BROOKINGS

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**TO:** President-Elect Obama

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**RE:** Fix the Tax System

## The Situation

Given the nation's economic slowdown and financial crisis, and the inevitable increase in the deficit that will result from efforts to address these problems, tax policy will feature prominently over the next four years. This offers an enormous opportunity to achieve your goals in health care and energy policy; to make taxes simpler and fairer; and to restore fiscal balance in the long run.

In the short term, taxes might play a role in the broad stimulus and economic restructuring package you have identified as an immediate priority upon taking office. However, direct investment in infrastructure, aid to states, an extension of unemployment benefits, and measures to stabilize the housing market should take precedence.

- Investments in U.S. infrastructure should be a crucial part of the stimulus package, since "shovel-ready projects" can immediately put federal funds to work and bolster U.S. competitiveness and environmental sustainability.
- The federal government should provide additional aid to hard-pressed states to help fund Medicaid and general budget expenditures. Because states have balanced-budget rules that require spending cutbacks when revenues fall, federal aid is sure to be spent.
- A significant part of the stimulus package should address the declining housing market and reduce foreclosures.

## Your Stance

During the campaign you promised broad-based tax relief to middle class families, tax breaks for small businesses and companies that create jobs in America, the restoration of fairness to our tax code and a return to fiscal responsibility. The underlying tax system needs repair of both chronic and urgent problems. Almost all of the tax cuts enacted since 2001 are slated to expire at the end of 2010. The alternative minimum tax (AMT) threatens to grow out of control. And over the long term, the nation faces a fiscal gap so large it will require both tax increases and spending reductions.

Your ability to reform the energy and the health care sectors, two of your highest priorities, also depends on creation of rational and effective tax rules.

## Recommendations

Besides the stimulus package, three distinct opportunities exist to move tax legislation through Congress: the need to reform how our nation produces and consumes energy, challenges to the provision of health care and the expiration of the Bush tax cuts in 2010.

***Energy:*** The nation's long-term challenges related to energy production and consumption require bold solutions. Government simply must make it more expensive to use and emit carbon by either a direct tax on carbon emissions or a "cap and trade" system, with the government selling "permits to pollute." The two approaches are economically equivalent and would produce wide-ranging benefits: the societal cost of producing and consuming carbon would be included in the price of goods like gasoline and electricity; energy security would rise; environmental damage would decline; and federal revenues would increase. Senator McCain supported the cap-and-trade mechanism during the presidential campaign, and many members of both parties continue to support it, making this reform an increasingly politically-feasible option.

A carbon tax or a "cap-and-trade" system would provide significant incentives for development of alternative energy sources and would render unnecessary the existing panoply of targeted energy subsidies.

***Health:*** Health care reform presents a variety of complex issues. By far the most significant tax issue is the employer deduction for employee health insurance premiums. Allowing such a large part of employee compensation to be deductible leads to gold-plated health insurance policies, gives a larger benefit to high-income taxpayers, and leads to billions of lost tax revenue every year, while disadvantaging families without employer-based coverage. Reform options include:

- capping the deduction on employer benefits, which would mitigate, but not resolve, some of these problems;
- converting the deduction into a fixed refundable credit for the employer; or,
- converting the deduction into a fixed, refundable credit for individual workers.

The third reform was supported by Senator McCain and consequently may provide the basis for discussion of bi-partisan reforms of the health care system.

***Long-Term Fiscal Balance:*** Since 1962, federal tax revenues have averaged about 20 percent of GDP. Under current projections, federal spending is projected to rise gradually and to reach about 27 percent of GDP by 2030, fueled mainly by increased spending for Social Security, Medicare and Medicaid. Unless Congress and your Administration are willing to make draconian cuts in these entitlement programs, the budget will require tax reforms that generate revenues well above 20 percent of GDP in the next decade.

Sensible structural reforms would combine the fiscal responsibility and progressivity of the Clinton years — without the complexities of targeted subsidies — and the lower marginal tax rates of the Bush years. In addition to fulfilling your campaign pledge to provide tax relief to middle-class families, reforms would give attention to revenue levels, the growth of the AMT, and loopholes in the taxation of capital income. Such a system could be created by reducing and restructuring tax expenditures in order to broaden the tax base and using the increased revenues to hold rates down and eliminate the AMT.

Addressing this issue in a timely manner is important, but the legislation can be delayed until the economy is back on track.

## FURTHER RECOMMENDATIONS

***Saving and Capital Income:*** The taxation of capital income — the return from saving — in the current system is, in plain terms, a mess. Capital income is taxed at greatly different rates depending on the type of investment, how it is deployed, the type of financing, and so on. Taxpayers use these conflicting rules to their advantage, leading some analysts to conclude that the country collects little if any net revenue from capital income taxes. The solution is to tax all capital income once and only once at the full income tax rate. Reforming this part of the system would require your Administration to address several issues simultaneously.

- First, integrate corporate and individual capital taxation only for income stemming from new corporate investment. There is no reason to give tax breaks on income from old investments; those tax breaks amount to windfall gains.

- Second, remove individual-level taxation of corporate dividends and capital gains (on new investments) only if the corporation has paid the full tax on the income. To the extent it has not, corporate dividends and capital gains should be taxed at the full individual rate, not capped at 15 percent.

- Third, strengthen efforts to eliminate corporate tax shelters. This could include both increased enforcement as well as altered accounting procedures that require more conformity between income reported to shareholders (book income) and income reported to the IRS (taxable income).

- Fourth, engage in a wholesale attack on corporate subsidies — for example, subsidies directed towards the agriculture, mining, oil, and timber industries.

Additionally, the tax code needs to be restructured to encourage more Americans to save and to equalize the tax benefits of savings for low- and middle-income taxpayers:

- First, your Administration should require every firm (with possible exceptions for the smallest businesses or those who do not use electronic payroll services) to enroll new workers automatically (with opt-out provisions) in a traditional defined-benefit retirement plan, a 401(k), or an IRA. Businesses also should be required to set various default features of the plans to promote saving, although workers could always override those defaults.

- Second, you should support legislation that replaces current tax deductions for retirement savings with a new program of universal, 30 percent matching contributions from the government for qualified household deposits to 401(k)s and IRAs. Currently, low-income households enjoy much weaker immediate incentives to contribute than do high-income households. This policy would shift incentives markedly, but cost the Treasury the same as existing tax deductions.

***Rationalize Deductions, Exclusions and Credits:*** The tax system subsidizes scores of economic activities through a variety of deductions, exemptions, exclusions and credits. Broadly speaking, many deductions and exemptions should be transformed to credits to give taxpayers of different income levels equal benefit. In addition, credits aimed at meeting social policy objectives should be refundable, so that they provide benefits to the households who need the funds most.

The best solution would address each of the current deduction categories directly. Charitable contributions should be fully deductible; this preserves the largest incentive for giving for the highest-income households, and also ensures that those who give away all of their income would not owe tax. After the housing crisis passes, the mortgage interest deduction should be converted to a refundable first-time homebuyers' tax credit. This would generate revenue, would improve homeownership rates and would eliminate incentives to buy ever-bigger houses with ever-bigger mortgages. Deductions for state and local taxes could be eliminated as part of AMT reform; if the AMT is allowed to grow as it will under current law, few taxpayers will be eligible for the state and local deduction, anyway.

***Simplify Taxes and Improve Administration:*** Every year the U.S. tax system becomes more complex. As a prime example of potential simplification, the IRS could implement a "return-free" system — which exists in dozens of countries — giving taxpayers the option of receiving pre-completed tax forms from the IRS that require only their verification. Return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code.

The number of households that could avoid filing would be further increased and other simplifications would occur if the personal exemption, child credit, and earned income credit were consolidated and if the standard deduction were increased. Increasing the standard deduction by the value of a personal exemption and reducing the number of personal exemptions by one would raise revenue and would reduce the number of taxpayers who must itemize. Similarly, education subsidies and retirement saving programs could be consolidated and streamlined.

An intelligent reform plan also must equip the IRS with the resources to enforce and administer the tax system. Many taxpayers simply do not pay what they owe. Providing the IRS with additional resources for enforcement generally would boost revenues and produce a fairer distribution of the tax burden.

Fortifying the tax system, as suggested here, is essential to securing the economic gains that need to be made for our country's short, medium, and long-term future.