

Suggested Principles for Tax Reform

Citizens for Tax Justice, October 15, 2009

We want a fairer, simpler tax code that raises enough money to pay for public services and promotes economic prosperity for all Americans.

Our current tax system falls far short of achieving these goals.

- On the revenue side, even after the current recession ends, we can expect to be funding about a quarter of all non-Social Security spending with borrowed money (including amounts borrowed from the Social Security trust fund). This fiscal profligacy, which sends our bills to future generations and endangers both public services and the private economy, must stop.
- As for simplicity and fairness, well, both parties have been guilty of using the tax code to promote a vast array of favored activities. One result is that taxpayers with similar incomes can be treated wildly differently depending on how they make their money or how they spend it. Another problem is that many, albeit not all, tax breaks tend to undermine the progressivity of our tax system. And, of course, tax filing is far too difficult for far too many taxpayers.
- In fact, our current tax system allows many of our biggest and most profitable corporations to pay little or no tax. It taxes investment income at less than half the rate workers pay. And it tolerates rampant upper-income tax sheltering. Many, if not most of these loopholes hurt our economy by misdirecting business activities into tax-favored areas at the expense of more productive pursuits.

So what should we do about this? If you asked most Americans what's wrong with the tax system, they'd say that it's unfair and complicated because it has too many loopholes for wealthy people and corporations. Most Americans are right.

- We should end the hundreds of billions of dollars a year in unjustified corporate and upper-income tax dodges, and tax people and corporations on what they really make, not on some figment of their accountants' imaginations.
- Graduated tax rates are essential to protect the poor and middle class and ensure that top earners pay a decent share to support the country that makes their prosperity possible.
- We must reject crackpot schemes such as the so-called "flat tax" and "national sales tax" that would shift tax burdens away from the well off and onto middle- and low-income families.
- By taking these steps, we can balance the budget, maintain and improve our country, and stop treating honest ordinary citizens as tax chumps.

We could use as a template for reform the loophole-closing Tax Reform Act of 1986, with tax rates sufficient to fund public services. The central principle of the 1986 reforms, that people and companies should be taxed on what they really earn, at progressive rates, is still a good idea today.

Senator Ron Wyden has introduced a bill that follows the principles of the 1986 Tax Reform Act, notably by narrowing the gap between taxation of earned and unearned income and by ending corporate “tax deferral” on profits styled as “foreign.” The Wyden plan would be an excellent starting point for designing an income tax reform program.

Beyond income taxes, the current Medicare tax cries out from reform. When Medicare was initially enacted, its tax applied only to earnings up to the Social Security wage cap. In the early 1990s, however, Presidents George H.W. Bush and Bill Clinton, along with the Congress, recognized that the wage-tax cap, while perhaps defensible for Social Security, made no sense in the case of Medicare. And so the cap was removed, which made the Medicare tax less regressive. But the Medicare tax still applies only to earned income, and thus largely exempts the income of the wealthy. By expanding it to investment income as well, the fairness and revenue-generating ability of the Medicare tax would be greatly enhanced.

Finally, we should also pay attention to tax compliance issues. One of our biggest problems in this area is offshore income shifting by wealthy Americans. Although the IRS is making some progress in addressing this problem, it needs more tools to do its job effectively. One major step would be to revise our model Taxpayer Information Exchange Agreement (TIEA) so that it requires regular and automatic exchanges of information, and then to negotiate adoption of that revised agreement with other nations. An example and explanation of such a new model TIEA should be posted soon at <http://faculty.law.wayne.edu/McIntyre/index.htm>.

Our website, www.ctj.org, includes longer explanations and analyses of many of these and other tax reform proposals. We would be happy to discuss any or all of them with you.