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Guiding Principles for Tax Reform

Raise Revenue, Enhance Fairness, Stop Corporate Tax Avoidance

There is widespread agreement in the halls of Congress and among the American people that the U.S. tax system desperately needs reform. Yet some proposed federal tax changes defy what most Americans would consider reform. This policy brief outlines three sensible, broad objectives for meaningful federal tax reform and discusses specific policies that can help achieve these objectives.

1. Tax Reform Should Raise Revenue

The most basic task of any tax system is to raise enough revenue to fund needed public investment, but the federal tax system has consistently failed to achieve this minimal goal. In 35 of the past 40 years, the federal government has failed to collect enough tax revenue to pay for all of federal spending, so in each of these years the nation has run a budget deficit. Anti-tax advocates would have the public believe that these persistent deficits are due to federal spending growth. But in fiscal year 2014, federal spending was lower as a percentage of the nation's Gross Domestic Product than it was in any year of Ronald Reagan's presidency. And in the past five years alone, discretionary spending has fallen by almost a third as a share of the economy.¹

The nation's federal deficits are primarily the product of our historically low federal tax revenues. In each of the past four years, federal revenues have been lower as a share of the economy than at any time since the early 1970s.² As a result, U.S. taxes are well below those of most other nations. In 2013, the most recent year for which complete data are available, the U.S. collected less tax revenue as a percentage of its economy than did any other economically developed country besides Chile and Mexico.³

Budget deficits can, of course, be balanced through a mix of revenue increases and spending cuts. But the main driver in the nation's ongoing budget deficits is the decline in federal tax revenues, driven by sweeping tax cuts enacted more than a decade ago. This suggests that a sensible goal of comprehensive tax reform should be to raise federal revenues substantially above their current depressed level.

Revenue-raising reforms must be designed in a way that strengthens our tax system in both the short run and the long term, but some current congressional proposals

emphasize raising revenue in the short run at the expense of sustainable long-term tax revenue. For example, proposals to enact a “tax holiday” for trillions of dollars in cash that American corporations are currently holding offshore would provide a small short-term revenue boost, but it would mean forgoing a much larger long-term revenue stream if these companies paid their fair share of the corporate tax when they eventually repatriate these profits.⁴

A sensible question to ask about any proposed revenue-raising plan is whether it would help provide sustainable long-term tax revenue or whether it would undercut this goal in the name of short-term expediency.

2. Tax reform should not exacerbate income inequality

Fairness is in the eye of the beholder, but Americans generally agree that a fair tax system should not tax poor people further into poverty. Contrary to the “skin in the game” rhetoric used by some presidential candidates, Americans at all income levels pay a substantial share of their income to support public services.

In fact, the poorest 20 percent of Americans will pay, on average, 19.2 percent of their income in federal, state and local taxes in 2015. The average annual income in this group is about \$15,000, so families living below the federal poverty threshold still pay a significant percentage of their income in taxes.

Mitigating poverty and creating conditions in which more citizens can participate and contribute to our nation’s economy is a necessary social policy goal. Requiring the poorest Americans to spend a fifth of their income on taxes is tantamount to making the poor poorer. For this reason, a minimal goal of revenue-raising federal tax reform should be to avoid increasing taxes on the most vulnerable Americans beyond their current level.

At the other end of the spectrum, our tax code contains special carve outs for the very best-off Americans that allow the wealthiest Americans to avoid paying their fair share. For example, the tax code treats income derived from wealth more favorably than income derived from work. The top tax rate on capital gains income is 23.8 percent, well below the 39.6 percent top tax rate on salaries and wages. Two-thirds of all capital gains are enjoyed by the top 1 percent of Americans.⁵ More so than virtually any other feature of the tax code, the capital gains tax break exacerbates widening economic inequality in our nation.

In spite of these inequities, the federal tax system helps offset the regressive nature of state tax systems, all of which take a greater share of income from their lowest-income residents than from their wealthiest residents. The share of total taxes paid by each income group is roughly equal to the share of total income received by that group. For example, the poorest fifth of taxpayers will pay only 2 percent of total taxes this year, which is not surprising given that this group will receive only 3.2 percent of total

income this year. Meanwhile, the richest 1 percent of Americans will pay 23.8 percent of total taxes and receive 22.2 percent of total income in 2013.⁶ In other words, the nation's collective tax system is relatively flat or proportional rather than progressive.

Tax reform should avoid pushing low-income working families further into poverty and make the very wealthiest Americans pay their fair share. Fortunately, there are straightforward policy solutions to help achieve each of these goals. Preserving and expanding targeted tax credits such as the Earned Income Tax Credit and the Child Tax Credit would reward work and help low-income families make ends meet. And taxing capital gains and dividends in the same way that salaries and wages are taxed would raise some revenue, add fairness and progressivity to the tax code as well as ease widening income inequality.

3. Tax reform should close corporate tax loopholes and ensure corporations pay their fair share

Fortune 500 corporations are aggressively seeking to avoid all income tax liability, lobbying intensively for new tax breaks while simultaneously engaging in an aggressive effort to shift their U.S. profits into low-rate foreign tax havens.

Further, some of the biggest Fortune 500 corporations are finding ways to shelter their U.S. income from taxes altogether. A 2014 CTJ/ITEP report found that 111 Fortune 500 companies were able to avoid all federal income taxes in at least one profitable year between 2008 and 2012,⁷ and a companion report found a similar pattern at the state level.⁸ In many cases, these zero-tax corporations are simply claiming generous tax breaks that have been enacted by Congress (at the behest of corporate lobbyists) over the years. All too often, these tax provisions lavish huge tax cuts on the most profitable corporations while offering little to smaller businesses with less lobbying clout.

Paring back tax breaks for accelerated depreciation, research and development and manufacturers could help achieve a level playing field for businesses of all sizes.

Many of the same big multinational corporations are aggressively seeking to avoid taxes by claiming, for tax purposes, that their U.S. profits are actually being earned in offshore tax havens.

This widespread income-shifting stems largely from an arcane feature of the U.S. corporate tax law: American multinational corporations are allowed to “defer” paying whatever U.S. taxes are owed on the profits of their offshore subsidiary companies until those profits are officially brought to the U.S.

Deferral encourages American corporations to use accounting gimmicks to make their domestic profits appear to be generated by subsidiary companies in countries with a very low tax or no corporate tax.

The most straightforward policy option to end this sham is to end deferral. This would mean that all the profits of American corporations are subject to the U.S. corporate income tax whether they are domestic profits or foreign profits generated by offshore subsidiaries. This change would eliminate the incentive for an American corporation to move its operations offshore or to make its U.S. profits appear to be generated in an offshore tax haven.

Putting it All Together

Our tax system chronically underfunds the public investments the American public demands—and does so in a way that pushes low-income families further into poverty while allowing huge corporations and the best-off Americans to avoid paying their fair share. True tax reform should raise revenue in the short run, to help meet the country's pressing budgetary needs, while simultaneously creating a sustainable long-term revenue stream to meet tomorrow's needs. Tax reform should also avoid making inequality and poverty greater problems than they already are. Each of these goals can be achieved by closing unwarranted loopholes for capital gains and offshore corporate profits, while preserving and expanding valuable low-income tax credits.

¹ Office of Management and Budget, Historical Tables, October 20, 2015.

<https://www.whitehouse.gov/omb/budget/Historicals>

² Ibid.

³ Citizens for Tax Justice, The U.S. Is One of the Least Taxed Developed Countries, April 9, 2015.

http://ctj.org/ctjreports/2015/04/the_us_is_one_of_the_least_taxed_developed_countries.php

⁴ Citizens for Tax Justice, \$2.1 Trillion in Corporate Profits Held Offshore: A Comparison of International Tax Proposals, July 14, 2015

http://ctj.org/ctjreports/2015/07/21_trillion_in_corporate_profits_held_offshore_a_comparison_of_international_tax_proposals.php

⁵ Citizens for Tax Justice, Ending the Capital Gains Tax Preference would Improve Fairness, Raise Revenue and Simplify the Tax Code, September 20, 2012.

http://ctj.org/ctjreports/2012/09/ending_the_capital_gains_tax_preference_would_improve_fairness_raise_revenue_and_simplify_the_tax_code.php

⁶ Citizens for Tax Justice, Who Pays Taxes in America in 2015?, April 9, 2015.

http://ctj.org/ctjreports/2015/04/who_pays_taxes_in_america_in_2015.php

⁷ Citizens for Tax Justice, The Sorry State of Corporate Taxes, February, 25, 2014.

<http://www.ctj.org/corporatetaxdodgers/>

⁸ Citizens for Tax Justice, 90 Reasons We Need State Corporate Tax Reform, March 19, 2014.

<http://ctj.org/90reasons/>