Rewriting the Tax Code for a Stronger, More Equitable Economy

Principles and Solutions

A Roosevelt Institute Brief by
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Based on the Work of
Joseph E. Stiglitz

March 2016

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Adapted from "Reforming Taxation to Promote Growth and Equity," by Roosevelt Institute Senior Fellow and Chief Economist Joseph E. Stiglitz

Introduction

Over the last 40 years, corporate influence and trickle-down ideology have pervaded the tax code, resulting in large tax breaks for corporations and the wealthy. These low rates have failed to deliver the widespread growth that was promised, and the results for the typical American have been disastrous: Wealth at the top skyrocketed with no equivalent boom in growth. At the same time, median wages have remained largely stagnant, and the United States now ranks 10th out of 13 OECD countries in upward mobility.[i 1] To correct our current trajectory, America needs a wholesale reconsideration of tax incentives and their impact on various economic activities.

In this brief based on previously published work by Roosevelt Institute Chief Economist Joseph E. Stiglitz, we propose a new paradigm for thinking about the tax system: Rather than rewarding bad behavior and using the tax and transfer system to redress poor outcomes after the fact, the tax code should be structured to encourage productive economic activities and a more equitable pre-tax distribution. The tax code can be used to adjust incentives and curb shortsighted, risky, and otherwise undesirable economic behavior. Loopholes should be closed, high taxes should be levied on harmful activities, and tax cuts and subsidies should be focused on productive investment that promotes inclusive growth and general well-being.

Our proposal aims to bring about inclusive growth through tax reform built around progressivity and positive incentives. Accomplishing this will require a better understanding of tax policy on three key points:

Tax cuts do not necessarily improve growth, and tax increases do not necessarily reduce growth.

Studies by trusted nonpartisan organizations like the Urban-Brookings Tax Policy Center and the OECD find no tradeoff between progressive taxation and economic growth.

While taxes play a role in post-tax redistribution, they also greatly influence pre-tax behavior through incentives.

Studies by the IMF, Congressional Research Service, and others show that low top marginal tax rates encourage profiteering, leading to less investment and larger pre-tax incomes for the very wealthy.

Tax cuts and preferential rates cost taxpayers money even though they don't appear in the budget, so cuts should benefit all of society, not just small, wealthy groups.

Shrinking revenue streams from top-heavy tax cuts have led to decreased public spending on key goods like education and infrastructure, which detracts from general well-being and our future prospects for growth.

i The top 1 percent of the population takes home 20 percent of the country's income along with 54 percent of capital gains and 95 percent of the wage growth since the 2008 crisis.

Some key policies needed to meet these guidelines include:

- Tailoring a multinational tax code to the true sources of corporate revenue in order to fight corporate tax avoidance
- Raising capital gains rates to reduce incentives for speculative behavior and increase the progressivity of the tax code
- Taxing harmful products, like excessive financial risk and carbon emissions

Trickle-Down Economics and the Economy Today

Today's tax code is riddled with loopholes for wealthy individuals and large corporations. Income from capital gains, for example, is taxed at roughly half the rate of income from labor; in 2013, this policy alone saved the top 1 percent well over $100 billion, while the bottom 80 percent of the population saved scarcely a tenth as much.[2] Similarly, while smaller domestic firms pay the full legal rate, large multinational corporations are able to reduce or completely avoid taxation by sheltering profits abroad.[3] Studies estimate current offshore holdings at over $2 trillion.[4] These policies, which consume tax revenue, increase inequality, and actually discourage productive investment, are the legacy of Ronald Reagan's failed "trickle-down" theory of economics, which has dominated our country since the early 1980s.

Trickle-down, or "supply-side," economic theory contends that tax cuts at the top will grow the economy by increasing the amount of money large businesses and the wealthy have to invest. Advocates of trickle-down economics therefore lobby for tax cuts and loopholes that will direct more resources to large corporations and the wealthy. History, however, shows that while trickle-down does succeed in raising incomes at the top, it fails to spur increased investment, growth, and improved prosperity for all.

Further, these top-heavy cuts have created a host of perverse incentives in the American economy. Under the top income rates of 70 percent or more, which

Trickle-down economics has been proven to be a major driver of inequality and a failed strategy for stimulating growth. Multiple studies show no correlation between lower tax rates and sustained increases in growth or investment. Moreover, since the advent of trickle-down under Reagan, America's degree of income inequality has risen considerably: While pre-tax incomes of the middle quintile grew by less than 10 percent, those of the top 1 percent nearly tripled.

prevailed prior to Reagan's Economic Recovery Tax of 1981, increased salaries for high-earning managers went mostly to taxes, so firms had more incentive to invest in productive spending such as raises for averages workers or expansionary investment. As top income rates and capital gains taxes fell, however, managers had the opportunity to take more for themselves and for wealthy shareholders without losing as much to taxes.[5] This encouraged higher salaries for high-level managers and increased payouts to shareholders while diminishing the relative incentive to invest in business and the workforce.[6] It also made other unproductive profit-seeking behavior, like cheating regulation or manipulating the stock market, more profitable and therefore more economically appealing.

Unfortunately for the American economy and middle class, the regressive and unproductive aspects of trickle-down ideology were lost in the face of its overwhelming political marketability, and its impact on tax policy has been long-lived. After Ronald Reagan, Bill Clinton cut the capital gains rate from 29 percent to 21 percent in 1998, and George W. Bush cut it again in 2001 to around 16 percent.[7] Time and again, these cuts have been sold as relief to American families and workers, but the direct benefits accrue almost exclusively to the wealthy; in 2013, 68 percent of the value of the preferential rate on capital gain and dividends went to the top 1 percent.[8,9]

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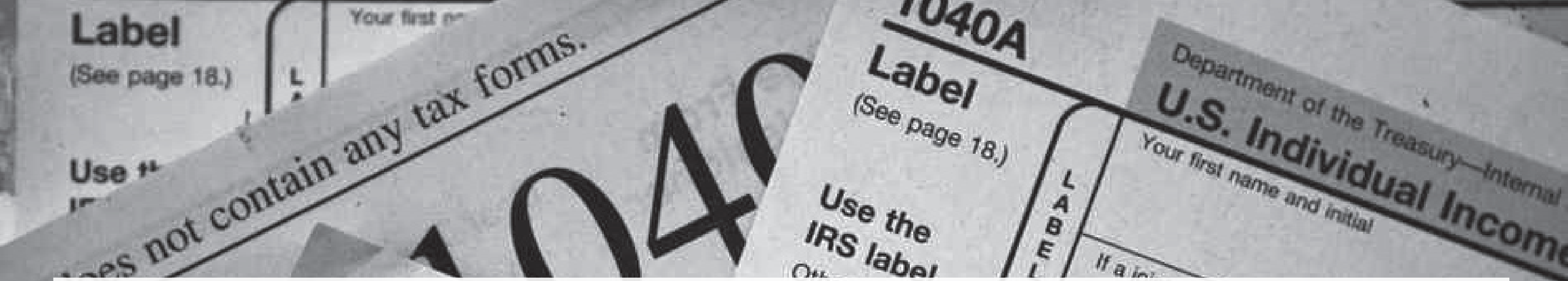

lower tax rates and sustained increases in growth or investment.[10] Moreover, since the advent of trickle-down under Reagan, America's degree of income inequality has risen considerably: While pre-tax incomes of the middle quintile grew by less than 10 percent, those of the top 1 percent nearly tripled.[ii][11] Yet conservative presidential candidates continue to propose tax cuts for large businesses and the very rich and promise runaway growth in return.

It is time to firmly reject trickle-down and write an efficient and progressive tax code that will usher in a new era of inclusive growth. We need an overhaul that provides revenue for reinvestment while ending subsidies to large corporations and tax breaks for America's wealthiest individuals.

Principles of an Effective Tax System

- Growth and equitable distribution are not mutually exclusive.
- Use taxes to improve economic behavior.
- Make tax cuts progressive.
- Make tax expenditures transparent.

Growth and Equitable Distribution Are Not Mutually Exclusive

We often hear from those on the right that taxes slow growth, and many policymakers act as if any government intervention to address inequality or raise revenue for investment will harm economic performance. Arthur Okun called this "the big tradeoff," but recent research thoroughly discredits Okun's argument that equity can come only at the expense of efficiency.[12] In fact, the IMF's historical analysis found that "the combined direct and indirect effects of redistribution—including the growth effects of lower inequality—are on average pro-growth."[13] Standard & Poor's echoed the IMF, finding that extreme inequality in the U.S. is a drag on growth: Due to rising inequality, S&P revised the 10-year growth forecast for the U.S. down from 2.8 percent to 2.5 percent annually.[14]

Advocates of trickle-down economics have claimed that tax rates on capital must be kept low in order to promote investment and drive economic growth. Again, the latest economic research discredits this trope; cross-country studies show no correlation between lower capital gains rates and improved investment, and case studies from recent history show that capital gains cuts improve neither investment nor employment.[15] Many economists agree that the societally optimal capital gains tax is significantly higher than what we have today.[16]

In summation, while it is possible that certain tax cut programs, like the EITC, can promote inclusive growth, these are not the tax cuts for which conservatives lobby. Top-heavy tax cuts, like those proposed during the 2015–16 Republican primary race, grow only the incomes of the 1 percent.

Taxes Structure Economic Behavior

Tax policies are some of the broadest and most potent influencers of economic behavior at our disposal, so it is essential that they be designed to boost inclusive growth and broad prosperity. Beyond affecting distribution, tax policies exert an enormous impact on the economy by rendering certain goods and behaviors either highly profitable or extremely costly. Generally, when something is taxed, society will produce less of it, so for the purpose of economic efficiency it is preferable to tax things that are either bad for society, like carbon pollution, or inelastic in supply, like land.[iii]

ii Gini is a statistic that measures income inequality on a scale from zero to one, with zero representing a country in which each individual earns the same amount of income and one representing a country in which a single individual earns all of the income. America's pre-tax Gini is the highest of all modern economies in the OECD.

iii In economics, the preference for taxes on land and other inelastic goods is referred to as the Henry George principle, after the economist who pioneered the theory.

Today's tax code encourages a range of activities that harm long-term economic performance and worsen inequality. Policymakers must address our tax code's most egregious perverse incentives, which encourage excessive financial risk, reward unproductive behavior, and further enrich the wealthy and big corporations.[17] At the same time, the government must sustain or create incentives for positive behavior, like productive corporate investment. We outline some key examples of each below.

Taxes Should Discourage Bad Economic Behavior

To spur sustainable growth and guard against crises, policymakers must use the tax code to discourage harmful economic activities such as excessive financial risk-taking, short-term trading, and polluting, which are costly to society. Currently, however, corporations and individuals are allowed to profit from these types of activities while passing the true costs on to American taxpayers. We should tax these activities in order to make them less profitable so that they occur less often and also to raise revenue for important investments in education and infrastructure.[18]

The United States currently spends roughly $18.5 billion per year on subsidies for the fossil fuel industry.20 Rather than add to their enormous profits, the government should tax these companies for the amount of carbon pollution they produce. Doing so would encourage the development of alternative energy sources, which would be both economically and environmentally beneficial.

Raising top tax rates and capital gains tax rates, for example, would discourage the profiteering that has disincentivized corporate investment. As previously discussed, cuts in top income and capital gains brackets have not increased corporate or individual investment. Rather, these cuts have increased the monetary return on allocating business resources to top salaries or individual resources to speculation. CEO pay, for example, increased nearly tenfold from 1978 to 2014 without any commensurate increase in corporate performance or worker salaries.[19] Indeed, by allowing corporate managers and shareholders to pocket such a large percentage of their salaries and dividends, these tax cuts have made worker wages and productive investment comparatively less appealing. Higher taxes on the income and capital gains of the wealthy would reverse this perverse incentive and encourage better behavior.

A carbon tax is another example of a tax that could discourage harmful behavior while encouraging more sustainable alternatives. Currently, large-scale polluters profit from selling goods without bearing the cost of carbon's impact on the environment. In fact, the tax code incentivizes this business model: The United States currently spends roughly $18.5 billion per year on subsidies for the fossil fuel industry.[20] Rather than add to their enormous profits, the government should tax these companies for the amount of carbon pollution they produce. Doing so would encourage the development of alternative energy sources, which would be both economically and environmentally beneficial. The tax would also generate revenue that could be used to combat the negative effects of climate change or put toward other productive investment.

By eliminating the advantages given to industries associated with negative externalities, and by creating new taxes on harmful behaviors, the government can raise revenue and reduce unwanted outcomes.

Taxes Should Encourage Good Economic Behavior

Although we generally argue against subsidies that end up in the hands of wealthy individuals and large corporations, incentives can encourage socially beneficial economic behavior, such as investment, job creation, wage increases, and saving for retirement. Under current law, corporations, for example, are allowed to write off interest payments on debt regardless of whether that debt is used to finance the construction of a state-of-the-art production facility or to fund buybacks that enrich wealthy shareholders. This write-off should be allowed only in instances where the debt is indeed used for investment. Otherwise, this kind of policy only invites more of the same corporate short-termism that slows innovation and growth and gives rise to high levels of inequality.

Policymakers should work toward a tax code that rewards investment rather than profiteering. The revenue generated from these higher tax rates will be doubly important for funding public investment if corporations refuse to invest for growth.

Make Tax Cuts Progressive

While it is almost universally accepted that taxes should draw a higher percentage of income from the rich than from middle- and lower-income Americans, the U.S. tax code contains a range of regressive tax expenditures. These expenditures increase inequality at a cost to potential consumer spending, which makes up 70 percent of the U.S. economy. This creates a drag on demand that is detrimental to the economy as a whole.[21] In the interest of fairness and growth, tax policy should be geared to maximize earnings for the broadest swath of Americans.

Because the income of wealthy families easily covers their basic needs, they are less likely to spend the extra dollars of income generated by top-heavy tax cuts. Meanwhile, a middle- or lower-income American who has a much smaller buffer between income and household expenses is almost guaranteed to spend an extra dollar, which, on a large scale, stimulates the economy and creates jobs.[22] Similarly, large corporations are more likely to pay out increased revenue to shareholders—a form of corporate short-termism detailed in other work from the Roosevelt Institute—while smaller firms will spend on hiring and investment.[23]

If our goal is to promote innovation, wages, and general well-being, it makes much more sense to reduce taxes on middle-income individuals and small businesses, which will boost consumer demand and investment in wages, than it does to provide more subsidies to wealthy individuals and corporations, whose incumbency advantage is already significant.

Make Tax Expenditures Transparent

One reason regressive tax cuts have proliferated within the U.S. tax code is that their costs are harder to identify than regular expenditures. To the general public, a $50 billion tax cut does not seem like a cost in the same way a $50 billion infrastructure investment might, but the impact on the budget is the same. The Joint Committee on Taxation can estimate the budgetary impact of tax cuts, but these estimates are far from certain and rarely reach the general public, so tax cut costs are easily misunderstood. Policymakers use this political cover to fund giveaways, such as enormous transfers to profitable corporations, which would never win approval in Congress—or pass muster in the court of public opinion—as direct allocations. Most importantly, American taxpayers ultimately foot the bill for these programs. Whether they are paid for through higher taxes, increased deficits, or spending cuts to national priorities like education, infrastructure investment, and national security, tax cuts are never free.

A tax overhaul should reassess every expenditure to guarantee that the general public benefits from tax expenditures as much as the private corporations and individuals who receive them.

Corporate Tax Reform

- Reform multinational taxation so corporations are treated as unitary entities and taxed on global income.
- Eliminate the tax preference for partnerships and S-corps with exceptions for small businesses.
- End subsidies for fossil fuel companies and other harmful industries.

American corporations are contributing less and less to the American society that allows them to flourish. In 1952, corporations contributed over 30 percent of U.S. tax revenue; today that figure is down to just 10.8 percent.[24] This is largely the result of two trends in corporate taxation: multinational tax avoidance and the shift from classic C-corporations to tax-advantaged "pass-through" entities. In the first case, the tax code allows multinational firms to avoid U.S. taxes by claiming residency in low-tax jurisdictions abroad, even when their primary business is based in the United States. In the second case, tax policies governing pass-through entities have encouraged a widespread transition to these tax-advantaged corporate structures

and eroded a sizeable government revenue stream; as of 2011, pass-throughs generated 65 percent of all U.S. business receipts—20 percent of which went to the top 1 percent—while paying just a 19 percent average effective tax rate.[25] The corporate tax code requires broad structural reform to end perverse incentives and opportunities for tax arbitrage.

Compounding these structural taxation problems are large corporate welfare programs that greatly increase the inefficiency and inequities of the U.S. tax code: Tax breaks and the transfer of public land and other assets to large corporations costs the federal government $100 billion per year.[26] These programs funnel money to wealthy corporations at a direct cost to taxpayers.

Multinational Taxation

One high-profile example of this kind of behavior occurred in late 2015, when the pharmaceutical company Pfizer announced its plans to merge with the Irish-based company Allergan for the purpose of "inverting," a way of avoiding a large part of its U.S. tax liability.[27 iv]

The current tax code allows for systemic tax avoidance and reduces incentives to invest in the U.S. Currently, American firms are able to defer tax payments and avoid U.S. taxes by sheltering their profits under legal entities located in tax havens. Even though these legal entities are little more than a piece of paper, they enable enormous corporations to avoid taxes and cheat the American people. Since the profits of American multinational firms are not taxed until they are repatriated to the U.S., they are encouraged to invest abroad, which allows them to pay lower foreign rates. U.S. multinational tax policy, therefore, not only fails to raise appropriate revenues but also actively discourages domestic investment. It is important to note that this behavior is not the scheming of a few rogue companies but the universal modus operandi of leading firms like GE, Apple, and Google, and it costs the American taxpayers somewhere between $50 billion and $70 billion per year.[28]

America needs a system of international taxation in which firms are treated as one entity, taxed according to the amount of business they conduct within the U.S., and required to pay on an annual basis. This sort of reform would not just prevent inversions and other multinational tax avoidance activities but would also realign incentives so that corporations once again invest in America. This will spur employment, encourage growth and investment, and help ensure the sustainability of the public research and development, human capital, and infrastructure that allowed these corporations to flourish in the first place.

Pass-Through Corporations

Pass-through designations such as partnerships and S-corps are taxed through an individual's personal income tax rather than the corporate income tax system. Pass-through categories were initially intended to simplify taxation for small businesses, but today wealthy individuals exploit these designations to reduce their overall tax liability.[29] As businesses have grown more interested in and savvy about avoiding taxes, the share of corporations organized as pass-throughs has grown, more than doubling from 20.7 percent in 1980 to 54.2 percent in 2011. The effective tax rate of these entities is just 19 percent, which is significantly lower than the 31.6 percent rate paid by traditional C-corporations. Perhaps most disturbingly, the source and ultimate destination of much pass-through income is difficult to track and verify, meaning the extent and nature of pass-through tax avoidance may not yet be fully understood.[30]

Recent research suggests that preferential rates for pass-throughs contribute substantially to the decline of corporate tax receipts and to the rise of income inequality.[31] A fair corporate tax code would treat all

iv In the wake of the Pfizer announcement, the term "inversion" became shorthand for multinational tax avoidance, but in reality, inversion is just one tactic that multinationals use to shelter profits abroad.

corporations equally and make exceptions only when social priorities, such as small business development, dictate their necessity.

Corporate Welfare

The most obvious corporate welfare programs come in the form of transfers and tax breaks to large, profitable corporations like the $5.3 billion in commodity payments made to the agriculture industry in 2012 or the $18.5 billion devoted to annual fossil fuel subsidies. The view that these subsidies support critical yet fragile industries goes from questionable to ludicrous when one considers that 77 percent of the agriculture subsidy goes to the wealthiest 10 percent of America's farms and $2.4 billion of the fossil fuel subsidy goes to the four largest producers.[32]

In both cases, Congress created the subsidies decades ago to help support American industries through difficult times beyond their control.[33] Today, they serve only to enrich large, profitable businesses at the taxpayer's expense, and they have survived only because of powerful lobbies in Washington.[v] It is time to rewrite the rules so that this money is spent on strengthening the American people and economy.

The federal government further subsidizes corporations in a range of industries by selling off public goods well below market rates. Fisheries, mineral deposits, and the electromagnetic spectrum that carries cell phone and TV signals are just a few examples of public goods that could be sold at open auctions in order to generate more revenue for public uses.

The federal royalty rate, for example, has not been raised from its mandated floor of 12.5 percent since it was established in 1920, despite advances that have cheapened production and growing understanding about the harmful side effects of fossil fuel consumption.[34]

Individual Tax Reform

- Raise top income rates.
- Balance out labor and capital taxes.
- End loopholes that inordinately benefit the wealthy.

For a country with an already top-heavy income distribution, America spends vast sums enriching those at the top. Wealthy Americans are able to take advantage of preferential tax policies in ways that people in lower income groups cannot. The home mortgage interest deduction, for example, is available to all taxpayers, but while a middle-income earner may use this benefit on a modest home, wealthy buyers are able to apply the same deduction to a multimillion-dollar vacation property. Similarly, the low capital gains rate theoretically benefits all income groups but, in practice, overwhelmingly benefits the very rich: 87 percent of the benefit of the reduced capital gains tax goes to the top 10 percent, with 68 percent going to the top 1 percent alone. Like other policies covered in this paper, this drives down tax revenues and increases inequality. The result is a system in which the super-wealthy are able to take advantage of many lucrative tax breaks and the government no longer makes necessary investments in public goods such as infrastructure and education.[35] Policymakers need to cap or close loopholes that unfairly benefit the wealthy and leave the middle class behind.

The estate tax is a prime example of a wealth-favoring tax policy. In 2013, the stepped up basis at death—a feature of U.S. tax policy that allows wealthy families to escape taxes through inheritance—cost the federal government $50 billion. Sixty-five percent went to the top quintile, while 21 percent went to the top 1 percent.[36] Unfairness aside, such lopsided tax breaks are bad for demand, distribution, growth, and mobility. With so much money going to keeping the rich rich in the form of expenditures, we have little left to invest in programs that would elevate the poor and middle class.

For revenue-raising purposes, given our country's top-heavy income distribution, even a slight upward adjustment could make a huge impact. A 5 percent increase in the tax rate of the top 1 percent would raise between $1 trillion and $1.5 trillion in additional revenue over 10 years.[37] To put this in perspective: For an extra $50,000 taxed on every $1 million of a wealthy individual's income, we could make all public college education free, fund universal pre-K, and still have money left over.[38]

v Peebody Energy, for example, paid a tax rate of just 6% despite $2.8 billion in US profits. Citizens for Tax Justice. 2012. "Corporate Tax Explorer: Peabody Energy." Washington, DC: Citizens for Tax Justice. Retrieved January 20, 2015 (http://ctj.org/corporatetaxdodgers/tax-dodgers.php?id=200).

Financial Taxes

- Tax financial transactions.
- Tax excessive financial risk.

The regulatory and tax code currently encourages excessive risk-taking and rent-seeking in the financial sector. Much of this must be addressed by regulation, as described in recent reports from the Roosevelt Institute's Financialization Project, but tax reform can do much to curb and reshape the financial sector.

Since the 2008 bailouts, banks have benefited from an implicit government guarantee on their excessive risk and irresponsible trading. Knowing they will be rescued if they fail, banks are willing to take on increased risk. This is economically unproductive and creates volatility that increases the odds of another crisis—and all of the associated consequences for average Americans. Taxing excessive leverage would reduce risk, redirect bank activity toward more productive endeavors, and raise revenue that could be put to productive public use. By discouraging short-term trading, taxing financial transactions would combat volatility and raise revenue without negatively impacting long-term productivity.

Many who have proposed taxes on the financial sector have done so because of the outsized profits of its firms and salaries of its employees. To the extent that these profits and wages are the result of profiteering, additional taxes make sense, but limiting the risky and negative behaviors of the sector is an even more compelling reason to restructure financial taxes. This is especially clear when one considers the enormous cost of the 2008 financial crisis and the direct toll it took on American consumers—estimated at hundreds of thousands of dollars per family.[39]

Conclusion

Tax policy is a contentious and complicated issue in the United States. Decades of clever political marketing have painted taxation as robbery and downplayed the necessity of a progressive and efficient tax code. At the same time, our tax laws were written to benefit the wealthy and large corporations at the expense of the middle class and the economy at large. Policymakers need to embrace the role that taxes play in shaping economic behavior and begin imagining a tax code that will create growth and increase the well-being of all Americans. Real tax reform will help level the economic playing field, but it will also improve efficiency.

The American people overwhelmingly support rewriting the rules of our tax system. According to a 2015 Pew Research Center survey, more than 60 percent of Americans say they are bothered a lot by the feeling that the wealthy and some corporations do not pay their fair share of taxes.

The American people overwhelmingly support rewriting the rules of our tax system. According to a 2015 Pew Research Center survey, more than 60 percent of Americans say they are bothered a lot by the feeling that the wealthy and some corporations do not pay their fair share of taxes. And a recent poll by the Roosevelt Institute showed that 72 percent of voters favor increasing taxes on the richest 1 percent to fund investments that will grow the economy in the long term, including public education, scientific research, and infrastructure. This isn't just good economics. It's good politics, and it's time for policymakers to take note and act.

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Cover illustration by John Hendrix.