

**Americans for
Democratic Action**
Policy Brief



Common Sense Tax Fairness

by Mary von Euler and Woodrow Ginsburg

Americans for Democratic Action
www.adaction.org
1625 K Street, NW, Suite 210
Washington, DC 20006

An Organization for Liberal Activists

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It's time for the American people to tell candidates for public office that they expect to be treated like grown-ups. We may differ on exactly which government services we want, but most of us would like such programs as Social Security, high quality affordable medical care for everyone, good schools and affordable public higher education, military forces to meet our international obligations, bridges that don't crumble, safe food, prescription drugs, and workplaces, and programs to help the poor meet their basic needs. All of these cost money. This paper is not talking about raising taxes on moderate-income families, who are already paying more than their fair share, nor is it about cutting them. It's about fairness. While a recession is no time for raising taxes on struggling families, every day is a time for tax fairness.

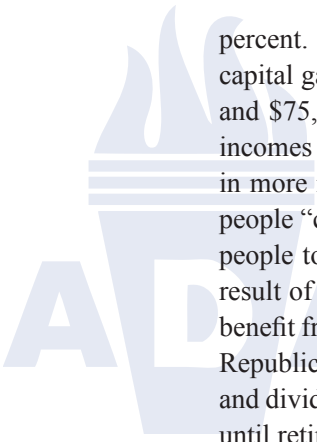
At present, while we're neglecting many of our needs, the US is running up a monstrous debt to be paid off by future generations. (And the debt is increasingly owed to foreigners like China and Persian Gulf states, who may decide any day that they have better places to invest their money.) That need not be the case if we take steps to restore fairness to the basic tax structure and if we collect taxes that are owed.

That means we also must close loopholes that make the personal income tax and corporate tax a bonanza for the wealthy, aided by their lobbyists, promoters, tax planners, lawyers, and accountants. What makes our tax code complicated is not the number of tax brackets – the least complicated aspect of our tax system – it's the multitude of deductions, credits, and exceptions that require a degree in accounting.

This paper will focus on three ways to restore fairness: (1) restore the progressive structure to the income and estate/gift tax codes, and stop favoring capital over work, (2) limit the availability of loopholes, shelters, and foreign tax havens by which corporations and wealthier taxpayers escape paying their fair share; and (3) provide the IRS with the resources to ensure that taxes owed are paid. Failure to address these flaws in the tax system means that the tax burden falls increasingly on wage and salary earners, whose taxes are withheld at the source, while the tax evaders enjoy all the benefits of schools, hospitals, courts, highways, safe food, medicine, and air travel, a cleaner environment, national defense, and a civil society without paying their fair share.

The Regressive Effects of the Bush Tax Cuts

- The tax rate paid by high-income taxpayers was reduced, cutting their tax bill significantly. The top rate was reduced from 39.6 percent (far from a rate so high that top earners would be discouraged from working hard) to 35 percent. In the past, during periods of prosperity, for example the Kennedy Administration years, we had top marginal rates well over 50 percent. Former President Bill Clinton noted that since leaving the White House and earning six-digit fees for delivering speeches, he suddenly became a multimillionaire. The Bush tax cuts were great for the likes of him, but not for more deserving families.¹
- The estate tax is being phased out. In 2005-2006, when the tax was assessed only on estates worth more than \$1.5 million per spouse, the tax affected only one percent of estates. In 2007-2008 the tax is applied to estates worth \$2 million per spouse. In 2009 it will be applied to estates of more than \$3.5 million.² In 2011 the estate tax is due to revert to what it was in the Clinton years, but the Republicans and some of their conservative Democratic allies would like to eliminate the estate tax entirely, or at least exempt estates up to \$3.5 million per spouse and leave the top tax rate at 45 percent. According to the Joint Committee on Taxation, repeal of the federal estate tax would cost the US Treasury \$669.8 billion over ten years.³ Reducing the federal estate tax has had the additional effect of squeezing state budgets since many states tie their estate tax to the federal estate tax.
- The top tax rate paid by individuals on capital gains and dividends was reduced from 35 percent to 15



percent. The lower dividend tax costs the US Treasury \$216.5 billion over 10 years, the lower tax on capital gains cost the Treasury \$101.5 billion over 10 years.⁴ A person with an income between \$50,000 and \$75,000 got a \$43 average tax cut from the new dividend and capital gains provision. Those with incomes over \$1 million saved \$37,962.⁵ Proponents of a reduced tax on capital gains claim that it results in more revenue to the Treasury. This claim is false. Only the first year results in increased revenue as people “cash in” their gains in the first year the rate cut takes effect. Otherwise, the lower rate encourages people to find gimmicks to shelter ordinary income and to reclassify it as capital gains.⁶ The principal result of the Bush program was to favor income from capital over income from work. 70 percent of the benefit from the capital gain and dividend tax cut went to people in the top one percent of taxpayers. While Republicans often claim that the middle class now owns stock and, therefore, benefits from capital gains and dividend tax cuts, those securities are in 401(k) and IRA accounts on which tax payments are deferred until retirement when they are taxed as ordinary income.

- Private equity fund managers (people paid to manage other people’s money) are allowed to pay taxes on their income at the capital gains rate of 15 percent, instead of at the higher rate for ordinary income, even though this so-called “carried interest” is not investment income. In 2004 corporations received additional special tax giveaways. (In the 110th Congress, the House of Representatives voted to correct this inequity, but the Senate refused.)
- In 2010, when the Bush tax cuts are fully phased in, half of the tax cuts will have gone to the wealthiest one percent of the population. The staggering size of the cuts amounts to *\$240 billion a year or \$2.4 trillion over ten years*, when the added interest on the national debt is included.⁷ More than half of all taxpayers will receive a cut of less than \$600. According to Citizens for Tax Justice, taxing dividends and capital gains at a lower rate than the tax on earned income cost the US Treasury \$92 billion in 2005, and $\frac{3}{4}$ of that amount went to the richest 0.6 percent of taxpayers.⁸ Were investment income taxed at the same

What Taxpayers Gain From Bush Tax Cuts of 2001 and 2003, Due to Expire 2010	
Annual Income	Average Tax Savings
Less than \$10,000	\$4
\$10,000-\$19,999	\$167
\$20,000-\$29,999	\$553
\$30,000-\$39,999	\$759
\$40,000-\$49,999	\$873
\$50,000-\$74,999	\$1,203
\$75,000-\$99,999	\$1,687
\$100,000-\$199,999	\$2,492
\$200,000-\$499,999	\$4,532
\$500,000-\$1 million	\$22,630
More than \$1 million	\$130,423

Source: Tax Policy Center (a project of the Urban Institute and the Brookings Institution), in Lori Montgomery, “As Candidates Warm to Bush Tax Cuts, Economists Warn of Long-Term Effect,” *Washington Post*, March 28, 2008

rate as other earnings, federal revenue would have increased by \$338 billion in 2004. The chart above presents the effect of the tax cuts in a slightly different way, but leads to a similar conclusion.

- The national debt when Bush entered office was about \$5.7 trillion (but we were running a budget surplus that would have whittled down the debt). With the cost of wars, combined with Bush’s tax cuts, the national debt will be about \$10.3 trillion when he leaves office.⁹ Paying interest on that debt is a drag on the economy while it gobbles up an increasing proportion of the federal budget that could otherwise be devoted to meeting domestic needs.
- Income of the richest one percent averaged \$1.3 million in 2006. For each of these individuals, the Bush tax cuts saved \$483,000 a year. In contrast, the average middle-income taxpayer saved \$659 annually. Each year the differential will grow wider. Thirty-one percent of the Bush tax cuts benefited the top one

percent of taxpayers, 74 percent went to the top 20 percent.¹⁰

- Prior to the Bush tax cuts, personal income tax revenues made up 20 percent of the economy. From 2002 through 2006 revenue from personal income taxes has averaged only 7.3 percent of the economy. This goes a long way toward explaining why the federal budget ran a surplus when Bush took office, and ran deficits upwards of \$500 billion after enactment of his tax measures.
- When those deficits are taken into account, ninety-nine percent of Americans are worse off, for the people must eventually pay off that debt. The richest one percent is better off. As of 2006, for the typical family of four, the net effect of that debt burden and the tax cuts they received averaged a cost of \$28,322. That burden will increase every subsequent year in which we run a deficit budget. (In 2008 we are running a deficit twice that of 2007.)¹¹
- The payroll tax rate on wages and salary for Social Security, levied on salaries up to \$102,000, and Medicare, plus income taxes averages 23.4 percent, while personal income taxes on investment income averages 9.6 percent. Yet the current recession belies the supply-siders' claim that cutting taxes on investment income would encourage investment, stimulate the economy, and create jobs. We know that jobs are generated when low- and middle-income consumers (the kind of people who must spend most of what they earn) have enough money to create a demand for goods. And jobs are generated when the government invests in ways that stimulate business: in transportation, education, and infrastructure.

By allowing these regressive tax cuts to expire in 2010, revenue would increase by \$1.6 trillion. The country could stop running a deficit and running up the national debt, and begin to meet our neglected human and infrastructure needs. Conservatives always disingenuously create a red herring that the estate tax forces the sale of family farms and businesses to pay the tax. The farm argument is a red herring inasmuch as the American Farm Bureau has never been able to produce a farm where this has been the case, largely because for years farmers have avoided hardship by a provision of the tax code allowing them to pay their estate tax over a 10-year period. And the number of small business affected by the estate tax has been grossly exaggerated because many high-income taxpayers attribute a relatively trivial portion of their income to "business income" – perhaps a little sideline of consulting or real estate

sales – and these "small businesses" have been added to the total of actual Mom and Pop businesses to exaggerate the point. Since many states tie their estate taxes to the federal estate, the Bush estate taxes cuts have slashed state revenue that they could ill afford to lose. For example, in 2005 the federal government collected \$21.7 billion in estate taxes, while the states collected \$7.4 billion – an amount they lose when the federal rate is cut if a state fails to "de-couple" its tax from the federal tax.

The regressivity of the Bush tax cuts is accentuated when the budget shortfall leads to cuts in public services needed by low- and moderate-income families. The Bush administration exerted no effort to pay for the tax cuts, except to propose slashing veterans' benefits, education, social services, environmental programs, transportation, community development, and Medicare.

How Corporations and Individuals Escape Paying Their Fair Share

On top of Bush's lower tax rates on corporations – now 35 percent -- and high-income taxpayers, every year profits of multinational corporations soar, in part due to their ability to game the current tax system. Through complexities of the tax code, enacted at the behest of lobbyists and wealthy campaign contributors, corporations and wealthy individuals avoid paying their fair share of taxes. One major ploy of corporations and wealthy individuals is to hide their money from the tax collector by stashing it in "tax havens" in foreign countries with low taxes and/or poorly enforced incorporation, banking, and tax laws.

First, corporations become expatriates. A company transfers its corporate headquarters in name only to an offshore tax haven without moving any of its physical operations or top management. Often the expatriate company is a shell, claiming all the corporate profits, using various devices to enjoy benefits in the US while significantly reducing their taxes at minimal expense. Corporations generate savings by paying no taxes on their overseas operations. Tyco, for example, which relocated to Bermuda in 1997, estimated that it saved \$400 million in 2001 alone.¹²

Specific Tax Avoidance Schemes Using Offshore Tax Haven

1. **Income Stripping:** In this scheme, money is “lent” by the offshore subsidiary to the US parent company or another US subsidiary and paid back to the offshore company at higher interest rates. That interest payment is a corporate income tax deduction for the parent company.
2. **Parking Intellectual Property Offshore:** The offshore subsidiary shelters income from overseas sales. The subsidiary company charges the parent company a licensing fee for the use of trademarks, patents, etc. This income from overseas operations is not taxed in the US. The subsidiary can also charge the U.S. parent or other US subsidiaries a variation of income stripping.
3. **Transfer Pricing:** Companies with operations around the world arrange their transactions so that profits show up in jurisdictions with kinder, gentler tax collectors. (Since a large percentage of international transactions and trade takes place within centrally-managed corporations either as sales between subsidiaries or as sales between parent and subsidiary, the prices are not set by arms-length market transactions.)

A study by Simon J. Pak of Penn State University and John Zdanowicz of Florida State University, released by Senator Byron Dorgan (D-ND) in 2002, estimated that US corporations avoided over \$53 billion in taxes in 2001 by means of these phony pricing schemes. The parent companies under-price goods they sold to offshore affiliates and over-price goods purchased by US companies from their overseas affiliates. The effect of these sham transactions was to move profits - and tax liability - out of the US to places where they are not subject to US taxation.¹³

The cost to the Treasury is tremendous. Robert McIntyre, Director of Citizens for Tax Justice, estimates that only about 44 percent of the US profits that big American corporations report to their shareholders are reported to the IRS, but that can't be explained solely on the basis of keeping two legitimate sets of corporate books: one reporting profits to stockholders; another reporting profits to the IRS. Although accounting treatment under the tax code is different from that under the generally-accepted accounting principles used for financial reporting, recent studies using internal IRS data suggest that at least half of the gap cannot be explained by conventional book/tax differences and is “consistent with increased sheltering activity.”¹⁴

In a recent analysis of the “corporate tax game,” a significant shift of our tax burden from corporations to individuals was found. In 1940 the amount of federal tax revenue raised from corporations approximately equaled revenue from individuals. In 2003, corporations paid only 13.7 percent of the federal income tax bill; individuals paid 86.3 percent.¹⁵ Senator Max Baucus (D-MT), chair of the Senate Finance Committee, estimates that tax avoidance by both individuals and corporations through the use of offshore tax shelters cost the Treasury \$70 billion a year - roughly the same amount that President Bush requested to pay for the first 6 months of the

war and occupation of Iraq. According to some lawmakers, as much as \$300 billion a year in taxes goes uncollected by the government, and by some estimates more than a third of this may be related to corporations' reliance on offshore tax havens.¹⁶

“Squadrons of lawyers, accountants, and Wall Street structured-finance experts have made an art form of minimizing the U.S. multinational's effective tax rate within this maze of the U.S. tax code, tax treaties, and global tax systems,” says Selva Ozelli, international tax editor for RIA, a New York provider of tax information and software.”

As *The New York Times* recently explained, the decline in corporate taxes in recent years “was concentrated among the largest corporations. Corporate profits are officially taxed at 35 cents on the dollar, but the 10,000 largest companies actually pay on average only about 20 cents of tax on each dollar of profit. Most of the tax savings, academic studies and Senate Finance Committee reports show, come from tax shelters that range from the perfectly legal to frauds so complex that I.R.S. auditors cannot understand them.”¹⁷

Meanwhile, according to a study by Transactional Records Access Clearinghouse, affiliated with Syracuse University, *IRS scrutiny of the nation's biggest companies is at a 20-year low due to a historic reduction in audits*. Major corporations, defined as those with assets of at least \$250 million, have about one in four chance of being audited, down from about three in four in 1990. The IRS points out that it is collecting 23 percent of all taxes from corporations, up from 13.7 percent in 2001, because it is auditing smaller corporations (which are quicker and cheaper to audit). However, the IRS also notes that many wealthy individuals are shifting money from audited corporate investments into elaborate partnership arrangements, thus evading the tax collector.¹⁸

How Individuals, Too, Hide Their Money Abroad

For a long time, wealthy individuals also have found ways to evade paying their fair share of taxes, such as through offshore accounts and trusts. As ADA Counsel Jack Blum testified before the Senate Finance Committee, “What is new is that the Internet has provided average citizens access to the offshore world, and credit and debit cards have made it possible to easily access money held offshore. As a result, offshore tax evasion has grown geometrically as has the threat to the U.S. system of voluntary taxation.”¹⁹

What is also new is that high-priced law firms and accountants are providing the wealthiest Americans with increasingly sophisticated ways to avoid paying taxes, and less pricey promoters have touted the same schemes to more and more taxpayers. Particularly disturbing, it appears that lawyers are advising clients not to abide by the law that requires taxpayers to report on their tax forms whether they have money in accounts overseas. As a result, IRS agents are given no clue of the existence of the accounts, and the IRS has been so starved for money that it cannot afford to allow its highly skilled employees to undertake the kind of complex labor-intensive investigations that would be required to uncover these schemes. Among the products sold by these lawyers and promoters:

- “Charitable trusts” stashed in places offshore that do not define charity or regulate trusts.
- Insurance products in which the insured is the owner of the insurance company and its only client.
- Offshore trusts that use insurance policies as the beneficiaries.
- US holding companies that cover holdings in offshore assets.

Lawyers claim that this kind of “asset protection” is legitimate, even when they know it is often requested by clients who are trying to hide money owed in child support and alimony, judgments in civil law cases, and fines and penalties in criminal cases – not just from the IRS, the Drug Enforcement Agency, and the FBI. These lawyers know that they are permitting – and therefore abetting -- their clients to commit perjury. (Suborning perjury is not merely grounds for disbarment; it’s a crime.)

One scheme used in the Cayman Islands is for American bankers there to do business with Canadian lawyers, accountants, and individuals, and refer American business to Canadian bankers. When Jack Blum was in the Cayman

Islands in 1974, investigating for the Senate Foreign Relations Committee, there were about 25 banks in the Cayman Islands. Today 590 banks there are serving American lawyers and accountants. And the Cayman is only one of many tax havens,

“[O]ffshore tax evasion has grown geometrically as has the threat to the U.S. system of voluntary taxation”

such as the Cook Islands, Vanuatu, Panama, the Channel Islands, and Liechtenstein. While the US Patriot Act has controls on offshore “shell

banks,” Europe does not, so the European Union must take action.

The Washington Post reported that another Cayman operation, an investment mutual fund composed of hedge funds, the Quellos Alpha Engine, used off-shore shell companies to engage in fake transactions that generated billions of dollars in capital “losses” that erased billions in capital gains that would have been taxed. The US Treasury lost millions of dollars in revenue.²⁰ A report of a subcommittee of the Senate Committee on Homeland Security, chaired by Senator Carl Levin (D-MI), found that the US loses \$100 billion every year from just two European offshore secrecy bank jurisdictions, Switzerland (UBS) and Liechtenstein (LGT).²¹

Starving the IRS for funds, as noted above, has been a critical part of tax inequity. Because of IRS under-funding, the gap between what taxpayers owe and what is collected was estimated to be \$345 billion in 2001. In addition, the Bush administration has misspent the funds Congress appropriated. In 2004 the administration outsourced to private companies the job of debt collection from deadbeats. Since the companies are allowed to pocket commissions of up to 24 percent, the IRS expects to lose more than \$37 million by using private collectors in 2008. Had the IRS used Federal employees, instead of outsourcing, the Treasury would have received more than four times the revenue collected by the contracting companies.²² Fortunately, the Democratic 110th Congress enacted legislation to stop this outsourcing. Far more significant is the annual loss of more than \$345 billion because the IRS lacks personnel to audit and go after tax evaders.²³ When people are allowed to get away with not paying taxes they owe, people whose taxes are deducted at the source – wage earners -- pay an inordinate share of the cost of government.

Do the Poor Pay Their Fair Share?²⁴

As the following cases will illustrate, the poor pay more than their fair share. It helps to stop and think what they have left after paying their federal income tax (and not to forget they also pay sales tax and perhaps state income taxes) with which they must pay for decent housing, utilities, food, clothing, and transportation.

First, consider Ms. A, a single minimum-wage worker with no dependents who works full-time, year-round. Assume her employer reports \$12,187 to the IRS on her form W-2. 6.2 percent or \$753 will be deducted for Social Security, 1.450 percent or \$177 will be deducted for Medicare Part A. (Both of these are flat taxes that are most burdensome for lower-income workers.) After her personal exemption of \$3,400 and standard deduction of \$5,350, she'll have a federal taxable income of \$3,437. She is allowed an Earned Income Tax Credit (EITC) of \$32, after which she owes federal taxes of \$311. That means more than 10 percent of her meager income goes to the IRS in payroll taxes and income taxes, leaving her with \$10,946 to pay for housing, utilities, food, clothing, transportation, and state and local taxes, too. That's not much above the 2007 federal poverty level of \$10,210 for an individual who has no dependents. (Whether the federal poverty level needs repair is another issue, which will not be treated here.) The EITC is virtually no help to a single person; the personal exemption and standard deduction are insufficient for a person at this income level. It is highly questionable whether a person at this income level should be paying any federal income tax.

It is notable that rates increase rapidly on taxable incomes under \$77,100. A single person pays 10 percent of the first \$7,825 of taxable income, at which point the marginal rate jumps to 15%. If she manages to pay for education or training to get a better job and her taxable income rises above \$31,850, she'll pay a marginal rate of 25 percent on income over \$31,850. In other words, the tax jumps in 5 percentage point increments up to \$31,850, at which point the rate increases more gradually and by larger increments: 28 percent marginal rate on income over \$77,100, 33 percent on income over \$160,850,²⁵ and finally 35 percent on income over \$349,000.

Second, consider Mr. B, a single father with three teen-age children, whose employer reports income of \$26,363 on his W-2; \$1,577 will be deducted for Social Security, \$369 for Medicare Part A, leaving an adjusted gross income of \$24,417. With a standard deduction of \$7,850 and personal exemptions

of \$13,600 (4 x \$3,400), the federal taxable income will be \$2,967. He will then receive a child tax credit of \$296, an EITC credit of \$2,813 and additional child tax credit of \$909, receiving a "refund" of \$3,722, in effect the return of what had been deducted for payroll taxes and then some. A family of four still will have a hard time living on \$26,139, but, thanks to tax credits, it would be above the federal poverty level of \$20,650 in 2007. This low-wage worker with three children is helped by the EITC and child tax credit. As his children turn 19 (hoping to go to college?), he will lose his child tax credits.

Third, consider Mr. C, a self-employed disabled individual with no dependents, who nets \$7,796 from his business, and receives \$8,504 annually in non-taxable SSI disability benefits. He will pay \$1,102 in self-employment payroll tax (although half, \$551, is deducted from gross income), a standard deduction of \$5,350 and personal exemption of \$3,400. He will have no federal taxable income, but an EITC of \$410 will be deducted from the \$1,102 self-employment payroll tax, so he must pay \$692, leaving \$15,608 to live on.

It should be noted that he forfeits 50 cents of SSI benefits for every dollar he earns above \$85 per month (\$1,020 per year) -- not through any fault of the tax code, but from SSI rules. This is in effect a 50 percent "marginal tax rate" on a low-income individual, a far higher marginal rate than that applied to any taxpayer, including millionaires. If a 50 percent "marginal tax" on disabled individuals' income above \$9,524 is apparently not considered a disincentive to work, it would not seem unreasonable to apply a marginal tax rate of 50 percent, for example, on income above \$250,000 for a single person and above \$500,000 for a couple. They could live comfortably on their after-tax income.

A fourth example is that of Ms. D, a retiree who, during her working years, did not make post-tax contributions to her pension. If she received a pension of \$18,166, all of it would be subject to income tax. She could take a standard deduction of \$5,350 and a personal exemption of \$3,400, leaving a federal taxable income of \$9,416. Her federal income tax would be \$1,023: 10 percent of income up to \$7,825, 15 percent on the remaining \$1,591, leaving her \$17,143 to live on. If she received Social Security benefits, instead of a pension, at this income level Social Security benefits would not be taxable.

Where Do the Presidential Candidates of 2008 Stand on Taxes?

John McCain has executed a quadruple flip-flop on tax policy.²⁶ Before he ran for President in 2000, he *opposed* closing tax loopholes or tax increases to reduce the deficit. In 1986, when the Senate approved a revenue-neutral tax reform, including some tax increases, he was with the majority for the increases. But after the Republicans took control of Congress in the 1990s, he followed his party line in voting for unaffordable *tax cuts*, while going against his party in favoring a \$1.10 tax increase on every pack of cigarettes, which was defeated by a Republican filibuster.²⁷

During his campaign for President in 2000, McCain said George Bush's proposed *tax cuts were unfair* because 60 percent of the benefits would go to the wealthiest ten percent of Americans. And for a time thereafter, he *voted against the Republican tax cuts* of 2001 and 2003, including cuts in taxes on capital gains and dividends, saying the burden fell unfairly on lower- and middle-income families, and they were too costly in time of war.

Then, when he decided to run for President again, in 2005 he voted to extend the low tax rates on capital gains and dividends. Previously he had also opposed repeal of the estate tax, recognizing that it would provide "massive benefits solely to the wealthiest and highest-income taxpayers in the country." Yet in 2006 he voted for a bill to gut the estate tax. Now he says he would exempt \$5 million per spouse from the estate tax, with the rate above \$5 million set at 15 percent (costing the Treasury \$17 billion in 2009, \$579.6 billion over 10 years.)²⁸

Now Senator McCain says he wants to make the Bush tax cuts permanent (costing the Treasury \$110 billion per year more than the actions proposed by Senator Obama on the Bush tax cuts, or \$1.663 trillion over 10 years), double the child tax deduction (cost: \$38 billion in 2009, \$464 billion over 10 years), and gradually reduce the corporate tax rate from 35 percent to 25 percent at a cost of 734.7 billion over 10 years,²⁹ allow businesses to write off the cost of new equipment and technology (cost: \$139 billion in 2009, \$1.363 trillion over 10 years), repeal the Alternative Minimum Tax (AMT) (cost: \$91 billion in 2009, \$1.761 trillion over 10 years.³⁰ Of the 4 million taxpayers paying the AMT, 93 percent earn between \$200,000 and \$1 million), ban Internet and cell phone taxes, and provide a permanent tax credit for research and development, at an annual cost to the Treasury of \$100 billion, according to McCain's senior policy adviser Douglas Holtz-Eakin.³¹ He has also advocated requiring a 3/5 majority of both the House and the Senate to raise taxes, something many states and localities have found serious impediments to meeting urgent needs.³² In a curious additional proposal, he would provide only two tax rates and a more generous standard deduction, allowing taxpayers to

choose whichever system gives them a lower tax bill.³³

While the Bush tax cuts provided 31 percent of their benefits to the top 1 percent of taxpayers, McCain's proposals would provide 58 percent of their benefit to the top 1 percent of taxpayers. The plan would increase sheltering of income, continue the shifting burden of taxes from capital to labor, and the total of the tax cuts could only be paid for by massive reductions in Social Security, Medicare, or other programs that benefit the majority of Americans, such as education, energy, law enforcement, national parks, and worker safety.³⁴

McCain doesn't say his opposition to tax cuts in 2000 was incorrect. Rather, he offers a new rationale: he opposed the Bush tax cuts because he wanted to cut spending to cover the cost. Now, in support of tax cuts he offers the discredited "supply-side" argument that tax cuts stimulate the economy so remarkably that they generate more revenue, paying for themselves, a claim that even the Bush Treasury Department said is false.³⁵

Advisor Holtz-Eakin says the current rationale is that all the tax cuts for wealthy individuals and corporations would be invested to create jobs.³⁶ In sum, total tax revenue raised under the McCain plan would add up to 17.6 percent of GDP.

His only proposal to help working people would be a temporary suspension of the gasoline tax from Memorial Day to Labor Day 2008 (at a cost of \$9 billion to the Highway Trust Fund), a curious proposal for a man who purports to favor stemming global warming.

Barack Obama³⁷ received a progressive tax rating of 100 percent from Citizens for Tax Justice. Obama would deny tax cuts to companies that ship jobs overseas, but provide benefits for companies keeping jobs in this country. He proposes to close corporate loopholes and deductions, including those for gas and oil companies. He would not tax seniors with incomes below \$50,000 (regardless of whether the income comes from Social Security, a pension, or work), at a cost of \$50 billion over 10 years, provide a refundable \$500 tax credit for individuals, including the self-employed, and a \$1,000 tax credit for working families making less than \$75,000, to offset the payroll tax, while raising the cap on income subject to the Social Security tax (set at \$102,000 this year) for people with incomes over \$250,000.

He has promised that the wealthy will pay more taxes by restoring progressivity to the income tax structure. One step would be to allow tax cuts for people with incomes over \$250,000 to expire. In addition, he favors closing loopholes, and providing the IRS with the tools and resources needed to end abuses of tax shelters and offshore tax havens by which \$350 billion of owed taxes go uncollected. In the Senate he voted against repeal of the Alternative Minimum Tax and

"John McCain has executed a quadruple flip-flip on tax policy"

the estate tax, opposed raising the estate tax exemption, and opposed making the current estate tax cuts permanent. Recently he proposed indexing the AMT “patch” at a cost almost as great as McCain advisers’ proposal, although on the stump McCain has said he would abolish the AMT.

Obama has consistently favored repeal of the low tax rate on capital gains and dividends, restoring the Clinton-era 28 percent rate on capital gains.³⁸ He would apply the ordinary income tax rate, rather than the inappropriate capital gains rate, to “carried interest,” the salary of managers of private equity funds. He has promised to keep the estate tax exemption at \$3.5 million per person. He would expand eligibility for the child tax credit, including parents paying child support, triple the earned income tax credit for workers earning minimum wage, expand eligibility, and reduce the marriage penalty of the EITC, costing over \$750 billion over 10 years. He would also create a new universal mortgage interest credit to benefit low- and middle-income homeowners, not just taxpayers who itemize, costing \$125 billion over 10 years. He opposes the gas tax moratorium

on grounds that oil companies will just increase the price, since demand exceeds the short supply. Instead he would take steps to limit the speculation in oil futures that is spurring the rising cost of oil. In sum, revenue raised under Obama’s proposals would add up to 18.3 percent of GDP.

Since the IRS receives earnings information from employers and banks, Obama advocates simplifying tax preparation for all wage earners by having the IRS prepare a pre-filled form based on that information. The taxpayer could verify, sign, and return it, or prepare his own form if there are facts that would change the taxes owed. His experts estimate that this proposal would save Americans a total of 200 million hours of work and up to \$2 billion in fees paid to tax preparers (which are deductible, hence paid for by taxpayers).

As the table demonstrates, Senator McCain would present the bottom 60 percent of all taxpayers with tax cuts of \$325, \$118, and \$21. Senator Obama would provide these same taxpayers with tax cuts of \$1,041, \$892, and \$567.

Comparison of Obama and McCain Tax Proposals by Percentile, 2009

McCain			Obama		
Family Income in Dollars	Tax Decrease in pp	Average Tax Change in \$	Tax Decrease in pp	Tax Increase in pp	Average Tax Change in \$
Above \$2,871,682 (top .01%)	-3.3pp	-\$290,708		+7.9pp	+\$701,688
\$603,403 to \$2,871,682 (top 1%)	-2.6pp	-\$48,862		+6.1	+\$115,713
\$226,983 to \$603,402	-2.4pp	-\$8,159	0		-\$20
\$160,973 to \$226,982	-2.3pp	-\$4,437	-1.4pp		-\$2763
\$111,646 to \$160,972	-1.9pp	-\$2,584	-1.6pp		-\$2130
\$66,355 to \$111,645	-1.1pp	-\$994	-1.4pp		-\$1257
*\$37,596 to \$66,354	-0.6pp	-\$325	-2.0pp		-\$1041
*\$18,982 to \$37,595	-0.4pp	-\$118	-3.2pp		-\$892
*Up to \$18,981	-0.2pp	-\$21	-5.3pp		-\$567
Average Cut	-1.6pp	-\$1,230	-0.3pp		-\$151

*bottom three groups amount to 60% of all taxpayers

^ pp= percentage points

Source: Len Burman et al., “An Updated Analysis of the 2008 Presidential Candidates’ Tax Plans,” Urban Institute-Brookings Tax Policy Center, Revised July 23, 2008, Tables 1 and 6.

Recommendations

The tax system can be made more progressive in the following ways:

1. Increase the number of tax brackets, while eliminating most special credits, allowances, and deductions. Advocates of a flat tax disingenuously imply that the number of tax brackets creates complexity, but they're wrong, especially with the Obama plan under which the IRS would calculate taxes (based on published tax tables) for people whose income is primarily based on wages and other amounts that must be reported to the IRS. Flat-tax advocates are simply trying to reduce the taxes for people who are well off, without regard to the hardship a flat tax would wreak on ordinary people since that lost revenue would necessarily be made up by means of a regressive sales or consumption tax. (Do they lack a fairness gene?) The average CEO compensation at the 350 largest public companies rose to \$9.2 million in 2004, a 109 percent jump from 2002. Income of CEOs was 240 times the income of the average worker in 2004, while it was "only" 145 times the average worker in 2002. In other industrialized countries CEO pay is about one-third of the American level. In the U.S. the differential is increasing every year, an unhealthy trend for our economy and for our democracy. For maximum fairness, income taxes should be eliminated for low-income wage earners and pensioners, with the marginal rate increased gradually – perhaps at one or two percentage-point increments -- up to a top marginal rate of 50 percent on millionaires (a rate that has not proven to be a damper on people's incentive to work). Increasing the rate at large intervals, such as by five percentage points, tends to be unfair to a taxpayer just above the income limit for a lower rate. What complicates calculating taxes are the multitude of deductions, exceptions, credits, special interest write-offs, shelters, loopholes, special rates (such as for dividends and capital gains, municipal bonds). From past experience, we know that the marginal rate on the highest earners can be as high as 50 percent without discouraging the wealthy from working and without putting a damper on the economy. We have had such a high rate in periods of remarkable economic growth. Moreover, many industrialized countries take a higher proportion of their gross domestic product in taxes (on personal and corporate income, payroll, and consumption) while their GDP-per-hour-worked grew at a faster rate than that of the U.S.³⁹
2. Repeal the special breaks for dividends and capital gains. (Taxing income from capital and salaries at the same rate simplifies tax preparation, eliminating one type of "preference income" that kicks in liability for the Alternative Minimum Tax.) It is unfair to favor income from capital over income from work. Until such time as the two kinds of income are taxed at the same rate, close the "carried interest" loophole by which the compensation of wealthy equity-fund managers (people who manage the investment of other people's money in "private equity" funds and generate billions of dollars for them) is taxed at the capital gains rate, rather than the income tax rate.
3. Restore the tax on estates and gifts, returning the exemption to \$1 million per spouse, while keeping the special provision that permits estate taxes on family farms to be paid over a ten-year period.
4. Expand and modernize the Earned Income Tax Credit (EITC), a notably successful program that reduces poverty and inequality while promoting work. Prices for necessities such as housing, transportation and childcare continue to rise faster than the income of low-wage workers, and some 14.5 million tax filers need help. The maximum EITC for low-income childless workers, like Ms. A, above, should be tripled to about \$1,300. Married couples should be allowed to exclude one-half of the second earner's income when calculating the EITC, thus reducing the disincentives for low-income couples to marry and for spouses to join the labor force. The EITC should be expanded for working families with three or more children, since these families are twice as likely as smaller families to have low incomes. The "marriage tax" should be reduced only for low-income families. And a new, streamlined periodic payment option should be created, so eligible tax filers could receive income from the IRS throughout the year, as other countries with similar tax credits do.⁴⁰
5. Expand eligibility for the Child Tax Credit to families with earned incomes as low as \$5,000. (Currently families earning less than \$12,000 are excluded.) Families with incomes from \$5,000 to \$12,000 tend to be families with young children, such that the wage earners have difficulty working full-time year-round.⁴¹
6. Restore the tax on corporate profits to its rate in the 1950s. At that time corporate taxes, plus excise taxes, made up 46 percent of federal tax collection. Today those taxes make up only 15 percent. Thus, over the years the burden has shifted from corporations to individuals, especially wage earners.

7. Enact a wealth tax. Wealth is even more unequally distributed than income.⁴² Concentration of wealth undermines our democracy by exacerbating the unequal distribution of power. As other industrialized, capitalist countries have adopted a wealth tax, the U.S. could, too. If we were to follow Switzerland's example, we would generate more than \$50 billion in new federal revenue, all paid by the nation's richest one percent.
8. Remove the cap on wages to which the Social Security payroll tax applies, so FICA is collected on all wages, thus contributing to the long-term solvency of the program. (Benefits for the higher-income people should be increased very modestly, thus continuing the traditional connection between earnings and benefits, while also continuing the progressive nature of the Social Security benefit structure.)
9. Eliminate the preferential tax treatment of multinational corporations and other loopholes that benefit only the wealthiest individuals and corporations.
10. Prevent American corporations and individuals from evading federal income taxes by incorporating and using offshore trusts and partnerships. Companies that move their headquarters offshore in name only should be taxed as if they are still incorporated in the US. At the same time, bar companies that have moved offshore from receiving taxpayer money in the form of government contracts. Create a presumption that every offshore company and offshore trust is controlled by the US taxpayer who formed them. Empower the US Treasury to take special measures against foreign jurisdictions that "impede" US tax enforcement. Require US financial institutions that open accounts for foreign entities controlled by US clients, or open accounts in offshore secrecy jurisdictions for US clients, or establish entities offshore for US clients, to report such actions to the IRS. Tax income of US beneficiaries of offshore trusts. Increase penalties on promoters of unlawful tax shelter. Prohibit the US Patent and Trademark Office from issuing patents for "inventions designed to minimize, avoid, defer, or otherwise affect liability for Federal, State, local, or foreign tax". Require hedge funds and company formation agents to establish anti-money laundering programs equivalent to those that apply to banks and other financial institutions.
11. Increase disclosure requirements. The secrecy surrounding corporate tax-reduction strategies should be eliminated. Investors have a right to a clearer picture of the financial health of a company's core business, while all citizens have a right to understand how much corporations are paying in taxes. Corporations should be required to base their tax obligations on the same data they submit to the Securities and Exchange Commission (which is designed to impress stockholders.) Close the loopholes in the Sarbanes-Oxley Accounting Reform Act and SEC regulations that permit an auditing firm that is paid to provide tax (evasion) strategy consulting to also be the auditor of the client's books.
12. At a minimum, double the Internal Revenue Service enforcement budget with particular focus on high-income taxpayers and avoidance of taxation of income from capital. Offshore hedge funds headquartered in the US should be required to report their distribution to the IRS.

Conclusion

These changes would begin to restore fairness to the income tax system so corporations and high-income taxpayers once again pay their fair share. The IRS must be given the resources to ensure that billions of dollars in taxes owed are paid, so the burden no longer weighs heaviest on wage earners whose taxes are deducted at the source. These measures

would enable the federal government to have sufficient revenue to meet some of our nation's needs, such as a reduced "marriage tax" for low-income families, refurbished infrastructure, good jobs, alternative energy research and development, low-income housing, and comprehensive affordable health care for all.

End Notes

- ¹ On April 4, 2008, the Clintons released their tax returns for the years since leaving office. In 2001, they earned \$16.2 million, paid \$6 million in taxing, being left with after-tax income of more than \$10 million. Matthew Mosk, James V. Grimaldi and Joe Stephens, “Clintons Earned \$109 million in 8 Years,” Washington Post, April 5, 2008.
- ² Citizens for Tax Justice, Tax Digest, March 14, 2008.
- ³ Cited in Lori Montgomery, “As Candidates Warm to Bush Tax Cuts, Economists Warn of Long-Term Effect,” Washington Post, March 28, 2008.
- ⁴ Ibid.
- ⁵ The Tax Policy Center, cited in Michael D. Shear and Jonathan Weisman, “McCain’s Plan for Working Class Offers Plenty for Corporate World,” Washington Post, April 16, 2008.
- ⁶ “Experts Agree That Capital Gains Tax Cuts Lose Revenue,” Center on Budget and Policy Priorities, April 18, 2008.
- ⁷ Joint Committee on Taxation, cited in Lori Montgomery, “As Candidates Warm to Bush Tax Cuts, Economists Warn of Long-Term Effect,” Washington Post, March 28, 2008.
- ⁸ .6% is fewer than 7,000 taxpayers.
- ⁹ American Progress Action Fund, “Progress Report: The Economic Costs of War,” February 26, 2008. As of March 2008 the national debt stood at \$9 trillion. Lori Montgomery, “As Candidates Warm to Bush Tax Cuts, Economists Warn of Long-Term Effect,” Washington Post, March 28, 2008.
- ¹⁰ Robert Gordon and James Kvaal, “Five Easy Pieces and Two Trillion Dollars: The Bush-McCain-Norquist Tax Agenda,” Center for American Progress Action Fund, March 2008, pp. 1-2.
- ¹¹ Jeannine Aversa, “Budget Deficit Twice as Big as Last Year’s,” Washington Post, July 12, 2008.
- ¹² Alex Berenson, “A Tyco Chief, A Big Risk Taker, Now Confronts the Legal System,” New York Times, June 10, 2002.
- ¹³ <http://dorgan.senate.gov/news/pressfull/record.cfm?id=187978>.
- ¹⁴ Mihir A. Desai, “The Divergence Between Book and Tax Income,” Tax Policy and the Economy, National Bureau of Economic Research, October 2002.
- ¹⁵ “The Corporate Tax Game,” Business Week, March 31, 2003.
- ¹⁶ “Congress Targeting Corporate Tax Dodgers in Cayman Trip.”
<http://edition.cnn.com/2008/POLITICS/03/04/tax.havens/index.html/>
- ¹⁷ David Cay Johnston, “Tax Inquiries Fall as Cheating Increases,” New York Times, April 14, 2003.
- ¹⁸ Lynnley Browning, “IRS Scrutiny of Big Firms Plummets, Study Says,” New York Times, April 14, 2008.
- ¹⁹ Testimony of Jack A Blum, Esq., before the Senate Finance Committee on Tax Schemes, Scams, and Cons, April 11, 2008. Jack Blum, a partner in the law firm of Lobel, Novins & Lamont, is an expert on money laundering, offshore tax evasion, and financial crimes. Unless otherwise indicated, all the facts on individual use of offshore tax shelters in this paper draws on his testimony, which includes much additional information and many concrete recommendations.
- ²⁰ Matthew Mosk, James V. Grimaldi and Joe Stephens, “Clintons Earned \$109 Million in 8 Years,” Washington Post, April 5, 2008, reporting on a 2006 investigation by the Senate Permanent Subcommittee on Investigations.
- ²¹ “Senate Investigation of Offshore Tax Evasion Focuses on Swiss Bank UBS and Liechtenstein’s LGT,” Citizens for Tax Justice, July 18, 2008.
- ²² Lyndsey Layton and Christopher Lee, “Collectors Cost IRS More Than They Raise,” Washington Post, April 15, 2008.
- ²³ Senator Carl Levin (D-MI) Subcommittee on investigations estimates that unreported income in tax havens cost the US \$100 billion a year. Bradley S. Klapper, AP, Washington Post, July 17, 2008.
- ²⁴ For information on the treatment of the poor, I am grateful to David Kingsbury, M.D., a retired biomedical scientist and ADA member, who has for several years helped D.C. low-income taxpayers to figure their taxes.
- ²⁵ Annual salaries of Congress Members and Senators are currently \$169,000. It almost seems as if many of them have difficulty putting themselves in the shoes of their constituents who earn far less.
- ²⁶ This analysis draws on “John McCain: Straight Talk on Taxes?” The Tax Digest, Citizens for Tax Justice, February 22, 2008.
- ²⁷ Jonathan Weisman, “McCain Offers Tax Policies He Once Opposed,” Washington Post, April 25, 2008.
- ²⁸ Except where specified otherwise, estimated cost of McCain and Obama tax proposals are derived from Len Burman et al., “An Updated Analysis of the 2008 Presidential Candidates’ Tax Plans,” Tax Policy Center, Revised July 23, 2008. The comparisons are much more detailed and sophisticated than the summaries provided here. As the authors point out, there is often a significant discrepancy between what the candidates say on the campaign trail and data provided by their expert campaign staffs.
- ²⁹ As noted above, with the multitude of loopholes, credits, write-offs, allowances, accelerated depreciation, etc. the largest corporations now pay on average at a 20 percent rate. With a nominal rate of 25 percent, corporations will not stop lobbying for special handouts that reduce their effective rate even further.
- ³⁰ McCain’s staff says he would merely “fix” the AMT. According to the Tax Policy Center this would cost only \$1.2328 trillion over 10 years.
- ³¹ The nonpartisan Tax Policy Center put the cost at \$133 billion over 10 years.
- ³² Citizens for Tax Justice, December 21, 2007.
- ³³ Michael D. Shear and Jonathan Weisman, “McCain’s Plan for Working Class Offers Plenty for Corporate World,” Washington Post, April 16, 2008. The cost of repealing the AMT is from the Tax Policy Center, a joint project of the Urban Institute and the

Brookings Institution. Variants of these figures appeared in editorials of the New York Times, April 20, 2008 and the Washington Post, April 21, 2008.

³⁴ Robert Gordon and James Kvaal, “Five Easy Pieces and Two Trillion Dollars: The Bush-McCain-Norquist Tax Agenda,” Center for American Progress Action Fund, March 2008. The paper is based on an analysis of McCain’s website, position papers, and speeches, and nonpartisan data on the costs. They more conservatively estimate the 10-year cost of the corporate rate cut at \$995 billion, the immediate expensing of corporate investment at \$745 billion, and eliminating the AMT at \$430 billion, a total cost of \$2,170 trillion, on top of the ten-year cost of the Bush tax cuts of \$2,110 trillion, and McCain is even more regressive, favoring capital over labor, the wealthy over the non-wealthy.

³⁵ “Evidence Shows That Tax Cuts Lose Revenue,” Center on Budget and Policy Priorities, July 18, 2008.

³⁶ Speech at the Tax Policy Center, July 23, 2008.

³⁷ http://www.ontheissues.org/Barack_Obama.htm#_Tax_Reform

³⁸ Anne E. Kornblut and Dan Balz, “Obama Pressed in Pa. Debate,” Washington Post, April 17, 2008.

³⁹ Australia, Czech Republic, Finland, France, Greece, Hungary, Iceland, Ireland, Norway, Portugal, Slovakia, Sweden, and the United Kingdom. OECD figures cited in Max Sawicky, “Improving With Age: Financing Government in the 21st Century,” Americans for Democratic Action, 2008.

⁴⁰ Alan Berube, David Park, Elizabeth Kneebone, “Earned Income Tax Credit, Inequality, Working Poor, and Children, and Families,” Metropolitan Policy Program, Brookings Institution, June 5, 2008.

⁴¹ “The Child Tax Credit Gap: A Snapshot of Families Left Out” www.firstfocus.net, drawing on work of Aviva Aron-Dine, “Improving the Child Tax Credit: An Important Step Toward Reducing Child Poverty,” Center on Budget and Policy Priorities, May 19, 2008.

⁴² Woodrow Ginsburg, “Income and Inequality: Millions Left Behind,” Americans for Democratic Action Education Fund, January 2008, p.12.

