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# Achieving Progressive Tax Reform in an Increasingly Global Economy

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# Achieving Progressive Tax Reform in an Increasingly Global Economy

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## Introduction

The progressive tax system, and the nation's fiscal system more broadly, have historically played an important role in expanding opportunities for all Americans while reducing inequality. But the same dynamic forces of technological change, financial innovation, and globalization that have contributed to rising income inequality also present new challenges for progressive taxation. Financial engineering, for example, has made it easier for the financially sophisticated—typically the wealthy—to take advantage of new financial instruments that shelter their gains from tax. And as capital is able to move ever more quickly and easily across borders, corporate income becomes increasingly elusive of taxation. These forces, together with deliberate policy changes, have led to an erosion of progressivity—the principle that higher incomes should face higher rates of taxation—and a dramatic reduction in the average tax rate facing very high-income households. More than half of that decline is the result of declining effective corporate tax rates, as high-income households own disproportionate amounts of capital.

The tax code is not only a means of raising revenue to pay for government services. It also impacts an astonishing array of economic and social activities, from homeownership to education and child care to support for low-income workers. Taxes contribute, as part of the problem or as part of the solution, to many of the challenges our nation faces. The present tax treatment of health insurance, for example, pushes health spending upward while offering many of the uninsured little help in getting coverage. The tax treatment of retirement savings provides a windfall for high-income Americans who would likely have saved anyway, while offering

scant encouragement to saving by low- and moderate-income Americans, many of whom face the prospect of an insecure retirement. America's factories and cars continue to emit vast amounts of the carbon dioxide that drives climate change, a problem that would be remedied, in part, if the tax code imposed a cost for burning carbon-emitting fossil fuels.

There is broad agreement about many of the shortcomings of our current tax system, but little consensus about the solution. To make progress, lawmakers will, at a minimum, have to come together in good faith and agree on a broad approach. In an effort to define a common approach, this strategy paper offers six broad principles that reflect the new challenges facing our tax system in the twenty-first century. We believe these principles should command wide assent as policymakers consider tax reforms, whether incremental or far-reaching:

1. Fiscal responsibility requires addressing *both* taxes and spending.
2. Rising inequality strengthens the case for progressivity.
3. The tax system should collect the taxes that are owed.
4. Tax reform should strengthen taxation at the business level.
5. Taxes for individuals should be simplified.
6. Social policy can and should often be advanced through the tax code—and it must be well designed.

The remainder of the paper will discuss each of these principles in detail.

## Principle #1:

### Fiscal Responsibility Requires Addressing *Both* Spending and Taxes

The nation's fiscal books remain seriously unbalanced, and the problem will soon become much worse. The only real solution is some combination of reduced spending and increased revenue. The long-term challenges from such trends as rising health care spending per capita are simply too great to solve if we limit changes to just one side of the budget.

Restoring a culture of fiscal responsibility can help policymakers address both taxes and spending. A familiar argument views cutting taxes as a way of “starving the beast,” in the belief that only large deficits will force spending restraint. But recent history suggests the opposite dynamic is often at work. In the 1990s, policymakers made the tough choices to balance the budget and invest in key priorities by raising taxes on the most fortunate, while at the same time reducing spending on Medicare and other government programs. In recent years, in contrast, policymakers have passed large tax cuts without regard for their budgetary cost. This recklessness shattered the ethic of fiscal responsibility and mutual restraint, facilitating sizable increases in government spending as well.

Whatever other ends it serves, the fundamental purpose of the tax system is to raise the money government needs to pay for the spending it has chosen to undertake. Indeed, government spending is actually a better indicator of the ultimate tax burden than is revenue collected at any given point in time. That is what the late Nobel laureate in economics Milton Friedman meant when he said, “To spend is to tax” (quoted in Ebenstein 2007). Whenever government spends a dollar, it commits itself to raising a dollar in revenue—the only question is when. To the extent the government funds spending with borrowing, it has merely deferred the taxes that future generations will have to pay.

N. Gregory Mankiw, the former chairman of President Bush's Council of Economic Advisers, recently wrote, “Everyone hates taxes, but the government needs to fund its operations...” (Mankiw 2006). In recent years the tax system has fallen far short of this goal. In 2000 the federal government had a \$236 billion unified budget surplus, which was projected to rise to \$573 billion in 2007. (The unified budget includes the balance in Social Security.) Instead the latest projection is for a \$177 billion deficit in 2007—a \$750 billion reversal.

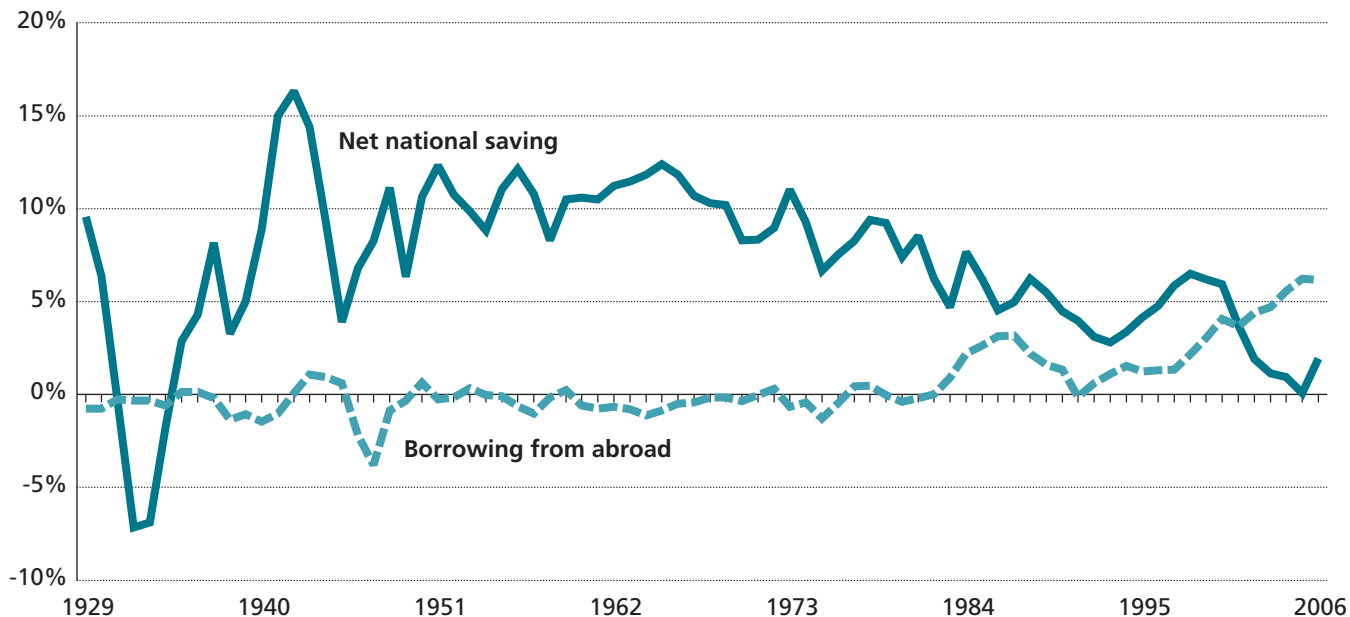
TABLE 1

Sources of the Change in the Projected Unified Budget Baseline, January 2001 to March 2007

	Billions of dollars	Percent of total change
Tax cuts	\$297	40%
Defense and homeland security outlays	\$234	31%
Other outlays	\$162	22%
Economic and technical projection errors	\$56	7%
<b>Total fiscal deterioration</b>	<b>\$750</b>	<b>100%</b>

Source: Auerbach, Furman, and Gale (2007).

FIGURE 1  
National Saving and Borrowing from Abroad as a Percent of GDP, 1929-2006



Source: Bureau of Economic Analysis (2007).

And as table 1 shows, the single largest source of this deterioration is the tax cuts enacted in 2001 and since.<sup>1</sup> In their absence the federal government would have run a sizable unified budget surplus in 2007—money that could have been used to pay down the national debt to prepare for the looming challenges in Social Security and Medicare.

Although the budget deficit in 2007 is not unusually large by historical standards, it still represents a serious long-term problem for budget policy—and for economic performance—for several reasons. First, major fiscal obligations are just around the corner, driven primarily by rapidly escalating health spending, and secondarily by the demographic changes associated with falling fertility rates and the aging of the baby-boom generation. Over the next seventy-five years, the federal government faces a fiscal shortfall of at least 6.3 percent of GDP if the tax cuts of this decade are extended and other likely fiscal changes, including a reform of the Alternative Minimum Tax (AMT), are not paid for (Auerbach, Furman, and Gale 2007). To put

this in perspective, achieving long-run fiscal balance would require an immediate and permanent 34 percent cut in all government spending, including Social Security, Medicare, and defense. Delaying these changes, or exempting some areas of government spending from cuts, would mean substantially larger reductions later to restore fiscal balance.

In these circumstances an optimal fiscal policy today would not aim for average deficits, or even the more modest target of a stable debt-to-GDP ratio, but instead would aim to balance the budget or, better yet, to achieve surpluses for a period of years—especially during economic expansions—to prevent unnecessarily large future tax increases (Barro 1979) or abrupt benefit cuts. The more quickly policymakers address this looming problem, the less painful the adjustments will need to be. The fact that the federal government is not running a smaller deficit or even a surplus today, when high corporate profits and rising incomes for wealthier households are driving up tax revenue, is especially troubling.

1. Another way to estimate the contribution of tax changes to the fiscal deterioration is to compare the actual deficit in 2000 with the actual deficit in 2007. This comparison tells the same story: revenue reductions were responsible for 61 percent of the deterioration in the fiscal balance. The unified budget surplus as a share of GDP worsened by 3.7 percentage points from 2000 to 2007, of which 2.2 percentage points was due to a decline in revenue as a share of GDP and 1.5 percentage points to an increase in outlays as a share of GDP.

Second, in addition to these foreseeable challenges, policymakers should be preparing for unforeseeable ones such as terrorist attacks, natural disasters, or economic downturns, by undertaking government saving in the form of budget surpluses. As one of us put it, “Higher saving has the central virtue of providing us with options, not merely if our current economic strength continues as we hope, but also if it does not” (Summers 2000).

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## Contrary to the logic of “starve the beast,” restoring a culture of fiscal responsibility can help policymakers address both spending and taxes.

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Third, the fiscal challenge posed by budget deficits—negative government saving—contributes to a serious problem of low national saving. National saving is the sum of private saving and public saving. In 2005 and 2006 net private saving (personal saving plus retained corporate earnings, less depreciation) averaged 3 percent of GDP, the lowest it has been since the 1930s. Personal saving was actually negative in 2005 and 2006. When combined with the negative saving of the federal government, the result was a net national saving rate that averaged only 2 percent of GDP annually (see figure 1). Thus, even though the deficit

was not especially large by historical standards, the net national saving rate was unusually low. This matters because both public and private investment in the economy necessarily comes out of saving—if domestic saving is not available, savings must be borrowed from abroad. In fact, the bulk of America’s investment in the last two years—6 percent of GDP, or \$800 billion annually—was financed by borrowing abroad. Worse, investment itself was likely lower than it would have been had America saved more. Our future national consumption will be lower as a consequence, both because the capital stock will be smaller and because more of national income will be needed to repay foreign creditors.

Finally, the least quantifiable but potentially most significant impact of budget deficits may be on confidence. As Robert Rubin, Peter Orszag and Allan Sinai (2004 p. 2) have argued, “The inability of the federal government to restore fiscal balance may directly reduce business and consumer confidence, as the view of the ongoing deficits as a symbol of the nation’s inability to address its economic problems permeates society, and the reduction in confidence can discourage investment and real economic activity.” Moreover, a sudden loss in confidence by investors—domestic or foreign—could lead to a hard landing that destabilizes financial markets and leads to serious or even severe economic difficulties (Ball and Mankiw 1995; Rubin, Orszag and Sinai 2005).

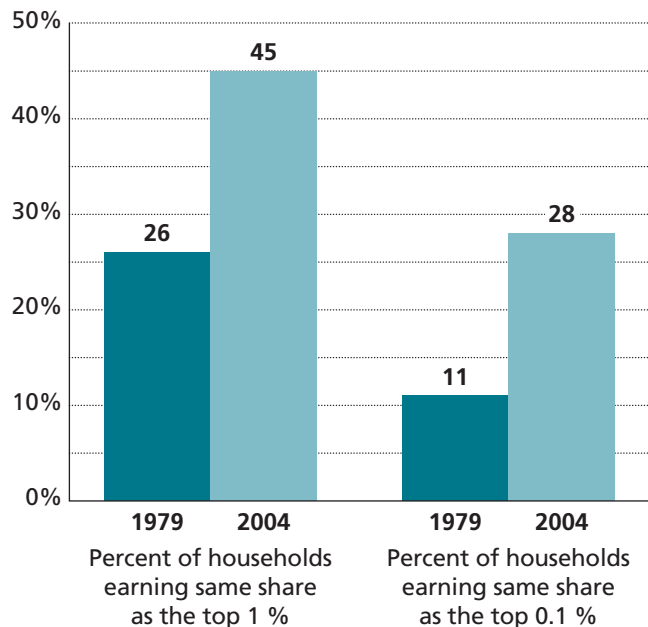


## Principle #2: Rising Inequality Strengthens the Case for Progressivity

America has experienced a large increase in income inequality in recent decades. The changes have been particularly pronounced at the very top of the income distribution. In 1979, the earliest year for which data are available, the before-tax income of the most affluent 1 percent of the U.S. population already equaled that of the bottom 26 percent (figure 2). That share has since risen nearly continuously, reaching 45 percent in 2004. That same year the top *one-tenth* of 1 percent had a before-tax income equaling the total income of the bottom 28 percent—a group 280 times larger in number. Several factors account for these shifts: primarily technological change that rewards skilled workers, but also declining unionization, the reduction in the real value of the minimum wage, increased immigration, and globalization more generally (see Autor, Katz, and Kearney 2007; Acemoglu 2002; Card, Lemieux, and Riddell 2003; Levy and Temin 2007). All told, the distribution of before-tax income between the top 1 percent and the bottom 80 percent has shifted by \$664 billion since 1979 (see box 1).

Incomes after taxes are distributed slightly more equally than incomes before taxes (box 1).<sup>2</sup> But the progressive tax system has cushioned only a small portion of the *increase* in inequality, in part because the tax system itself has become considerably less progressive. Reductions in taxes have been particularly dramatic for very high income taxpayers, precisely the group that has benefited the most from economic growth. According to estimates by Thomas Piketty and Emanuel Saez (2007a), the av-

FIGURE 2  
Percent of Households at the Bottom of the Income Distribution Earning Same Share of Income as the Top Percentiles, 1979 and 2004



Sources: Authors' calculations based on Congressional Budget Office (2006) and Piketty and Saez (2007b).

Note: Each bar represents the percentage of the income distribution, starting with the lowest-income household, whose combined incomes would just equal those of the top 1 or 0.1 percent of the distribution.

erage federal tax rate—actual taxes paid, including individual, corporate, payroll, and estate taxes, as a share of income—for the top 0.1 percent of households (families making over \$1.3 million in 2005) has fallen sharply in the last forty-five years, from 60 percent in 1960 to 34

2. Ideally a complete accounting would include transfers, such as Social Security, food stamps, Medicaid, and Medicare, and possibly the distribution of the value of government consumption as well. This would likely show that the fiscal system as a whole is more progressive than the tax component alone. For example, Social Security payroll taxes are regressive. But when the progressive benefit formula is taken into account, the Social Security system as a whole is mildly progressive on a lifetime basis (Liebman 2002; Cohen, Steuerle, and Carasso 2001).

BOX 1

**The \$664 Billion Income Shift**

Since 1979 the share of before-tax income going to the top 1 percent of income earners (a family of four at this level would be making more than \$533,600 in 2004) has risen nearly continuously, while the share of income going to the bottom 80 percent (for a family of four, less than \$128,600 in 2004) has fallen by the same margin. The share of income going to the remainder of the population—upper-middle-income families in the 80th through the 99th percentile—has remained roughly stable (see the table below). In total, the before-tax income share of the bottom 80 percent fell by 7.4 percent while that of the top 1 percent rose by 7.0 percent.

To provide some sense for the enormity of this income shift, 43 percent of all of the income earned by the top 1 percent in 2004 is attributable to increased inequality. In contrast, the increase in inequality is

responsible for a 14 percent reduction in the income of the bottom 80 percent of households.

The fact that the tax system is progressive offset only 0.5 percentage point of the shift in income to the top 1 percent. If not for the tax cuts since 2000, the tax system would have offset 1.4 percentage points of this shift, or 20 percent of the increase in inequality. To fully offset the income shift in 2004 would have required transferring \$664 billion from the top 1 percent of households to the bottom 80 percent—the equivalent of nearly \$600,000 from every household in the top 1 percent and \$7,000 to each household in the bottom 80 percent. No one would suggest this is feasible or even desirable, but it provides a useful benchmark for gauging the magnitude of the public policy interventions that would be necessary to address inequality on this scale.

**Share of Income Going to Each Group, 1979, 1990, and 2004**

Income group	1979	1990	2004	Change from 1979 to 2004
<i>Before-tax income</i>				
Bottom 80 percent	55%	51%	47%	-7%
Next 19 percent	36%	37%	37%	1%
Top 1 percent	9%	12%	16%	7%
<i>After-tax income</i>				
Bottom 80 percent	58%	54%	51%	-7%
Next 19 percent	35%	36%	36%	1%
Top 1 percent	8%	11%	14%	6%
<i>After-tax income (Assuming no tax changes after 2000)</i>				
Bottom 80 percent	58%	54%	52%	-6%
Next 19 percent	35%	36%	36%	1%
Top 1 percent	8%	11%	13%	6%

Source: CBO (2006) and authors' estimates.

Note: Incomes are adjusted for family size. For a family of four in 2004, the bottom 80 percent have incomes below \$128,600, the next 19 percent make up to \$533,600, and the top 1 percent more than \$533,600. Detail does not necessarily add to 100 percent because of rounding.

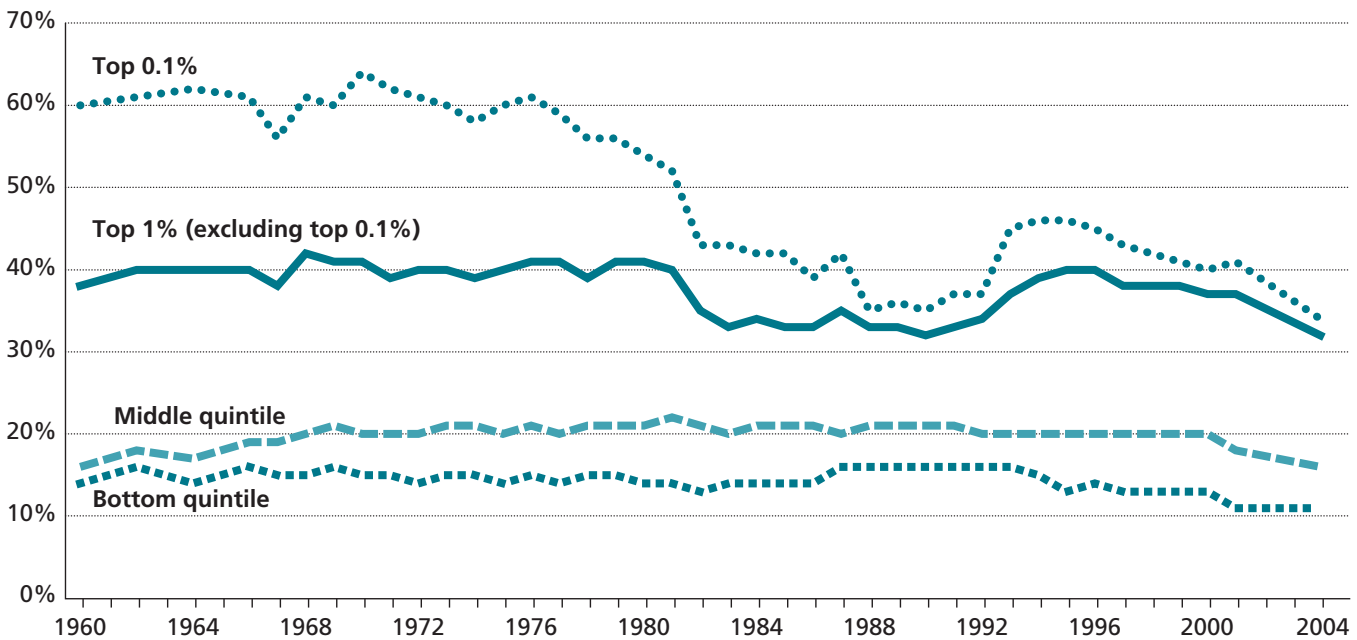
percent in 2004. This decline is far greater even than that enjoyed by the rest of the top 1 percent of income earners (from 38 percent to 32 percent; figure 3).

More than half of the reduction in the average tax rate for the top 0.1 percent of households is due to a decline

in corporate taxes (table 2), whose share of GDP has fallen from an average of 4 percent in the 1960s to an average of 2 percent in the 2000s.<sup>3</sup> More than a third of the change is due to a reduction in estate taxes (and the Piketty-Saez estimates do not include most of the scheduled reduction and eventual repeal of the estate

3. Piketty and Saez assume that the incidence of corporate taxes falls in proportion to ownership of the capital stock, under the assumption that

FIGURE 3  
Average Federal Tax Rates for Selected Income Groups, 1960-2004



Source: Piketty and Saez (2007a).

tax enacted as part of the 2001 tax cut). Less than 10 percent is due to the reduction in combined individual income and payroll taxes, and this reduction is entirely the result of the recent tax cuts.<sup>4</sup>

In contrast to the sharp fall in average tax rates for families at the top, the average federal tax rate for families in the middle income quintile rose over the same period and even after the recent reductions remains at 16.1 percent in 2004, slightly higher than the 15.9 percent rate in 1960 (figure 3). Expansions in the Earned Income Tax Credit (EITC) and other refundable credits have slightly reduced the tax rate for the poorest families.

Some of these dramatic tax changes have been acts of commission, in particular the reductions in taxes passed in this decade. But they are also due to acts of omission, as policymakers have failed to reform the tax code to keep

TABLE 2  
Changes in the Average Federal Tax Rate  
for the Top 0.1 Percent of Households

	Change from 1960 to 2004 (percentage points)	Contribution to total change (percent)
Individual income and payroll taxes	-2.7	10%
Corporate taxes	-14.0	53%
Estate taxes	-9.6	37%
All federal taxes	-26.4	100%

Source: Piketty and Saez (2007a).

up with the rapid pace of change due to globalization and an increasingly sophisticated financial system. Both these phenomena have made it easier for corporations to avoid paying taxes, thus contributing to the halving

corporate taxes reduce the before-tax rate of return to noncorporate forms of capital such as housing (Harberger 1962). There is, however, considerable uncertainty about the actual incidence of corporate taxes: they may fall entirely on owners of corporate stock (which would exacerbate the trends discussed in the text), or they may fall entirely on workers (which would partly ameliorate the trends), or somewhere in between. See Auerbach (2006) for an extensive discussion.

4. Note that the top marginal tax rate was reduced from 91 percent in 1960 to 39.6 percent in 1993 without any reduction in the average income tax rate facing the top 0.1 percent of taxpayers, which was roughly 30 percent, because these rate reductions were done in conjunction with broadening of the tax base (for example, setting limits on tax deductions) and an increase in the capital gains rate. In contrast, the recent tax cuts lowered the top rate to 35 percent without any base broadening, resulting in a large reduction in average tax rates.

in corporate taxes as a share of GDP. Financial innovation also makes it easier to take advantage of the highly variable tax treatment of economically identical forms of income and of different investments, including tax-exempt investments. For example, the large differential between tax rates on income and rates on capital gains and dividends encourages financial engineering that allows some taxpayers to relabel labor compensation or interest as capital gains or dividends to take advantage of the dramatically lower rates. Although occasional attempts have been made to patch the tax system, the underlying principles of the income tax were developed more than ninety years ago, long before most derivatives and other sophisticated financial instruments were dreamed of (Kleinbard 2007).

The tax cuts enacted in 2001 and since have reinforced this long-term trend, increasing after-tax incomes for high-income families substantially more than for the rest. When fully in effect, the tax cuts will have increased the after-tax incomes of the top 1 percent of the income distribution by 6.8 percent, but that of the bottom 20 percent by only 0.5 percent. The middle 20 percent will have received only a 2.3 percent income boost on average (figure 4). As a result the tax cuts increased the after-tax income share of the top 1 percent of families by nearly 1 percentage point.

Moreover, these estimates are incomplete, because they do not take into account the unknown distributional effects of the future tax increases or spending cuts that will be required to pay for these tax cuts (Gale, Orszag, and Shapiro 2004).<sup>5</sup> If we assume that each household will pay an equal amount to finance the tax cuts, for example through reduced Medicare benefits, the cost would outweigh any benefits of the tax cuts for all but the top 20 percent of households (figure 4).<sup>6</sup> If instead low-income families end up bearing a disproportionate share of the burden, through cuts in programs such as

Medicaid and food stamps, the result would be even more regressive.

In fact, most *income* tax cuts will increase after-tax income inequality. The bottom 60 percent of households pay less than 1 percent of total income taxes. (They do pay substantial payroll taxes and thus 15 percent of total federal taxes. This makes the federal tax system moderately progressive, since the bottom 60 percent receives 27 percent of total income. With state and local taxes included, the overall tax burden is barely progressive.) Any income tax cuts that do not include expansions in refundable credits such as the EITC are therefore necessarily regressive. Meanwhile the federal programs funded by income taxes tend to be progressive. If income tax cuts lead to reductions in spending in areas such as education, health care, or food stamps, the result will be even more inequality.

There is widespread support for the notion that the tax system should be progressive. Several reasons are usually cited: high-income households have a greater ability to pay, and so their well-being is less adversely affected by, say, an extra \$1,000 in taxes, than that of a moderate-income family struggling to make ends meet.<sup>7</sup> Also, by imposing proportionally higher tax rates as incomes rise, progressive tax policy can mitigate the impact of sharp losses in income, thus acting as a form of insurance (see Orszag 2007a; Varian 1980; Eaton and Rosen 1980). At some point inequality in outcomes becomes so great that the quintessential American promise of equality of opportunity becomes unattainable. As Bradford DeLong (2007) has observed, “The very first thing that any society’s wealthy try to buy with their wealth is a head start for their children. And the wealthier they are, the bigger the head start.” No one begrudges any parent seeking the best opportunities for his or her children. But our economy and society work best when more opportuni-

5. Depending on the macroeconomic effects of the tax cuts, their ultimate financing could be more or less than indicated by conventional estimates of their cost. The Department of the Treasury (2006) estimated that, in the more favorable scenario, the economic impact of the tax cuts would offset just 10 percent of their long-run cost; in less favorable circumstances the economic impact would actually increase their long-run cost. See Furman (2006) for more discussion.

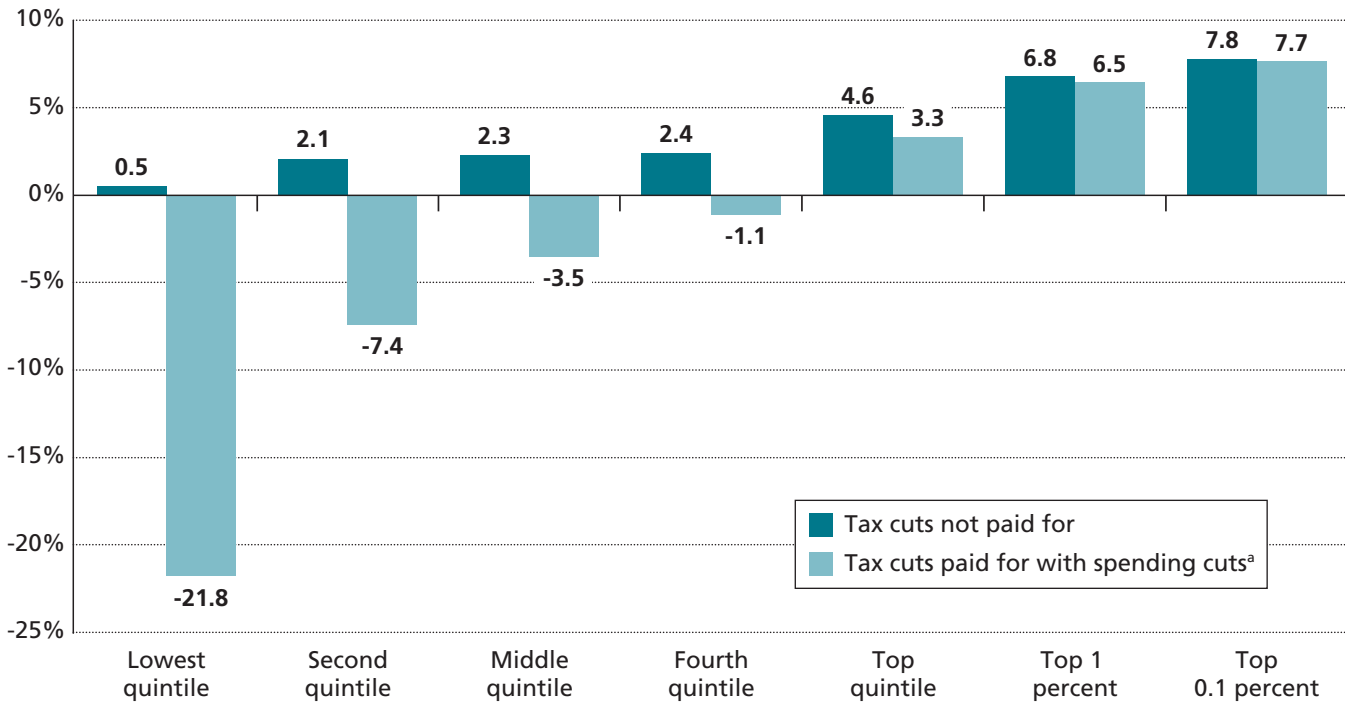
6. Note that proponents of the tax cuts often advocate something like lump-sum financing or even more regressive forms of financing, for example cutting means-tested programs such as Medicaid and food stamps. This is also the assumption made in much of the theoretical literature that motivates claims about the positive macroeconomic effects of tax cuts; see, for example, Mankiw and Weinzierl (2006). The distributional results would be different if the reductions were to government *consumption* (e.g., spending on parks or the justice system) rather than to government transfers because public goods may disproportionately benefit higher-income families if they would be willing to pay more for items like parks and the justice system.

7. A theoretical literature finds that not only does inequality create a rationale for progressive taxes, but *increasing* inequality creates a rationale for even more progressive taxes (see Salanié 2003; Tresch 2002; Saez 2001).

FIGURE 4

### Effects of 2001–2006 Tax Cuts Made Permanent

Percent Change in Income for Selected Income Groups When Tax Cuts are Fully in Effect in 2012



Source: Authors' calculations based on Urban-Brookings Tax Policy Center (2007, Table T07-0082).

a. Assumes tax cuts are financed by a reduction in government transfer payments, or an increase in lump-sum taxes, that is the same total amount for each household.

Note: Estimates based on extension of 2006 AMT exemption and indexed for inflation after 2006. The income break for 2006 for the lowest quintile is \$13,640; for the second quintile is \$26,417; for the middle quintile is \$46,362; and for the fourth quintile is \$82,316. The top 1 percent consists of those making more than \$418,664, and the top 0.1 percent includes those making more than \$1,907,342.

ties are available to all—a goal that progressive taxation can help serve. Finally, extreme inequality threatens to undermine political support for a competitive market economy, the most successful recipe ever found for generating economic growth. Former Federal Reserve chairman Alan Greenspan (2007) has argued that “income inequality is where the capitalist system is most vulnerable. You can’t have the capitalist system if an increasing number of people think it is unjust.”

Progressive taxation is not the only policy tool available to help push back against rising inequality and ensure that everyone shares in the gains from a growing economy. Why, then, put so much emphasis on it? There are at least four reasons to favor progressive taxation over other possible solutions to inequality in many circumstances.

First, progressive taxation is often more economically *efficient* than other solutions, because it leaves most

economic decisions to participants in a competitive marketplace. Industrial policies and direct market interventions can try to change the before-tax distribution of income. But ultimately such policies harm the economy—for example, excessively high living-wage laws can result in large job losses for low-skilled workers. Progressive taxation first lets the competitive market economy maximize the total pie, and then uses instruments such as the EITC and the top marginal tax rate, in combination with a variety of other social policies, to help spread the gains thereby generated more widely (Bordoff forthcoming).

A second rationale for preferring progressive taxation, together with transfer programs, is that they can be very effectively *targeted*. Tax and transfer programs can be fine-tuned to deliver benefits that vary according to family income, the number of children in the family, or other characteristics. Such targeting avoids diverting scarce government resources to households who do not

really need the assistance. For those who are targeted, the tax benefit can also be applied *universally*. For example, expanding the EITC for families who make less than \$30,000 could benefit virtually all families in that income range. It would be extremely difficult to design a set of protective trade restrictions, for example, that benefit virtually everyone making less than \$30,000, and it would be impossible to do it in a way that provided benefits proportional to family size. In fact, trade restrictions are likely to help some people—mainly the workers and business owners in the protected industry—while hurting many lower-income families who rely on inexpensive imports for their consumption or even their jobs.

Third, progressive taxation can respond at a significant *scale*. Other programs—whether currently existing, like worker training, or proposed, like wage insurance—are often worthy in themselves. But they are hopelessly mismatched against the sheer magnitude of the recent increase in inequality. The typical program is funded at a few billion dollars annually, a small fraction of the \$42 billion that the EITC alone adds to the paychecks of low-income workers in a single year.

Finally, progressive taxation has the ability to act *nearly instantaneously*. Education is a frequently mentioned and critical part of any strategy to achieve shared growth. But the gains from, say, public investment in early childhood education may take decades to materialize. This is not at all an argument against such investment—the gains are potentially enormous, both for the economy and for the families that benefit from the expansion of opportunity. But increased education spending should not be a substitute for more immediate actions.

An important part of the progressive tax system is a robust tax on large bequests and gifts. The United States taxes large wealth transfers through the estate and gift tax. This tax has several beneficial features: it is highly progressive (affecting less than 1 percent of the population in total); it promotes equality of opportunity by reducing dynastic concentrations of wealth; it may be a relatively efficient way to collect progressive taxes; and it serves as a backstop to the income tax system, bring-

ing back into the system gains that may have escaped taxation for years or decades (Graetz 1983). Indeed, as noted above, the reduction in the estate tax is responsible for more than one-third of the reduction in the average tax rate for the top 0.1 percent of households between 1960 and 2004, and substantial further reductions in the estate tax have taken place since and are scheduled to grow even larger.

A Hamilton Project discussion paper by Lily Batchelder (2007) argues that an inheritance tax would be an even better way to accomplish these goals. She proposes that heirs pay income tax at the usual rates, plus a 15 percentage point surcharge, on any inheritances above a \$2.3 million exemption. Batchelder believes that this new system would better reflect a taxpayer's ability to pay, encourage equality of opportunity, and simplify the tax law while raising as much money as the 2009 estate tax. At the same time, the already miniscule number of taxpayers affected by the present estate tax would fall further; indeed the proposal would reduce the number of heirs burdened by the tax on bequests, from a projected 22,000 in 2009 to 14,000 under her inheritance tax.

To be sure, there are limits to how far policy should go in using progressive taxation to offset inequality. Some inequality is inevitable and can even be beneficial. Indeed, it is the possibility of greater rewards based on hard work and skill that has long driven Americans to industrious activity and entrepreneurship, and with these our nation's economic growth. Moreover, as noted earlier, restoring the distribution of income that existed in 1979 would require shifting \$664 billion each year from the wealthy to everyone else, and the high tax rates necessary to effect such a shift would be both infeasible and undesirable. Excessively high tax rates distort economic behavior by changing the incentives to work, save, and invest, which can harm economic performance. Policymakers need to balance the desire to promote progressivity with an awareness of the effects of such policies on the economy overall, and thus on the well-being of precisely the low- and moderate-income families that progressivity is designed to help.<sup>8</sup> The preferred path is somewhere

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8. Diamond (1968) and Mirrlees (1971) launched the modern literature formalizing this trade-off between income distribution and economic performance. See also Okun (1975).

in between—using progressive taxation to offset some, but not all, of the increase in inequality.

What changes should be made, then, to restore the progressivity that the tax system has lost?<sup>9</sup> At a minimum, the tax cuts of 2001 and 2003 should be repealed or allowed to expire for married couples making above \$200,000 a year. This alone would offset roughly one-sixth of the increase in inequality since 1979. It is hard to argue that returning to the top rates that prevailed in the 1990s—the period that saw the longest economic expansion in U.S. history, with strong job growth and rising incomes at all levels—would hurt the economy. Some scholars have proposed going even further: they would design the tax system such that rates automatically change as the distribution of income changes, to offset a certain percentage of the change in inequality (Burman et al. 2007b).

Finally, advocates of progressivity should look not just at the distribution of taxes but also at what the taxes are paying for. For example, if a value added tax (VAT, essentially a form of sales tax) replaced the income tax, the result would be regressive because a VAT does not have graduated rates, and high-income people spend a relatively small fraction of their income on consumption.<sup>9</sup> But if a VAT were added (on top of the income

tax) to pay for universal health insurance, as proposed in a forthcoming discussion paper by The Hamilton Project (Emanuel and Fuchs forthcoming), the result would be highly progressive, because low-income households would end up paying much less for health insurance than high-income households. Moreover, the evidence suggests that a VAT would be considerably less regressive than many other proposed means of financing such insurance, including payroll taxes, for several

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## Progressive taxation can help everyone share in the fruits of growth in a manner that is efficient, targeted, large-scale, and nearly instantaneous.

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reasons. One is that payroll taxes generally only apply to wages, whereas a VAT would apply to all spending, including spending paid for out of dividends or interest or by liquidating assets. Another is that payroll taxes are subject to avoidance, for example when taxpayers relabel their wage and salary income as small business income to avoid the tax. A third is that payroll taxes are generally capped at a certain income level, whereas a VAT is not.

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9. On a lifetime basis a VAT, by itself, would be regressive, but less regressive than the standard annual distributional tables indicate (Caspersen and Metcalf 1994). The reason is that the very low or negative saving rates of low-income households in part capture life-cycle effects (for example, students consuming out of expected future income, and retired workers consuming past income) and transitory effects (for example, when a worker suffers a temporary job loss and smoothes consumption by liquidating assets or borrowing).

## Principle #3: The Tax System Should Collect the Taxes That Are Owed

In addition to inadvertent errors stemming from complexity and ignorance, much tax revenue is lost because of purposeful evasion. The result is the “tax gap”—the difference between what taxpayers should have paid and what they actually paid on time each year. The Internal Revenue Service (IRS) estimates that in 2001 the gross tax gap was \$345 billion, which was 16.3 percent of the total tax liability that year. Of that amount the IRS estimates that it recovered (or will recover) \$55 billion, leaving a net tax gap of \$290 billion (IRS 2006). Assuming the tax gap grows with GDP, the net tax gap will total \$400 billion this year and \$5 trillion over the ten-year budget window from 2008 through 2017. As Nina Olson (2006, p. 2), the National Taxpayer Advocate, has noted, this shortfall amounts to a per-taxpayer “surtax” of some \$2,000 per year to subsidize noncompliance.” In other words, taxpayers pay about 17 percent more in taxes to subsidize those who do not pay the taxes they owe.

The American tax system relies fundamentally on substantial voluntary compliance. When large amounts of taxes go uncollected, other people may conclude that it is not fair for them to pay taxes either. The result can be a downward spiral in compliance and even higher taxes on the dwindling number of taxpayers who remain compliant. In addition, the tax gap is economically inefficient because it provides an incentive to misallocate labor and capital into those sectors of the economy that facilitate tax evasion.

**TABLE 3**  
**Unverifiable Income by Taxpayer Income Group, 1980 and 2000**  
Percent of adjusted gross income

	1980	2000
Bottom 95% of taxpayers	6%	8%
Top 5% of taxpayers	19%	38%
All taxpayers	9%	18%

Source: Bloomquist (2003).

The majority of the tax gap (an estimated 57 percent) is attributable to underreporting of individual income taxes.<sup>10</sup> Compliance rates are highest where there is third-party reporting or withholding, such as wages and salaries, and lowest where sources of income are not disclosed to the IRS, such as for some of the self-employed.<sup>11</sup>

Some evidence suggests that underpayment of taxes undermines the progressivity of the tax code.<sup>12</sup> The tax gap is substantially larger for business income (where underreporting is estimated at 43 percent) and capital income (8 percent), both of which are disproportionately earned by high-income households, than for labor income (1 percent). Moreover, the percentage of total adjusted gross income that is unverifiable because there is no third-party reporting to the IRS is substantially higher for upper- than for lower-income families, and this gap has grown in the last two decades (table 3; this

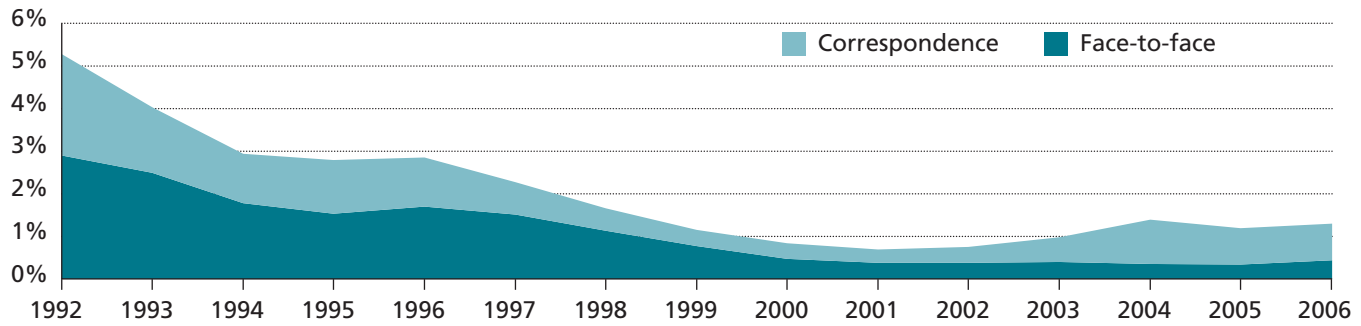
10. Of the \$345 billion gross tax gap, the IRS estimates that \$285 billion is underreported income, \$197 billion of which is underreported individual income tax (GAO 2007).

11. According to the GAO (2007), taxpayers underreport roughly 1 percent of income when there is substantial reporting and withholding, such as for wages and salaries, but more than 50 percent when there is little or no reporting, as is often the case for nonfarm proprietor income.

12. This evidence also suggests that inequality may be even greater than suggested by income tax-based measures such as the Congressional Budget



**FIGURE 5**  
**Audit Rates for High-income Individuals, 1992-2006**



Source: Transactional Records Access Clearinghouse, Syracuse University (2006).

Note: High-income individuals are those with \$100,000 or more in total positive income whose primary source of income is from salaries and investments rather than from a sole proprietorship, farm, or business.

income includes such items as capital gains, income of sole proprietors and partnerships, and alimony). These data, however, are only suggestive and do not directly indicate the true impact of tax underpayment on progressivity.<sup>13</sup>

For all these reasons, policymakers should help the IRS increase its efforts to close the tax gap. But policymakers should also recognize that closing the tax gap is no fiscal elixir. It will be hard and take a long time, even with increased resources. Nor is it a painless proposition; rather it will involve weighing the benefit of increased revenue against the cost of increased enforcement and more burdensome requirements and oversight for firms and individuals. Despite these inherent difficulties, certain steps can and should be taken:

**Improved service.** The IRS has made major strides in improving customer service, by making greater use of the Internet, improving call centers, and in other ways. Further improvements should both facilitate tax paying and reduce the tax gap, especially the portion due to underpayments that stem from unintentional error.

**Enhanced enforcement, especially for high-income taxpayers and corporations.** Although many taxpayers would pay taxes even without any enforcement, out of a sense of civic duty, in reality choices about whether and to what extent to evade taxes are

influenced by the probability of getting caught and by the likely penalty (Allingham and Sandmo 1972). Empirical studies show that taxpayer compliance increases when the probability of being audited increases (Slemrod, Blumenthal, and Christian 2001; Alm and McKee 2006). Yet IRS audits of high-income individuals have dropped dramatically over the past decade and a half (figure 5). The rate for face-to-face audits fell from 2.9 percent of high-income tax filers in fiscal 1992 to 0.38 percent in fiscal 2001 and to 0.35 percent in fiscal 2004. Correspondence audits of high-income individuals, which are less effective, also fell sharply over that same period but have rebounded somewhat. And between 1992 and 2004 corporate audits fell by more than two-thirds (figure 6).

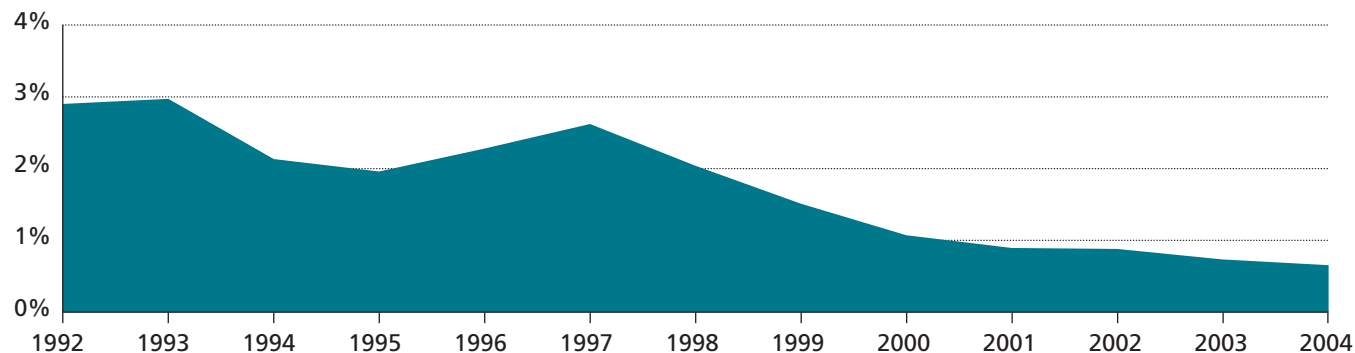
In addition, the IRS has identified tens of billions of dollars in underpayments that cannot be collected because it has insufficient staff resources. In a 2002 report, then-IRS commissioner Charles Rossotti estimated that the agency could collect an additional \$30 billion annually with a \$2.2 billion budget increase to expand its staff.

New resources alone are not enough, however. It is important that the IRS deploy those resources where they will have the largest effect. There is little justification, for example, in the IRS's devoting more attention to fraud in the EITC than to the substantially larger

Office data or the frequently cited Piketty-Saez data.

13. Bishop, Formby, and Lambert (2000) found that noncompliance appeared not to undermine the progressivity of the tax code, although they stressed that the data were insufficient to allow a definitive conclusion. But even if this were true in the past, it may no longer be true today, as evidenced by the disproportionate increase in unverifiable income for high-income families shown in table 2.

FIGURE 6  
Share of Corporate Returns Audited, 1992-2004



Source: Transactional Records Access Clearinghouse, Syracuse University (2005).

problems in the cash economy. Although the error rate in the EITC is high—largely the result of the complexity that also leads nearly three-quarters of recipients to pay a tax preparer to fill out their returns—the revenue lost to EITC noncompliance is modest: an estimated \$10 billion in 1999 (GAO 2007). By contrast, the annual underreporting of income by small businesses is estimated to be almost eleven times that amount (\$109 billion) (IRS 2006).

**Improved reporting.** Given that so much of the tax gap stems from income for which there is no verifiable reporting or withholding, improving reporting should be a focus of reform. The Bush administration and some members of Congress have recently made two promising proposals to increase reporting. One would require credit card companies to tell the government how much money was charged every year at each merchant using their services. For privacy reasons, the information reported would be the aggregate amount paid to each merchant, not data on individual transactions. Yet even that aggregate information would make it more difficult for small businesses to underreport income to the IRS. This reform needs to be carefully studied and implemented in a way that minimizes the burdens on merchants and credit card firms, who have complained that it would force them to spend millions on new data and reporting systems (Solomon 2007).

The second promising reform would be to require financial institutions to report the basis (that is, the original purchase price) for investments on which capital gains have been earned. This reform could simplify taxes for individuals while improving compliance. Currently financial institutions are required to report dividends, interest payments, and sale prices of financial assets to taxpayers and to the IRS. But capital gains are determined by the sale price minus the purchase price, which is not reported. Inflating the purchase price reduces the taxable gain, contributing to the tax gap. The IRS estimates that the tax gap for capital gains is \$11 billion (a 12 percent noncompliance rate), more than three times that for interest and dividends which are subject to third-party reporting requirements (\$3 billion, or 4 percent).<sup>14</sup>

**Simplification.** The complexity of the tax code plays a role in increasing errors, both intentional and unintentional. Principle #5 below discusses simplification in more detail, in terms of both its usefulness in reducing the tax gap and its broader, more intrinsic importance. Taken together, these four steps could eliminate 10 percent of the tax gap, raising \$500 billion over the next decade. Moreover, these tax changes would be progressive, both because the tax gap itself may be disproportionately due to high-income families and, more important, because the most efficient steps to address the tax gap would be borne by those families.

14. As the GAO (2006) notes, the overall capital gains tax gap could be larger than \$11 billion, because the IRS did not estimate the portion of the combined \$48 billion tax gap attributable to capital gains for individual taxpayers who did not file tax returns or did not pay the taxes they reported on filed returns.

## Principle #4: Tax Reform Should Strengthen Taxation at the Business Level

**T**ax collection at the business level has failed to respond to the challenges of globalization and financialization, and today the business income tax system is badly broken. The business tax code is enormously complex and unnecessarily inefficient, and often it does not raise the revenue it is meant to raise. The erosion of the corporate income tax, without any corresponding increase in income tax rates, is the main reason why average tax rates on high-income households have fallen.

The United States has the second-highest statutory corporate tax rate among the thirty countries in the Organization for Economic Cooperation and Development (OECD 2006a, table II.1), but the fourth-lowest corporate tax revenue as a share of GDP (OECD 2006b, table 12).<sup>15</sup> One rough estimate is that one-quarter of corporate income is never taxed at any level (Gale and Orszag 2003). And on average, the income of noncorporate businesses (such as partnerships and sole proprietorships) is taxed even more lightly than corporate income. Much routine business income is taxed at low or even negative rates, which means that these businesses are actually subsidized by the government, through deductions and credits whose value exceeds the taxes on the associated income. Meanwhile sheltering and other opportunities to avoid paying taxes appear to have grown over time.

A large part of the erosion of corporate taxes has been the widening gap between the book income that corpo-

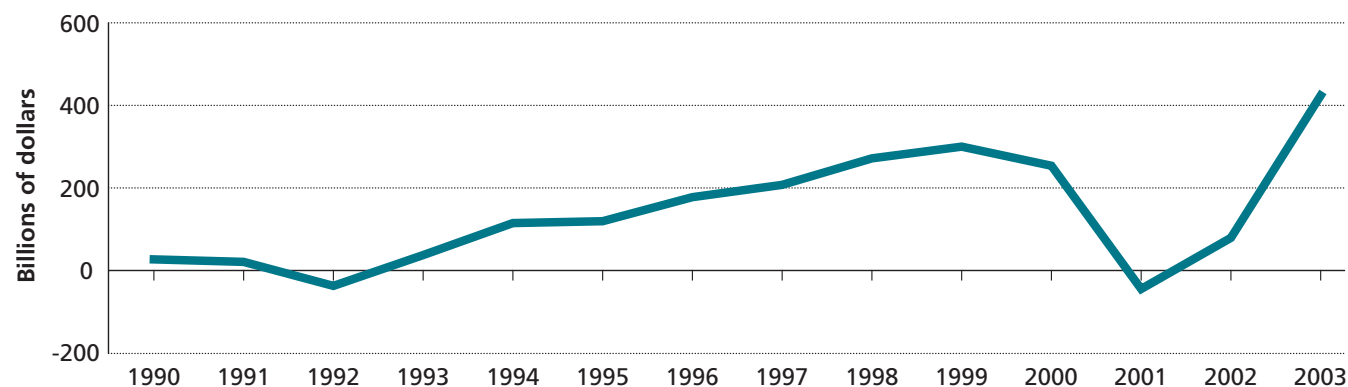
rations report to their shareholders and the tax income they report to the IRS (figure 7). The evidence suggests that much of the increase in this gap cannot be explained by standard accounting differences (such as the treatment of depreciation or stock options) but is instead likely due to increased sheltering activity (Desai 2003). An IRS contractor has estimated the tax revenue loss from such shelters in 1999 at \$14.5 billion to \$18.4 billion, although the IRS admits some uncertainty about the methodology used (Government Accountability Office [GAO] 2003). Joseph Bankman (1999) has estimated the loss at \$10 billion annually.

Sheltering not only reduces revenue but can also foster an environment in which corporate governance problems become more serious, because the sham transactions that a company uses to hide income from the IRS are easy to hide from its shareholders as well. As Raghuram Rajan and Luigi Zingales (2003, p. 58) note, “The corporate income tax effectively gives the government a large, non-controlling stake in all companies. Its incentives are perfectly aligned with those of minority shareholders: both want the company to disclose and distribute profits... [IRS] scrutiny can also help prevent self-dealing whereby management transfers goods from the public company it runs to a private company it fully owns. The tax authority therefore helps keep management malfeasance in check.”

For the corporate tax system to function effectively it is essential that these mounting problems be addressed.

15. These receipts are also highly volatile from year to year. In 2003 corporate taxes were 1.2 percent of GDP, the second-lowest share of GDP since 1940. But as corporate profits have recovered, so have corporate taxes, reaching 2.7 percent of GDP in 2006, the highest figure in more than twenty-five years (Congressional Budget Office 2007b). Both CBO and the Office of Management and Budget (2007b) project that corporate taxes will fall back to about 2 percent of GDP as corporate profits return to more normal levels.

FIGURE 7

**Book-tax Differences for Large U.S. Corporations, 1990-2003**

Source: Boyton, DeFilippes, and Legel (2005).

At a minimum policymakers should undertake steps to ensure greater transparency. Current law even prevents the enforcement agencies, like the IRS and the Securities and Exchange Commission (SEC), from sharing information about tax and book profits. More broadly, public disclosure of the profits that public corporations report to the IRS could potentially motivate better public policy and improve corporate governance. Transparency may not be enough and policymakers should seriously consider whether the law should prevent companies from reporting widely variable incomes to their shareholders and the IRS through so-called book-tax conformity.<sup>16</sup> Finally, a large part of the problem is the ambiguity over the rules that govern tax shelters and other borderline abusive transactions. Policymakers should adopt robust anti-shelter legislation that formally codifies tax shelters as transactions that are undertaken for no reason other than reducing taxes. Moreover, shelters could be further curbed by legislation to disallow unrelated losses. Taken together these steps could raise anywhere from \$2 billion to \$20 billion annually on domestic transactions (see box 2).

As U.S. firms become increasingly global, the treatment of their foreign income has emerged as one particularly problematic source of tax avoidance. The U.S. government taxes U.S. multinationals on income earned both

at home and abroad. Income earned abroad, however, is generally not taxed until it is repatriated (and firms receive a credit for any foreign taxes paid on that income). This “deferral” of taxation allows foreign-earned income to grow tax free, distorts investment decisions, potentially leads to overinvestment abroad, creates an incentive for firms to earn (or report) profits in low-tax countries, and reduces U.S. corporate tax revenue. Moreover, multinational firms can reduce their tax liability by shifting income between their U.S. operations and foreign subsidiaries. For example, if a firm faces a higher corporate income tax rate in the United States than abroad, it can lower the internal (transfer) price that its foreign subsidiary pays to its U.S. operation for goods, services, or intangibles (such as intellectual property). This reduces the profits, and therefore the taxable income, of the U.S. operation but has no impact on the firm’s total before-tax income.<sup>17</sup>

A Hamilton Project discussion paper by Kimberly Clausing and Reuven Avi-Yonah (2007) provides a dramatic illustration of these problems. Clausing and Avi-Yonah point out that the top three source countries of overseas profits reported by American multinationals in 2003 were (in descending order) the Netherlands, Ireland, and Bermuda, which together accounted for more than 30 percent of the total. Not coincidentally,

16. See Weisbach (2002). For a discussion of the arguments for and against book-tax conformity, see Joint Committee on Taxation (2006) and Bankman (1999).

17. In theory, such tax-motivated transfer pricing should be limited by the requirement that firms set prices for intrafirm transactions no differently than if the transaction were between parties acting at “arm’s length.” In practice, however, establishing such arm’s-length prices is often difficult and creates significant opportunities for tax avoidance—a problem likely to worsen as the economy becomes increasingly global.

**BOX 2****The Controversy over Revenue Estimates for Measures to Reduce Evasion and Avoidance**

The official revenue estimates of steps to reduce tax evasion (like the tax gap measures discussed above) or close tax loopholes (like the measures sketched here) by Congress' Joint Committee on Taxation (JCT) and the Treasury tend to be relatively low, on the order of a few billion dollars annually. In contrast, a number of knowledgeable observers have pointed out that the phenomena in question are orders of magnitude larger. In some cases the official revenue estimate for closing a particular type of shelter is well below the amount that a single, identifiable company benefits from that same shelter.

The sources of this discrepancy are not clear. One possibility is that the official estimators are reflecting the fact that closing loopholes is like putting another finger in a dam—the same revenue losses will just materialize under the heading of a new loophole. Another possibility is the tendency of those most concerned with the problems to exaggerate the benefits of addressing them.

But a distinct possibility is that the revenue estimates are too low. And that the undue pessimism of the revenue estimators acts to inhibit policymakers from undertaking changes for which they will not get much credit in the form of officially sanctioned revenue estimates.

To date there has been relatively little outside research in this area, including assessing the track record of past revenue estimates by JCT and Treasury. Such research is essential in guiding the future work of policymakers.

these countries have effective corporate tax rates of 5.3 percent, 6.1 percent, and 1.7 percent, respectively, compared with 26.3 percent in the United States. Clausing and Avi-Yonah argue that this allocation of profits reflects tax planning, not genuine economic activity, as evidenced by the fact that none of these three countries is among the top ten locations of U.S. multinational jobs.

In a separate study, Clausing (2007) estimates that international tax avoidance lowers U.S. corporate tax col-

lections by about \$50 billion annually. Estimates by the Joint Committee on Taxation, the American Enterprise Institute, and the Congressional Budget Office (CBO) have all found that *eliminating* all taxes on profits earned by U.S. multinationals' overseas activities—and the associated tax deductions and credits—would actually *raise* revenue; the CBO estimates that the revenue gain could total \$6 billion annually (CBO 2007a, Option 45; Joint Committee on Taxation 2005; Grubert and Mutti 2001). Of course, it would be preferable actually to collect the taxes due on these overseas profits; doing so would result in substantial increases in revenue.

The taxation of business income also unnecessarily distorts domestic business decisions, leading to inefficient use of resources. Economists differ on the optimal level of capital taxation, but all would agree that tax rates should not differ across types of investments, because this leads investors and entrepreneurs to make decisions for tax reasons rather than to maximize profits. Table 4 reports CBO estimates of the current widely varying tax rates on different types of activities. It shows, for example, that businesses that adopt a corporate form are taxed somewhat more heavily than noncorporate businesses. This may discourage adoption of the corporate form when it would otherwise be advantageous.

More seriously, there is an enormous discrepancy between the taxation of corporate debt and corporate equity. To the extent this leads corporations to overleverage themselves, it can increase financial fragility throughout the economy and worsen corporate governance. The effective tax rate on corporate debt is actually negative—below even the zero tax rate on capital income that a consumption tax would apply. (A consumption tax would not tax the normal returns to capital.) This happens because businesses can both deduct the interest on their borrowings and take “accelerated depreciation” deductions that exceed the true economic depreciation of the corresponding investments, and meanwhile the entities receiving this interest often are tax exempt or else pay less in taxes on that interest than the business saves on its deduction. Depreciation rules result in widely variable tax rates for different forms of investment, from more than 30 percent on investments in computers and manufacturing buildings to less than 10 percent on mining structures and petroleum and natural gas structures. In addition, and not shown

**TABLE 4**  
**Effective Tax Rates on Capital Income**  
 Percent a Year

Type or form of investment	Effective tax rate
Corporate	26%
Debt financed	-6%
Equity financed	36%
Non-corporate	21%
Computers and peripheral equipment	37%
Manufacturing buildings	32%
Mining structures	10%
Petroleum and natural-gas structures	9%

Source: CBO (2005).

in table 3, companies are taxed much more lightly on investments overseas than investments in the United States, because of the ability to defer paying taxes on their overseas income and to use transfer pricing to avoid paying U.S. taxes on their domestic income.

Finally, the sheer complexity of the business tax code itself has a substantial efficiency cost. Joel Slemrod (2004) has estimated that American businesses spend roughly \$40 billion a year on tax compliance. And tax avoidance has efficiency costs aside from just the lost revenue: it creates an incentive for the misallocation of labor and capital into sectors of the economy that facilitate such activities. Another worrisome development spawned by opportunities for tax avoidance has been the recent trend toward patenting tax strategies. This practice allows those holding the patents to extract economic rent from other tax practitioners and taxpayers, while possibly increasing compliance costs and encouraging the development of even more abusive tax shelters (see box 3).

If nothing else, policymakers should patch the existing business tax system by eliminating abusive tax shelters and closing other loopholes. But an even better approach would be comprehensive reform of business taxation. Two Hamilton Project discussion papers offer potential approaches. Edward Kleinbard (2007) proposes a comprehensive reform of business taxation

through his Business Enterprise Income Tax (BEIT). The BEIT attempts to tax all forms of capital income in a uniform manner by allowing businesses to deduct the cost of capital at the enterprise level while requiring individuals to pay taxes on the accrued normal returns of all their capital investments. The result, Kleinbard argues, would be to simplify the tax system, eliminate opportunities for tax shelters that exploit the different tax rules governing different assets, and, perhaps most important, harmonize tax rates on different forms of business, sources of financing, and types of investment. Kleinbard's proposal would thus solve a major problem associated with the current tax system—the different tax rates on different forms of capital income—without resorting to a consumption tax that would set all these rates at zero. In addition, Kleinbard proposes to repeal the law that allows American companies to defer paying tax on international income until they repatriate it to the United States. This reform is also intended to eliminate opportunities to abuse the taxation of overseas income, and by itself would raise \$3 billion to \$10 billion annually (CBO 2007a, Option 44; Office of Management and Budget 2007a, table 19-4). He estimates that a BEIT with statutory rates between 25 and 28 percent could raise the same revenue as the current corporate income tax rate of 35 percent.

Clausing and Avi-Yonah (2007) propose an alternative reform to the international tax system known as formulary apportionment, whereby U.S. firms would be taxed on a percentage of their worldwide profits equal to the U.S. share of their total sales. Clausing and Avi-Yonah argue that this reform, which is similar to the way U.S. states tax the income of companies operating across several states, would simplify international taxation while eliminating the opportunity for transfer pricing schemes and other international tax abuses, because taxes would be based on market prices and would not require imputing prices on intrafirm transactions. They estimate that their proposal could capture significant additional corporate tax revenue or, alternatively, could allow a sizable reduction in the corporate tax rate. Adopting formulary apportionment unilaterally might be difficult, if not impossible, but Clausing and Avi-Yonah argue that the United States could help prod other countries into taking this step as well.

## Patenting Tax Advice

The government, through its intellectual property laws, grants inventors a temporary monopoly over the rights to their inventions in order to provide adequate incentives for people to invest in innovation. Without patents, inventors might find it difficult to reap enough of the benefits of their innovations to repay their investment, and thus would underinvest in them.

Recently, some tax practitioners have begun seeking patents on tax strategies they have developed, and the Patent and Trademark Office (PTO) has granted patents on these strategies as a patentable business method. This has disturbing implications. Although patents should certainly be available for tools to ease taxpayer compliance with the tax laws, such as tax preparation software, the trend toward patenting of tax planning methods and strategies to minimize tax liability raises several concerns (see Aprill 2007). Most fundamentally, tax patents seem contrary to the public interest. Tax patents provide exclusive proprietary rights over interpretations of the tax laws and over the application of those laws, potentially allowing the patent holder to collect economic rent from other taxpayers who are taking the most efficient (or conceivably the only) steps they can to comply with the tax laws, which is obligatory for all. Tax patents thus might raise compliance costs for taxpayers not only by allowing patent holders to charge monopoly

prices, but also because other tax practitioners would be obliged to conduct due diligence searches for existing patents and pay licensing fees to patent holders. Heightening these concerns is the rise in the PTO's issuance of "bad patents" (for example, for inventions that are not "novel or non-obvious"); especially since patent examiners are not tax experts, they might mistakenly grant patents for tax strategies that are both legal and common.\* Additionally, by providing monopoly rents to patent holders and potentially creating the mistaken impression that a patent on a tax strategy means it has been approved by the IRS as legal, tax strategy patents may encourage the creation of more abusive tax shelters.

All these concerns weigh against patenting of tax strategies, but probably the most important reason is simply that the basic justification for patents is absent. As tax professor Ellen Aprill (2006, p. 7) testified to Congress, the purpose of patent law is to encourage innovation, but "it would be hard to identify a subject less in need of further innovation than tax planning."

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\* See Lichtman (2006). The concern that tax practitioners will be able to patent obvious tax strategies may be mitigated by a recently released Supreme Court decision, *KSR v. Teleflex*, 127 S.Ct. 1727 (2007), which raised the bar to obtaining a patent by broadening the meaning of "obviousness" and finding that "common sense" cannot be ignored in determining a patent's validity.

## Principle #5: Taxes for Individuals Should Be Simplified

A good tax system is not only equitable and efficient, but simple. Simplicity is especially important for individuals for numerous reasons. A complex tax system creates enormous burdens for individuals. Complexity also reduces revenue by increasing both inadvertent mistakes and purposeful evasion. And efforts to use the tax code to encourage certain activities, such as saving and homeownership, will be less effective if people cannot understand how they work.

The complexity of our present tax system is a perennial lament of reformers. Examples abound: In 1940, instructions to the Form 1040 were about 4 pages long. Today the instruction booklet fills more than 100 pages, and the form itself is accompanied by more than 10 schedules and 20 worksheets (Graetz 2007). Proponents of the recent series of tax cuts justified them, in part, as tax simplification, but according to the IRS it took 34 minutes longer to complete Form 1040 in 2004 than in 2000.<sup>18</sup> Most notably, the tax cuts of 2001 and 2003 nearly doubled the number of households subject to the AMT. This provision was originally enacted to prevent a small number of wealthy individuals from escaping taxation, but by 2008 it will, unless amended, affect 24 million filers, who must calculate their tax liability under both methods and pay the higher amount (Joint Committee on Taxation 2007). In total, Americans spend 3.5 billion hours doing their taxes, the equivalent of hiring almost 2 million new IRS employees. Compliance costs \$140 billion annually, and about 60 percent of household filers hire a paid

preparer rather than try to do it themselves (President's Advisory Panel on Federal Tax Reform 2005).

In some ways the goal of tax simplification is at odds with the use of the tax code to effect social policy. Targeted deductions and credits aimed at influencing certain behavior ineluctably add complexity to tax preparation, while also eroding the tax base and increasing the potential for error. Indeed, errors in claiming tax credits and deductions contributed \$32 billion to the tax gap in 2001, according to the GAO (2007). If policymakers continue to use the tax code in this way, which is not only likely but in many ways desirable, as argued in principle #6 below, then some complexity is inevitable. But there are still several steps policymakers can take to achieve simplification.

For one, subsidizing certain behavior through the tax code can be greatly simplified by consolidating various subsidies with similar purposes. New credits, deductions, and exemptions tend to get layered on top of old ones, creating a confusing set of rules with different phase-outs, contribution limits, and eligibility criteria. That is the case, for example, with three of the main tax subsidies for higher education: the Hope credit, the Lifetime Learning credit, and the tuition deduction. Moreover, a taxpayer's use of one of these may affect a student's eligibility for other forms of higher education assistance, such as Pell grants and subsidized loans. One potentially sensible reform would be to consolidate the Pell grant and the education tax subsidies into a single, unified program, as proposed by Susan Dynarski and Ju-

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18. According to the Paperwork Reduction Act notices included in the official IRS forms and instructions booklets, completing the 1040 was estimated to take 13 hours, 1 minute, in 2000 (p. 56) and 13 hours, 35 minutes, in 2004 (p. 75).



dith Scott-Clayton (2007) in a paper for The Hamilton Project. Similarly, legislators could consolidate the tax credits that deal with families and children: the EITC, the dependent exemption, and the child credit (Elwood and Liebman 2001). They should also create common standards and definitions, such as for the maximum age of a qualifying child and what qualifies as a postsecondary education expense.

Another helpful simplification would be to offer return-free filing to the nearly 40 percent of tax filers who have relatively simple tax situations. As Austan Goolsbee proposed in a 2006 Hamilton Project paper, under such a “Simple Return” program the IRS would use information that it already receives from employers and financial institutions to send pre-filled-out tax returns to tax filers with sufficiently simple finances. The program would be voluntary: those who prefer to fill out their own tax forms, or to pay a tax preparer to do it, could just throw the Simple Return away and file their taxes the way they do now. Goolsbee estimates that a return-free filing system would save tax filers up to 225 million hours of tax compliance time and more than \$2 billion in tax preparation fees each year. Return-free filing is already used extensively in some European countries and proved popular in a 2005 California pilot project, where a survey found that 99 percent of participants wanted to continue using the program.<sup>19</sup>

Finally, as mentioned above, one of the least necessary sources of tax complexity faced by many families is the AMT. Its reach has been limited up to now by a series of one-year temporary patches that Congress has passed to exempt many families from AMT liability—at an increasing cost in terms of lost tax revenue each succeeding year. About half of the increase in the AMT results

from the exemption level not being indexed for inflation. Thus, as family incomes rise in nominal terms, more families become subject to the AMT. The other half of the increase in the AMT is due to the fact that the 2001 and 2003 tax cuts were not accompanied by corresponding reductions in the AMT, in a deliberate effort to produce a low estimate of the cost of the tax

## Subsidizing certain behavior through the tax code can be simplified and improved by consolidating various subsidies with similar purposes.

cuts. As a result, if the current AMT patch were allowed to expire, the number of people paying the AMT would explode, from 4 million in 2006 to 24 million in 2008 and 36 million in 2017. If the tax rates in the 2001 tax bill are extended, the number would grow to 51 million in 2017. Continuing the current patch would cost \$569 billion over the next decade if the tax cuts are allowed to expire, and just over \$1 trillion if they are extended. Repealing the AMT entirely would cost nearly twice as much.

At a minimum the AMT should be reformed in a revenue-neutral manner that eliminates the associated complexity for the large majority of taxpayers who fall under its rules. Leonard Burman et al. (2007a), for example, have proposed a number of options for doing so. As part of a more comprehensive reform that improves tax collection and broadens tax bases, the AMT might no longer even be necessary and could be repealed entirely.<sup>20</sup>

19. See Goldberg (2006). Despite its popularity, the program was not expanded because of opposition from the tax preparation industry.

20. See, for example, Center for American Progress (2005) and President’s Advisory Panel on Federal Tax Reform (2005).

## Principle #6: Social Policy Can and Should Often Be Advanced Through the Tax Code—And It Must Be Well Designed

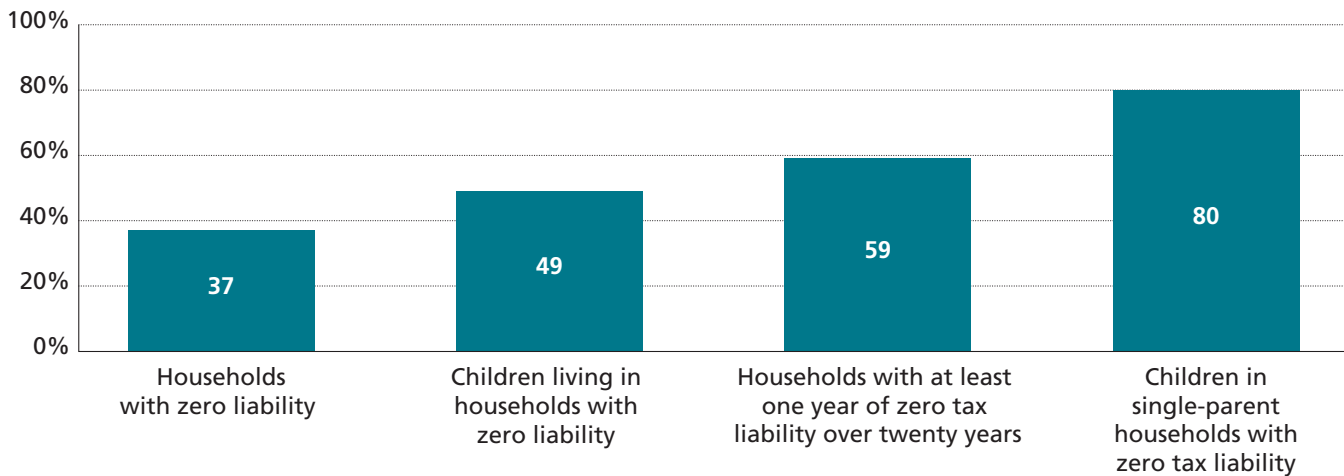
In many cases the government can implement a program or subsidize a desired activity either through direct spending or through tax breaks. Any time the government uses the tax system to provide a subsidy, through deductions, exclusions, or credits, it creates what the late Harvard Law School professor Stanley Surrey famously labeled a “tax expenditure” (Surrey 1974; Surrey and McDaniel 1985). In the administration’s last annual budget document, the Treasury listed a total of \$911 billion of tax expenditures in fiscal 2006—an amount approaching total discretionary spending (\$1.025 trillion in that year; mandatory spending was \$1.418 trillion). These tax expenditures subsidize homeownership, health care, education, charitable giving, and many other aspects of our lives.

Many in the tax community have a longstanding suspicion of tax expenditures, preferring to get the IRS out of the business of administering hundreds of billions of dollars worth of social programs. But although some tax expenditures are poorly thought out and serve goals of dubious value, it is unlikely that they will disappear anytime soon. And if we as a nation have decided to subsidize activities like housing and health care, it is far from clear that those goals would in all cases be better served by moving the programs out of the tax code. It is true that converting tax expenditures to spending programs would reduce the administrative burden on the IRS and reduce the complexity that families face in filling out tax returns. But all of that complexity would simply be shifted to another government agency. Duplicative paperwork would, in fact, likely increase the overall administrative burden for the government, not to mention the burden on families struggling to provide the same information on multiple forms to mul-

multiple government agencies. Moreover, many spending programs phase out benefits as incomes rise in a manner that is not fully transparent and not integrated across programs. As a result, it is common for beneficiaries to discover that, for every \$1 they earn, they lose 50 cents to \$1 in reduced benefits plus higher taxes. Locating social expenditures in the tax code makes their phase-out rates more transparent and easier to harmonize, while preventing the effective marginal tax rates in excess of 50 or even 100 percent that are often observed in the tax and transfer system.

But to accept—and in some cases even embrace—tax expenditures is not to defend how they are presently structured. For years tax analysts of widely differing philosophies have written about the benefits of shifting tax expenditures from deductions to uniform, refundable tax credits. A deduction of \$1 is worth 35 cents to someone in the 35 percent marginal tax bracket, but only 15 cents to someone in the 15 percent bracket. A credit, by contrast, provides the same tax subsidy regardless of one’s tax bracket, and a refundable credit does so even if the credit exceeds one’s total tax liability. Recently Lily Batchelder, Fred Goldberg, and Peter Orszag (2006) laid out the most comprehensive case for the efficiency benefits of using credits rather than deductions to encourage desired behavior that may have broader benefits than accrue to the individual alone (what economists call positive externalities). They point out that the goal of tax expenditures is often to encourage people to consume more of something—for example, health insurance. But since deductions reduce the after-tax price more for high-income families than for low-income families, they generally produce too much added consumption by the former and too little by the latter.

FIGURE 8  
Percent with Zero Federal Income Tax Liability, 2003



Source: Batchelder, Goldberg, and Orszag (2006).

In the absence of evidence on how much families at different income levels will respond to a given tax incentive, Batchelder, Goldberg, and Orszag suggest that credits should be the same for all. In reality, however, it is likely to be more economically efficient to make subsidies progressive, with larger subsidies to lower-income households. For example, a uniform credit might be too little to encourage a lower-income family to purchase health insurance, yet more than enough for a high-income household that would have purchased the insurance in any case. If credits are to be effective in encouraging behavior among low-income households, it is also critical that they be refundable. As figure 8 shows, a large percentage of low-income households pay no federal income tax (but do pay significant payroll taxes) and thus may not benefit from a nonrefundable credit against their income tax liability.<sup>21</sup>

Moreover, many tax expenditures are designed to encourage a particular activity, whether owning a home, getting health insurance, or going to college. But policymakers facing limited budgets may not be interested in subsidizing *more* of these activities—owning a larger home, getting more generous health insurance, or going to a more expensive college. In these cases the subsidy should take the form of a flat credit for undertaking the activity, or be capped at a certain level, to increase

the incentive to undertake the activity but limit the incentive to undertake more of it. In a Hamilton Project discussion paper, Stuart Butler (2007) proposes to move the health insurance system toward universal coverage by, among other steps, reforming the tax deductibility of health insurance to limit larger subsidies while making the subsidy more generous for low-income families.

Tax expenditures, like other government programs, should be designed with behavioral considerations in mind. Substantial evidence shows that how savings decisions are presented to people can have a much larger effect on saving for most households than changes in the after-tax rate of return on savings, the traditional focus of tax policy. For example, a Hamilton Project discussion paper by William Gale, Jonathan Gruber, and Peter Orszag (2006) argues that saving could be increased through automatic enrollment in 401(k)s and Individual Retirement Accounts (though individuals could always opt out). In addition, both Gale, Gruber, and Orszag and Gene Sperling (2005) have proposed replacing deductions for contributions with a government matching contribution that is the same across income levels.

At a minimum, any new tax expenditures with a behavioral motivation should be implemented as credits rather than deductions and should be based on sound

21. Some families without income tax liability would still benefit from nonrefundable credits because of the interaction of these credits with the way the refundable portion of the EITC is calculated.

behavioral considerations. But the big gains will come only from reforming the *existing* system of tax expenditures. Ideally that process would contribute toward reducing the nation's large fiscal gap and toward making the tax system more progressive, helping to offset some of the increase in inequality in recent decades. But even a revenue- and distribution-neutral reform of tax expenditures would pay substantial dividends, making the tax code fairer and more efficient while promoting goals that policymakers have identified as important, such as increasing health insurance coverage, college enrollment, and homeownership.

Tax policy can affect outcomes not just by subsidizing desirable activities but also by penalizing undesirable ones. In this manner, so-called Pigouvian taxes can lead businesses and consumers to take the social costs of their actions into account, helping to ensure that the outcome of market competition is efficient. Today, for example, gasoline is taxed at both the federal and the state level, but the evidence is that these taxes fall short of neutralizing the external harm associated with gasoline consumption, which includes not only climate change but also congestion, traffic accidents, and increased economic vulnerability to supply disruptions. Meanwhile the production of electricity and other energy from coal and natural gas is not taxed at all, despite its large contribution to climate change. A forthcoming Hamilton Project discussion paper will show how carbon taxes to address these issues could be combined with other tax cuts to keep the outcome revenue neutral and distributionally neutral, thus protecting low- and moderate-income families who would otherwise have a hard time paying the higher bills. Alternatively, a well designed system to limit carbon emissions and allow firms to trade emissions permits could achieve a similar objective, as proposed in another forthcoming Hamilton Project discussion paper.

## Conclusion

Tax reform will be very difficult. Yet the scheduled expiration of the 2001 and 2003 tax cuts in 2010 may force a major reform on the scale of the Tax Reform Act of 1986. Alternatively, policymakers may continue to make piecemeal changes to the tax code. In either case, this strategy paper has identified a number of principles that should guide any of these tax changes. These principles do not predetermine any specific reforms, but rather are intended to provide guidance for the direction that any reforms should follow.

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