories of professionals, such as architects and engineers, shifted categories as the conference bill evolved.

The most obvious gaming opportunity that this deduction enables is for individuals in preferred service industries who can be recharacterized from employees (ineligible for the deduction) to nonemployees (who benefit from it). Even those who are employed in exempt categories, like legal professionals, can benefit from the deduction by "cracking" income streams to take advantage of the tax break, for example by forming separate firms to hold their real assets in real estate investment trusts (REITs) eligible for

the deduction; or by "packing" income into qualified service categories, as described by Kamin et al. (2018).

Estimates suggest that this provision will reduce federal revenues by $430 billion in the next decade (Joint Committee on Taxation 2017). Its elimination from the Internal Revenue Code will raise revenue primarily from taxpayers making more than $1 million annually and eliminate the wasteful intellectual energy spent on trying to qualify for this deduction.

LOWERING THE ESTATE TAX THRESHOLD

Before the TCJA, only 5,000 Americans were liable for estate taxation. The recent changes more than halved that small share by doubling the estate tax exemption to $22.4 million per couple. The Joint Committee on Taxation estimates that this change costs $83 billion (2017), with the benefits accruing entirely to 3,200 of the wealthiest American households. Repealing these changes and applying estate taxes even more broadly than before—for example, as the Obama administration proposed, by lowering the threshold to $7 million for couples—would raise around $320 billion in a decade, while still imposing estate tax liability on only 0.3 percent of decedents.

In addition to broadening the estate tax base, there is also significant room to attack the many loopholes that enable the well-advised ultra-rich to avoid estate taxation. The current estate tax rate is 40 percent; however, the effective estate tax rate (total tax collections as a share of the gross taxable estate) is less than 10 percent. Even after adjusting for the fact that many estates are nontaxable, since they are bequests to surviving spouses, the effective estate tax rate remains only around 20 percent, about half of the actual estate tax rate. This is because a great deal of wealth escapes estate taxation, such as through the establishment of trusts that enable division of assets among family members, planning devices that give income to charity while keeping the remainder for heirs, and other complex estate tax avoidance devices known to sophisticated tax advisors.

We support proposals that limit these loopholes and curb opportunities for estate tax planning. One approach with substantial merit is Lily Batchelder's proposal to transition from an estate tax to an inheritance tax, imposing tax liability on the heirs who profit from inherited wealth, rather than the estate that provides it. This approach would have the benefit of rewarding estates that disburse wealth broadly, attacking wealth concentration directly. It is also likely to be more efficient than more progressive income taxation or wealth taxation because the available empirical evidence suggests that the wealthy, when making work and saving decisions, do not place as high a

value on the inheritance of their heirs as they do on taxes that impact them or their estates directly (Batchelder 2020).

INCREASING THE CORPORATE TAX RATE TO 25 PERCENT

When corporations began lobbying for corporate tax reform, their stated object was a 25 percent tax rate. The TCJA delivered more than the business community asked, slashing the corporate rate to 21 percent. The CBO estimates that a 1 percentage point increase in the corporate tax rate would generate $100 billion in the next decade (2018), so a 4 percentage point increase to 25 percent could generate an additional $400 billion in revenue.

Raising the corporate tax rate would not increase the tax burden on most new investment, because it would raise in equal measure the valuation of the depreciation deductions that corporations can take when they undertake investments. This increase would primarily burden those earning excess rents from monopoly-like profits and those who have received enormous windfalls from the TCJA. This increase would be administratively straightforward given that the corporate tax infrastructure is well established. As discussed, since the costs of corporate taxation fall overwhelmingly on owners of capital rather than workers, increasing the corporate tax rate would also be very progressive. A higher corporate tax rate would also mitigate, at least somewhat, the incentives created by the TCJA to reclassify labor income as corporate income to minimize tax liability.

MINIMUM TAX ON BOOK INCOME

In 2018 around 1,200 U.S. companies reported net income of more than $100 million. Of these, nearly 25 percent paid zero or negative federal income taxes (authors' calculations using Standard & Poor's Compustat Services 2018). A minimum tax on book income would help ameliorate the regular failure to levy taxes on profitable firms. A minimum tax is preferable to an additional tax on book income—as has been proposed in the 2020 election cycle—because it does not create distortions from double taxation of firms that already bear substantial tax liabilities.

We estimate that a minimum tax of 10 percent on book income would raise nearly $800 billion in a decade. However, it is important to adjust this total to account for taxes paid by large multinational corporations in foreign jurisdictions. Further, tax liabilities must be adjusted to allow for carryforwards, so that companies with variable tax liabilities are not treated unfairly. These adjustments decrease the revenue-raising potential of a 10 percent minimum tax to slightly over $200 billion over a decade.

Importantly, these estimates are based on the number of firms liable for a minimum tax on book income in 2018; these are firms that, in this scenario after the passage of the TCJA, would be eligible for this tax because their total federal and foreign tax liabilities do not reach the 10 percent minimum threshold. We also propose increasing the corporate tax rate from the current 21 percent rate to 25 percent. This scaling back of the TCJA will mechanically decrease the number of firms paying a minimum tax on book income and thus will have the potential to raise revenue.

Some Issues with Newer Alternatives

The measures that we propose in this chapter meet a stringent test. They are reforms that would be desirable even if the government did not have pressing revenue needs. They are progressive and reduce the ability of those at the top to make use of special breaks that have advantaged them at the expense of American taxpayers for too long.

It is useful to compare the approaches we advocate—increased investment in tax compliance as well as base-broadening reforms—to alternatives in the current tax reform debate, such as wealth taxation and accrual taxation of capital gains. From both an economic and a political economy perspective, we believe the approaches we describe are superior.

Economists tend to favor base-broadening tax reform. This is because broadening the tax base is more efficient than increasing tax rates. The logic is simple: increasing tax rates encourages inefficient behavior to avoid higher tax liability. In contrast, broadening the tax base decreases such inefficient behavior; for example, eliminating loopholes like the pass-through deduction decreases effort by individuals and the tax planners they employ to recharacterize income to exempt it from tax liability. This suggests that even if we decide that the government's revenue needs require substantial increases in top tax rates, such approaches should be pursued only after the revenue potential of base-broadeners is exhausted.

The question of what base should be used to evaluate tax progressivity requires further consideration. Conceptually, lifetime expenditure would be the ideal base, but traditionally economists have evaluated how progressive the tax code is with respect to individual income. Many believe that the concentration of wealth has risen faster than the concentration of income in the United States in recent decades. This line of study is complicated by the fact that the definition of wealth and measures of its concentration are far from obvious (Smith, Zidar, and Zwick 2019; Weil 2015). To make the case that measurement of progressivity should be based on wealth shares

rather than income shares requires confidence that wealth can be measured properly and a belief that wealth somehow confers benefits even if it is not spent. This case has yet to be made.

From an administrability standpoint, we are skeptical of wealth taxation and mark-to-market proposals. Recent estimates speculate that wealth tax proposals could generate nearly $4 trillion in a decade and that mark-to-market accrual of capital gains could raise around $2 trillion (Batchelder and Kamin 2019; Saez and Zucman 2019a). We believe these estimates are substantially overstated because both approaches raise practical questions—largely ignored by naïve revenue estimation—that any implemented policy will have to grapple with.

One issue for wealth taxation involves valuation: how will ownership stakes in private firms without market valuations be ascertained, for example? Wealth taxation is also complicated by the illiquidity of the assets held by the ultra-wealthy. An entrepreneur who has built a successful start-up may be liable for a wealth tax but unable to pay it since she cannot sell shares or borrow against the value of her own shares of the firm. Wealth tax advocates believe they have come to a "clean solution" around questions about liquidity that plagued wealth taxation in European countries by raising the exemption threshold so that fewer households are liable for the tax (Saez and Zucman 2019a). But given that the available empirical evidence shows that portfolio shares of the 0.1 percent are most heavily tilted toward illiquid asset classes, it is hard to see how this qualifies as a solution (Smith, Zidar, and Zwick 2019). Other issues around implementation include, for example, the fact that a given wealth exemption will encourage distortionary bunching to avoid wealth tax liability.

In earlier work, we make the point that on an optimistic read, the estate tax—a form of wealth tax that already exists in the United States—generates only 40 percent of the estimated revenue predicted by wealth tax advocates (Summers and Sarin 2019). This difference is attributable to estate tax avoidance strategies such as the use of trusts, tax-advantaged borrowing schemes, charitable contributions, valuation discounts, and the like. Furthermore, the wealth tax base is overstated, likely by a factor of two (Smith, Zidar, and Zwick 2019). In our view a more realistic estimate of the wealth tax's revenue potential is around half of the estimated $3.75 trillion over a decade. Thus, beyond its efficiency virtues, the approach we outline is likely to raise substantially more revenue than this alternative strategy.

Similarly, mark-to-market taxation of capital gains is administratively cumbersome and likely to raise less revenue than has been estimated. Should mark-to-market taxation be applied to both publicly traded and

private assets, then—as with wealth taxation—the valuation difficulties will pose an awesome challenge to the IRS each year. If, instead, taxation on private assets is deferred, then the tax code will contribute to the already increasing trend of firms to stay private for longer to avoid tax liability. Additional questions concern how current unrealized gains and losses will be treated in a mark-to-market regime. If mark-to-market applies only to gains and losses arising *after* the effective date, the result will be a hybrid system that exacerbates lock-in concerns by disincentivizing individuals from realizing gains and losses, lest these transactions trigger annual tax liability in the new mark-to-market regime.

As with a system of wealth taxes, implementation issues also arise from the mark-to-market threshold. Some have suggested that mark-to-market losses can be used to decrease future capital gains taxes (Leiserson and McGrew 2019). But what happens if losses are so large that individuals are no longer eligible for the mark-to-market regime?

On grounds of economic efficiency and administrability, we believe that an approach encompassing base broadening along with restoration of tax rates, like the one laid out in this chapter, dominates approaches based on new tax concepts like wealth taxation or mark-to-market capital gains taxation, or approaches that focus predominantly on increases in tax rates. It is capable of raising substantial sums, probably as much as is politically feasible from those in the top 1 percent of the income distribution.

Additionally, an approach like the one we have outlined is more likely to be implemented successfully than riskier, untested alternatives that are vulnerable to political attacks, legislative impasse, and legal challenges. For example, even if a wealth tax could be passed, it faces a large risk of being found unconstitutional by the current Supreme Court (Hemel and Kysar 2019).

Finally, there are important issues of fairness and equity that suggest base-broadening measures are preferable to alternative approaches. We suspect most Americans would regard tax reform that halved the wealth of the nation's 800 billionaires as being manifestly unfair and setting a worrisome precedent, both for those with less wealth and for those who might be successful in the future. Yet over 10 years, a 6 percent wealth tax does exactly that, even aside from the impact of current income and property taxes. The fact that this taking occurs over a decade rather than all at once does not strike us as all that meaningful a distinction. American experience does not provide a basis for judging the impact of such measures on incentives. Further, political theorists have long felt that government expenditures that most of the population is involved in paying for are more rigorously

scrutinized and better managed than those in which most citizens have no contributory role.

An important consideration is the broad question of whether the correct strategy for addressing inequality is to rely on tax strategies that soak the rich. More egalitarian societies than the United States, such as Sweden and Canada, maintain highly preferential taxation of capital gains and do not tax wealth or estates at all. Instead they pursue the objective of reducing inequality by using broad-based taxation methods, such as the value-added tax, which are borne by all citizens to finance universal entitlements and transfers to the poor.

To some extent our base-broadening tax reform strategy can be criticized along these same lines. But it can be justified on economic efficiency grounds, and it is much less likely to crowd out more universal taxes than a focus on new levies only on those with high income.

Ultimately, those concerned with inequality need to decide whether their greater concern is taking down the rich or raising up the middle class. We believe that a base-broadening strategy is much more conducive to the latter approach.

An objection to the strategy we propose is that many of our ideas, like taxing capital gains at death or limiting deductions, have been around for a long time and have never been enacted. Some argue that perhaps new, more unitary ideas like wealth taxation have a greater chance of enactment. We find the leapfrog idea that big transformative changes are easier to enact than incremental measures highly implausible. Our reading of American political history is that big, immediate transformation efforts like the Clinton 1993 health plan are rarely if ever successful. The success stories like Social Security and Medicare or even the introduction of the income tax all involved long implementation periods and much discussion. The fact that after a half century of discussion the deduction of state and local taxes was repealed in the 2017 tax reform effort illustrates that long-considered proposals can go from unacceptable to acceptable surprisingly quickly.

Questions and Concerns

1. What role should horizontal equity play in determining tax policies?

The principle of horizontal equity suggests that similarly situated individuals should be taxed equivalently. A wealth tax does not achieve this objective. Individuals above the wealth tax threshold will be taxed twice on the same returns: first as income and second as wealth. Those

with equivalent income streams, but who are right below the wealth tax threshold, will pay only income taxes. This is both unfair and creates significant gaming incentives. Further, even among those who face wealth tax liability, their illiquid assets will be taxed based on potentially arbitrary and likely inconsistent appraisals of their value.

Increasing compliance and base-broadening approaches, in contrast, will help ensure that all individuals with the same level of income, regardless of how it is accrued, face the same tax burden.

2. How would you sequence your reforms?

We propose a range of policies from overhauling capital gains taxation, to increases in corporate tax liabilities, to much greater investment in the IRS' enforcement efforts. Since it is unlikely that such a wide range of changes can be implemented immediately, it is helpful to think through what reformers should prioritize first.

We believe that substantial investment in tax compliance is the appropriate place to start. This is practical, because it will take large outlays of both financial resources and time for the IRS to build up a workforce that is well-suited to the substantial increase in auditing and new data-driven enforcement efforts that we recommend. It is also sensible because at least some aspects of our compliance agenda can be implemented without new legislation: better targeting current IRS resources toward policing the returns of high-income earners and matching individual returns to existing information reports are examples of changes that can be implemented immediately. Finally, compliance investment has the fewest economic risks—it increases revenue without introducing any potentially distortionary changes to the tax code and is guaranteed to make the taxation more efficient, by decreasing the incentives for wasteful expenditure to dodge tax liability.

Conclusion

Growing federal spending needs require that the government find ways to raise additional revenue. Given the growth in inequality, progressive tax reform is and should be high on progressives' tax agenda. Our belief is that the way forward involves changes to the tax code that increase compliance, close loopholes, and broaden the tax base. On grounds of economic efficiency and administrability, we believe such an approach dominates new tax concepts like wealth taxation or mark-to-market capital gains taxation.

The program that we lay out is capable of raising substantial sums: around $4 trillion over the course of a decade. As a share of GDP, this total is more than was raised by any tax increase in the last half century, and we believe it represents as much as is politically feasible to raise from increasing taxes on those in the top 1 percent of the income distribution.

The challenges facing the United States today may mean that this base-broadening approach will not raise as much revenue as is needed, but it is clearly the place to start. Measures to increase tax compliance and decrease the ability of the wealthy and large corporations to take advantage of preferential tax loopholes comport with basic notions of fairness, and creating a more efficient tax system will increase the revenue potential of future reforms.

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Endnotes

1. This is a lower bound, since we calculate the total tax liability of the wealthy using the deductions that they claim for taxes paid.
2. The Auten and Splinter (2019) income concept is broader than our focus on adjusted gross income. The authors add to adjusted gross income sources that are not captured on individual returns, including corporate retained earnings, corporate taxes, business property taxes, retirement account income, and other sources.
3. The compliance proposals referenced in this section are detailed at much greater length in Sarin and Summers (2019). The data presented and much of the discussion follow directly from our past work.
4. Note that this estimate is based on the rate of corporate audits, which decreased from 1.5 percent in 2011 to 0.9 percent in 2019. This does not correspond to the total dollars of corporate income that are audited—which is a substantially higher percentage. This is because audit rates for large companies are much higher than the audit rates by number of corporations. One way to see this difference is by looking at the share of large corporations ($20 billion or more in assets) that were audited in 2018—49.3 percent. This is much higher than the general corporate audit rate of 1.5 percent. But the decline relative to the 2011 peak remains significant: in 2011, 95.6 percent of large corporations were audited.
5. One of the problems with the audit study approach is that the wealthy accrue income that is unobservable on their individual tax filings. Cooper et al. (2016) are unable to ascribe 30 percent of partnership income to individual filers, which they interpret as evidence that the tax code encourages firms to organize in opaque partnership forms to lower tax liability.
6. A 2015 Treasury Inspector General for Tax Administration report suggests a similarly low share, reporting that the Automated Underreporter Program that matches individual and information returns routinely identifies more than 20 million individual tax returns with discrepancies annually and typically reviews around 20 percent of the discrepancies it identifies (Treasury Inspector General for Tax Administration 2015).

7. In 2013, the last time the data were made available, the IRS estimated that nearly 70 percent of S corporations are noncompliant with tax rules and that the majority of these cases involved underreported income (GAO 2009). This loophole closure would increase the tax burden on high-paid professionals and small business owners who currently avoid payroll tax liability. S corporations are not large: only 0.12 percent have assets greater than $100 million (IRS 2015). Further, because the Social Security payroll tax is capped at a maximum of employee's wages ($132,900 in calendar year 2019), the gains from this avoidance strategy are limited. However, Medicare taxes are not capped, and the 3.8 percent tax on self-employment earnings for high-income taxpayers can be avoided by using the S corporation structure.
8. Up to an AGI cap of 30 percent (Fidelity Charitable n.d.).
9. An explanation of the workplace health insurance exclusion is provided by the Urban–Brookings Tax Policy Center (2016).

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