Ideas for Reforming Tax Policy

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Introduction

Federal tax policy in the United States is a big deal. The United States has the largest economy in the world, and the federal government collects over $3 trillion in taxes each year. This massive source of revenue allows the government to do all the other things it wants to do, whether it is paying our retirees, funding health care for tens of millions of people, creating the most powerful military the world has ever seen, helping the poor make it through difficult times, or funding the basic functions of government. Making sure we raise these taxes efficiently and effectively is an important priority, and there are ways to do it better.

There are six main tax reform initiatives that could make our tax system even stronger in the United States. Changes could be made to the tax code to reduce income inequality, alleviate poverty, invest in young children, provide greater help to retirees, make it easier for students to attend college, and reduce the pollution let into the environment. In this policy memo, I briefly touch on ideas that could help achieve all of these individual goals and in other policy memos I cover each one in greater detail (Sly 2020a, 2020b, 2020c, 2020d, 2020e, 2020f).

Reducing Income Inequality

Since the early 1980s, incomes have grown much faster for the top 1% than the rest of the population, where now the top 1% earns over 20% of all the before tax income in the US compared to about 10% in 1980. At the same time, real after tax incomes for the bottom 80% of the population have grown much more slowly, achieving gains from 2.5 times to nearly 5 times less than the top 1% since 1979. Taxes are a powerful tool for income redistribution and the federal income tax is perfectly situated to address this problem.

The first reform that could be done in the United States would be to raise taxes on the top 1% and create a new refundable tax credit for the bottom 80%. Raising taxes on the top 1% could be done by lifting the top income tax rate in the US above its current 37% rate, or by increasing taxes on capital income like capital gains, dividends, or corporate profits. At the same time, the US should use this new tax revenue to redistribute income to the bottom 80% by offering large tax credits for low and moderate income households that phase out as incomes go higher. This could have a significant impact on the disturbing income trends, and would also be incredibly politically popular as well. The question then really becomes how much of this do you actually do, and my approach would increase taxes on the rich in $200 billion dollar increments over time to see how high we can go without causing any major economic or political problems, and then use the money raised to expand the tax credits for low and moderate income people.

Alleviating Poverty

The second major tax policy reform would eliminate income tax deductions to help pay for measures to help families stuck in poverty. The 2017 tax bill nearly doubled the standard deduction, which resulted in many fewer taxpayers (only about 12%) itemizing their deductions each year, which means that eliminating those deductions would only have an impact on the upper middle class families that have been doing relatively well recently. The revenue raised from say eliminating the deductions for home mortgage interest, state and local taxes, medical expenses, and making the deduction for charitable contributions less generous could then be spent on anti-poverty initiatives (like expanding SNAP, the EITC, and housing vouchers) that generally impact the bottom 20% of families that are the worst off. This would not be as popular as the reforms that reduce income inequality (which redistributes income from the top 1% to the bottom 80%), since there are more people who will see their taxes increased and fewer people will get benefits from the revenue raised under the poverty reduction proposals (which redistributes income from the top 10% to the bottom 20%).

Investing in Young Children

The third major policy reform would have the US create its own Value Added Tax, and use the money raised to pay for important investments in young children. A Value Added Tax is just a broad based consumption tax collected along each step of the supply chain that is used as a major source of revenue by the vast majority of countries around the world. This tax is easy to collect and can raise a lot of money in a fair and efficient fashion, and could easily pay for some of the very expensive priorities designed to help young children do better later in life. When looking at ways to invest in young children, the money could be spent on extending paid maternity leave, expanding child care subsidies, paying for universal pre-K, or creating a new program to provide college aid for low incomes families that accumulates throughout a student's childhood.

The problem with this idea is that it is incredibly unpopular because it collects money from 100% of the population and redistributes it to the less than 15% of households with children under the age of 5. It has long been known among policy experts that the US has needed a Value Added Tax and also needed to invest more in young children, but the political economy problems make these initiatives difficult to get through the legislative process. In European countries, the basic tradeoff is that both sides agree to fund a stronger social safety net as long as it is largely raised through higher taxes on the middle class. A similar deal could be made between the two political parties in the US, where the Democrats would get a Value Added Tax and more investments in young children, and in exchange the Democrats agree to get rid of taxes currently collected by Medicare. This would include the 2.9% payroll tax on all wage income, the 0.9% payroll tax surcharge on high income households, and the 3.8% tax collected on capital income that primarily impacts the rich, which would appeal to Republicans. If each side got something out of the deal where Democrats got more spending on kids and Republicans got lower taxes on the rich, then perhaps this might be possible to achieve in an overarching political deal, especially if the alternative is more reforms to reduce income inequality.

Expanding Funding for Social Security

The fourth major tax policy reform the US should enact is to raise the cap on earnings when calculating how much a person pays in payroll taxes dedicated to Social Security. Right now, Social Security charges a 12.4% payroll tax on wages up to $137,700 to fund its system of benefits. The earnings cap is adjusted for average wage growth but because incomes at the top have been rising faster than the average wage, this means a lower percentage of earnings is covered by Social Security's payroll tax. When last adjusted in 1977, the earnings cap was set so that 90% of earnings were covered by the tax, but now that percentage has declined to 82% and the US could increase the cap to 95% of earnings. This would increase funding for Social Security by about $150 billion dollars (or about 0.7% of GDP), which would represent a 16% increase. Some of the funding could be used to expand Social Security benefits, perhaps while also prioritizing the needs of low income retirees, and some could be used to reduce the long term funding gap that the Social Security Administration currently expects. If approximately half of that increase were used for expanded benefits, the average benefit could increase by about $120 a month (or about $1,400 a year) for each beneficiary, but that number would vary by income depending on how the benefit expansion is structured.

Reforming Subsidies for Higher Education

The fifth way to reform taxes in the United States would eliminate the tax subsidies targeting higher education and redirect the revenue directly to the states, so that they could experiment with new ways to fund higher education subsidies for college students. The United States currently provides federal tax subsidies worth about $30 billion dollars a year, but research has shown that this does almost nothing to get more students to attend college. Since these subsidies are both ineffective and are not well targeted to the poor, the money could be better spent by giving money to the states who have more effective ways of spending the money, like increasing funding for public colleges and universities. Ideally, if the states were given an influx of new money, they could not only spend it on the traditional subsidies provided by states for higher education but to also experiment with new ways to spend the money in order to find even better ways to get more students to attend and graduate from college. This could be done by providing free tuition at public colleges, expanding merit aid, providing universal higher education subsidies, or making the subsidies targeting the poor more effective in encouraging enrollment and graduation.

Reducing Pollution Through a Carbon Tax

The sixth major reform to the tax code would impose a new carbon tax to reduce the amount of C02 going into the environment, and then redistribute the revenue from the tax in the form of an equal dividend to every person in the US. The tax could start small, say perhaps at $25 a ton (which represents a 23 cent increase in the tax on gasoline), and then gradually increase as public support goes up once they realize the financial benefits from the carbon dividend. This would raise about $100 billion a year in revenue, which could fund dividend checks worth $300 a year for each individual (young or old, regardless of income) or about $25 per person per month. This means about 70% of the population would get more back from the dividend check then they pay in carbon taxes, which over time would likely make this a politically popular policy, both for its environmental benefits but also for purely financial reasons as well.

Conclusion

Taken together, these six major reforms of the tax code would have a substantial impact on our economy. When you add them all up, taxes might go up by about $500 billion to $1.5 trillion dollars, depending on how much you wanted to do to reduce income inequality, where some of the money raised will go to programs that disproportionately help the low income families, and some of the money would be spent on broad based programs that help just about everyone. This represents a redistribution worth about 2.5% to 7.5% of GDP, which is about a quarter to three fourths of the 10 percentage point increase in the share of income going to the top 1%.

This would have a substantial impact on the distribution of after tax income in our economy, but would not reverse the trends completely. Moving policy in that direction would seem to be an important priority for our country and these policy reforms would represent a viable path forward. Changes would not happen overnight, but this is a problem that took decades to unfold so it is reasonable to expect that it would take a long time to reverse as well. Making progress on each reform would help in its own right, and eventually, if all the reforms ultimately get implemented, perhaps we will be able to live in a more equitable society over the long term.

References

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