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TAXES

Do We Need a Grand Bargain?

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Almost everyone agrees that broadening the tax base is good tax policy, and it is at the heart of all tax reform proposals. Holding all else equal, base broadening will increase tax revenues. The big question in Washington is what to do with the additional tax revenues? The GOP wants to use all of the revenues to decrease tax rates, lowering top tax rates to 25 percent. Most Democrats want some or all of the revenues to go for deficit reduction. The GOP and President Obama want to reduce the 35 percent corporate tax rate. Further, many GOP policymakers want tax reform to be distributionally neutral—that is, not affect the after-tax distribution of income.

The public, however, appears to have different ideas regarding taxes. According to an April 2013 [Gallup poll](#), 61 percent of Americans think that upper-income people pay too little in taxes. Furthermore, 66 percent think corporations pay too little in taxes. Slightly over half of the respondents (52 percent) agreed that the government should “redistribute wealth by heavy taxes on the rich.” All this suggests that the public is not too keen on the idea of distributionally neutral tax reform. Instead, most Americans want the wealthy to bear a greater share of the tax burden, and almost surely would not want revenue raised by closing tax loopholes to finance cuts in top income tax rates.

The House, the Senate, and the president are far from agreement on whether or not additional revenue will be part of any “grand bargain.” In fact, GOP insistence that not a single penny be raised on net from tax changes has been a constant sticking point in negotiations (and Rep. Paul Ryan reiterated this stance recently). Most people think the tax code could be substantially improved by reform. And there is talk that tax reform instructions could be part of an agreement produced by the budget conference committee, so it’s worth looking at some of the issues and proposals for income tax changes.

Individual income tax

The Buffett Rule: The U.S. individual income tax is a progressive tax, in that the average tax rate increases as income increases. However, there is a great deal of variation of average tax rate within an income category; a relatively high proportion of wealthy taxpayers face a lower average tax rate than many low- and middle-income taxpayers, mostly because they receive income in forms (dividends and capital gains, particularly) that are taxed less than wage income. To address this, the president proposed the **Buffett Rule**, a tax on the millionaires who pay tax rates lower than many taxpayers with income below \$100,000 (the group the rule would affect constitutes less than 0.1 percent of taxpayers). The president has also advocated capping the tax benefits of certain itemized deductions and other tax preferences to the **28 percent level**, which would potentially increase the amount of taxes paid by the richest 2 percent of taxpayers. It is **estimated** that, if enacted, these two provisions could reduce deficits by \$560 billion over the next 10 years.

Indexing tax parameters to CPI-U: The tax bracket thresholds and other tax parameters are adjusted for inflation to protect taxpayers from experiencing tax increases simply due to rising prices. The **administration** has proposed switching from the CPI-U to the “chained” CPI-U for indexing tax parameters. One of the consequences of this change would be to bump taxpayers into higher tax brackets over time (known as “bracket creep”). This **stealth tax increase** is not progressive—almost 60 percent of the **increased tax burden** would fall on taxpayers with income under \$75,000. It is **estimated** that this proposal would increase tax revenues by \$115.7 billion over the next 10 years.

Rep. David Camp’s proposal: House Ways and Means Chairman Dave Camp (R-Mich.) has proposed revenue-neutral and distributionally neutral **tax reform** with the highest tax rate at 25 percent (down 14.6 percentage points from the current top tax rate of 39.6 percent). He proposes broadening the tax base in exchange for lower tax rates, but has offered no specifics. Given the **barriers to broadening the tax base**, Chairman Camp, however, may be having trouble putting together a tax reform package that meets his stated goals.

Corporate income tax

Ending deferral: The statutory top rate on taxable corporate income is 35 percent. The corporate tax system is a hybrid system with features of a worldwide tax system (income of a U.S. firm is taxed regardless of where it is earned) and features of a territorial system (U.S. firms only pay taxes on income earned in the United States). U.S. multinational corporations are allowed to defer taxes on foreign-sourced active income until it is repatriated to the U.S. parent company. U.S. firms are allowed a tax credit for foreign taxes paid (up to the amount that would be paid in U.S. taxes). It is estimated that about **\$1.7 trillion in untaxed (by the United States) foreign-sourced income** is sitting offshore, and deferral costs the Treasury **\$50 billion per year** in tax revenue. Fiscal 2013 corporate tax revenues were about **\$275 billion**, or less than 2 percent of GDP, which is far below the 4 percent of GDP average in the 1950s.

Moving to a territorial system: GOP members of the Ways and Means Committee have offered a **discussion draft** for revenue-neutral corporate tax reform that would reduce the corporate tax rate to 25 percent and move to a territorial tax system. Foreign-sourced active income would be subject to a minimal U.S. tax, but passive highly mobile income would continue to be taxed at the full U.S. statutory tax rate. The House GOP proposal has **several weaknesses**, including the fact that it does not adequately protect the corporate tax base. The administration has **proposed** corporate tax reform

that would broaden the corporate tax base and reduce corporate tax rates. There are, however, **few details and many unanswered questions** about the proposal.

The Stop Tax Haven Abuse Act: An underappreciated part of the corporate income tax revenue problem is the continued **tax avoidance** (and sometimes outright evasion) by many U.S. multinational corporations. One way to increase corporate income tax revenue in lieu of wholesale corporate tax reform would be to reduce the use of offshore tax havens by multinational corporations. Recently, Senators Levin, Whitehouse, Begich, and Shaheen introduced the **Stop Tax Haven Abuse Act** (S. 1533), which would close some corporate loopholes, provide measures to combat the corporate use of tax havens to evade paying U.S. taxes, and raise more than \$200 billion over the next 10 years.