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Citizens for Tax Justice

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Principles for Progressive Taxation During a Recession

The recession faced by the United States has changed the nature of the debate over taxes. Questions of who should pay how much to fund public services have been replaced with questions about how quickly we can boost the economy with tax cuts or government spending that is not paid for. Some of the points raised in this debate have been quite valid, while others have been more problematic. While raising taxes to balance the federal budget is not a high priority during an economic downturn, this should not be used as a justification for enacting unlimited tax cuts without replacing the lost revenue in the future. The following principles can guide the search for a rational and fair tax policy that will mitigate the recession without causing long-term fiscal damage.

1. The economy thrived at the end of the Clinton years, when taxes were higher, and sank severely at the end of the Bush years, after 8 years of lower taxes. This should tell us that lower taxes, overall, are not the answer to saving the economy.

Taxes were higher during the Clinton years than during the presidency of George W. Bush. Real median household income, which grew during the Clinton years, has fallen in the Bush years. The poverty rate, which declined under Clinton, has inched back up during the Bush years. Unemployment, which fell under Clinton, has risen under Bush. (And these unhappy trends under Bush all began before the current crisis in the financial sector.) Overall, the idea that we should preserve or expand the Bush tax cuts to protect the economy simply does not make sense.

2. If tax increases have any negative effect, this is usually outweighed by the positive effect of whatever public service they pay for.

Even if we accept the idea that higher taxes could, taken by themselves, reduce economic output to some extent, that would not end the discussion. The public services funded with taxes increase economic output and can be so vital that their benefits outweigh the costs of increased taxes. For example, few would argue that we would be better off if we didn't pay taxes to fund public roads. These roads make commerce, and most of our jobs, possible. The same goes for national defense and local police, since it's hard to imagine that abolishing those services and refunding their costs to the taxpayers would be a gain in the end if a foreign invasion or lawlessness ensued.

These examples are obvious, but the same argument applies to other public services. Arguably, a national health care program funded with tax dollars could help the economy so much (by reducing health care costs paid by families and employers) that the benefits would far outweigh the cost. Indeed, other developed nations with taxpayer-financed health care programs pay less for their health care overall and also have better health outcomes.

3. In normal circumstances, taxes should be high enough to pay for public services.

Whenever the federal government spends more than it collects in revenue, this leads to an increase in the national debt and an increase in the interest payments that must be made. And the larger these interest payments are, the larger the fraction of every taxpayer dollar that goes towards interest payments instead of health care, defense or other public services. In other words, we end up spending more to pay for the cost of borrowing rather than the services we need.

Currently, around nine cents of every dollar taxpayers send to Washington goes towards interest payments on the national debt. This fraction could go up if the national debt grows relative to the economy. This situation deteriorated during the presidency of George W. Bush, who turned a balanced budget left behind by the previous administration into annual deficits of hundreds of billions of dollars.

Of course, there must be some limit to how large the national debt can become before creditors start to doubt that the United States can meet its obligations or voters simply rebel against the interest payments they're shouldering. At some point the national debt must be paid, and that can only happen through either tax increases or cuts in spending. So increasing the deficit is really just a way of delaying a tax increase or a cut in public services.

4. These are not normal circumstances, so some deficit-spending may be justified.

So there is a real cost to deficit-spending, and we should avoid that cost in normal circumstances. But these are not normal circumstances and the cost of deficit-spending might be justified if it's part of a temporary plan to stimulate the economy.

Most economists believe that the type of recession the United States is now facing is caused largely by a collapse in demand for goods and services. As people buy less, businesses have to cut back staff or shut down altogether. The federal government can increase spending in a way that leads to an immediate boost in consumption so that businesses are less likely to have to cut staff or close entirely, to keep the downturn from reaching a level of severity that is truly destructive and more difficult to reverse.

The federal government could, for example, increase unemployment benefits or food stamps. This would increase the buying power of people who are likely to immediately consume more in response, since they have likely held back from purchasing all sorts of necessities during these hard times.

Some economists argue that increasing taxes to pay for this federal spending would simply undo the stimulative effect by reducing the money available for consumption. It's highly debatable whether increasing taxes on high-income people will undo any stimulative effect, as will be discussed below. But so long as the deficit-spending is temporary and targeted to those who will immediately increase their consumption in response, there is a certain logic behind increasing the deficit in this way. And the stimulative effect on the economy is potentially well worth the cost of increasing the budget deficit.

5. Deficit-spending won't help the economy if its main beneficiaries are high-income people.

How do we know when an increase in the deficit is justified? One way is to consider the stimulative effect of a given policy option. Most economists believe that a dollar spent on increasing the income of low- or middle-income people has a greater stimulative effect than a dollar spent on increasing the income of a high-income family.

If you generally believe that a recession is caused largely by a lack of demand (and therefore a lack of consumption), then you should also believe that the best response is to increase the incomes of people who are likely to immediately increase their consumption in response. Low- and middle-income people use almost all of their income for consumption. Necessities like housing, food, transportation, clothing and utilities swallow up most of their income, leaving little behind for savings or investment.

For very wealthy people, the situation is just the opposite. The wealthier a family is, the more likely it is that they save and invest most of their income.

The implication is that boosting the income of poor or middle-class families will lead to a much larger boost in consumption, and therefore greater stimulative effect on the economy, than boosting the income of rich families.

This is backed up by economic research showing that creating new breaks for investment has less stimulative effect than increasing benefits for low-income people. Moody's economist Mark Zandi estimates that every dollar of additional unemployment insurance benefits increases real GDP by $1.64, and every dollar of additional Food Stamps increases real GDP by $1.73. These are initiatives that would target people most likely to spend, right away, any extra cash (or vouchers) they receive. The same can be said, to a lesser extent, of tax cuts aimed at the same people. Zandi estimates that every dollar of reduced payroll taxes would increase real GDP by $1.29.

Zandi comes to very different conclusions when he estimates the effects of policy options that would basically increase the incomes of those who invest (who are mostly high-income people). Every dollar lost from cutting the corporate income tax would increase real GDP by just 30 cents. Every dollar lost from making President Bush's tax cut for capital gains and dividends permanent would increase real GDP by only 37 cents.

The implications of this are very clear. Expanding the loophole that already exists in the income tax for capital gains and dividends is not likely to have a great stimulative effect. Other options like increasing unemployment insurance benefits or Food Stamps and, possibly, a targeted refundable tax credit, are likely to be more effective.

6. Deficit-spending won't help the economy if it is not temporary.

The economic growth that could result from some of the policy options described above depends on those policy options being temporary. The entire point is that consumption, and the economy as a whole, can receive a short-term boost to get it through the hard times until we are thriving again and in a better position to pay down our debts.

A permanent increase in the budget deficit is not sustainable in the long-term. Sooner or later, the debt must be paid off with tax increases or reduced spending, which is fine if deficit-spending was only used for a short period. But if the federal government runs large deficits for decades, the ultimate denouement will be more painful and potentially bad for the economy.

But of course there are many initiatives that Congress wants to enact which will involve new, permanent spending that can boost the economy, like health care reform or initiatives to invest in alternative fuels. These initiatives should be paid for (at least eventually). That means Congress will need to consider tax increases.

7. To pay for new initiatives that are not temporary, we should consider new progressive taxes and reducing loopholes that allow the wealthy to escape taxation.

If someone must pay more in federal taxes, it is reasonable to expect this responsibility to fall disproportionately on America's wealthy, who have benefitted the most from the policies in place during the Bush years.

Even if we accept that raising taxes could reduce economic output in the short-run, there is no reason to believe the same goes for raising taxes on the very wealthy. As discussed above, tax cuts for the wealthy investor class are not likely to provide much of a short-term boost to the economy. If that's true, then the converse is also true. Tax increases on the wealthy are not likely to result in any immediate loss of economic output.

But there is another, more fundamental reason for turning to progressive taxes. Our current tax system does not ask a great deal of those who benefit the most from the public services that government provides.

Shares of Total Income and Federal Income Taxes & Payroll Taxes In 2007, Before and After the Bush Tax Cuts

	% of total income	Percent of total taxes paid			
		Income tax	Payroll tax	Both taxes	
Pre-Bush Law					
Lowest 20%	3.3%	–1.0%	3.1%	**0.7%**	
Second 20%	6.7%	0.7%	7.7%	**3.5%**	
Middle 20%	11.0%	5.2%	14.7%	**9.0%**	
Fourth 20%	18.2%	13.4%	25.8%	**18.3%**	
Next 15%	24.1%	24.3%	32.3%	**27.5%**	
Next 4%	14.4%	20.0%	11.5%	**16.7%**	
Top 1%	22.4%	37.4%	4.8%	**24.4%**	
ALL	**100.0%**	**100.0%**	**100.0%**	**100.0%**	
Bush Law					**Change in total share**
Lowest 20%	3.3%	–1.5%	3.1%	**0.6%**	–0.0%
Second 20%	6.7%	–0.4%	7.7%	**3.3%**	–0.2%
Middle 20%	11.0%	4.5%	14.7%	**9.0%**	+0.1%
Fourth 20%	18.2%	13.1%	25.8%	**18.8%**	+0.5%
Next 15%	24.1%	24.0%	32.3%	**27.8%**	+0.3%
Next 4%	14.4%	21.2%	11.5%	**16.9%**	+0.2%
Top 1%	22.4%	39.1%	4.8%	**23.6%**	–0.8%
ALL	**100.0%**	**100.0%**	**100.0%**	**100.0%**	

Source: ITEP Tax Model, June 2008

The two main federal taxes paid directly by Americans are income taxes and payroll taxes. We estimate that the share of federal taxes (including both payroll taxes and income taxes) paid by the richest one percent of taxpayers is not very different from the share of total income received by the same group of taxpayers. As the table above illustrates, the tax cuts enacted under President Bush decreased the share of federal taxes paid by the richest one percent of taxpayers.

America's wealthy have benefitted more than anyone else from the stability and safety provided by government, as well as the infrastructure and educated workforce and countless other public goods that make commerce possible. It is entirely fair to ask more from these families than we do from families who are struggling in our turbulent economy.

Instead of asking more from America's wealthiest families, the Bush administration enacted many tax cuts and new tax loopholes that disproportionately benefit the very rich. As a start, these should be reversed (or perhaps allowed to expire, in cases where they are not permanent).

Estate Tax

For example, President Bush's cut in the estate tax only benefits those who pass millions of dollars in assets from one generation to the next. (Less than one percent of deaths have resulted in any estate tax liability in recent years.) President-elect Obama and many of his allies in Congress propose to partially extend Bush's cut in the estate tax, but they ought to let it expire altogether.

We should not be afraid to ask those families who pass down huge fortunes — most of which include a lot of capital gains income that has never been taxed — to help pay for the very public services that made their fortunes possible.

Capital Gains and Dividends

Speaking of capital gains income, that leads us to another tax cut for the wealthy that should be reversed. President Bush increased the loophole in the income tax for capital gains and created a new one for corporate stock dividends. Before Bush took office, capital gains were subject to a special top rate of 20 percent and dividends were taxed like any other income. Bush set the top rate for both at 15 percent, thus expanding the loophole for capital gains and creating a brand new one for dividends.

To get a sense of just how unfair this is, imagine an heiress to a hotel chain who is so wealthy she doesn't have to work. She receives stock dividends and when she sells assets for more than their original purchase price, she enjoys the profit, which is called a capital gain. On these two types of income, she only pays a tax rate of 15 percent, thanks to the tax cuts enacted under President Bush.

Now imagine a receptionist that works in the brokerage firm that handles some of the heiress's dealings. Let's say this receptionist earns $50,000 a year. Unlike the heiress, his income comes in the form of wages, because, alas, he has to work for a living. His wages are taxed at progressive rates, and a portion is actually subject to a 25 percent income tax rate. On top of that he also has to pay federal payroll taxes on all his earnings.

President-elect Obama proposes to set the top income tax rate for both capital gains and dividends at 20 percent for the richest 2.5 percent of taxpayers (who receive the vast bulk of the of this sort of income) and leave it at 15 percent for everyone else. But why should we bother to preserve these loopholes at all? President Reagan signed a law that taxed all income at the same progressive rates, and President Obama should do the same.

So-Called "Ordinary" Income

President Bush also lowered income tax rates for "ordinary" income, the income that is not subject to the special low rates for capital gains or dividends. It seems quite doubtful that these rate cuts were particularly helpful for Americans. As explained on the first page, the economy was performing far better at the end of the Clinton years, when income tax rates were higher, than at the end of the Bush years, when rates are lower. There is therefore no logical reason to think that preserving these low rates is important for the functioning of our economy.

Unfortunately, President-elect Obama has pledged to preserve these low rates, along with other types of tax cuts enacted by Bush, for the vast majority of Americans. He has promised, perhaps foolishly, to not raise personal income taxes on taxpayers with adjusted gross income (AGI) below $200,000 (or $250,000 for married couples). We estimate that only 2.5 percent of taxpayers will have AGI above these levels in 2009.

Obama originally proposed to repeal the Bush tax cuts for taxpayers over the $200,000/$250,000 threshold before they expire at the end of 2010. He has recently signaled that he may leave the tax cuts in place for these taxpayers until they expire, out of concern that repealing them early would somehow harm he economy.

Again, if the Bush tax cuts did so little to help the economy, it's unclear how the economy can depend on preserving them right now — particularly when we are talking about the Bush tax cuts for the richest 2.5 percent of taxpayers.

Congress and the President-elect may want to entirely rethink the wisdom of his pledge to not raise taxes on anyone with AGI below the $200,000/$250,000 threshold. Circumstances have changed vastly since it was made. At very least, the pledge should be construed narrowly. For example, no reasonable person should interpret this pledge to bar a tax increase that funds a brand new public service, like a national health care program.

Other Revenue Options

Closing tax loopholes and undoing some of President Bush's tax cuts for the rich will not be enough to balance the federal budget in the long-term. And even more revenue will be needed to pay for new permanent initiatives. Congress must consider additional ways to raise revenue in a progressive manner.

For example, new taxes may be needed to pay for health care. One option is to expand the Medicare tax to apply to the types of income that are currently not subject to it. For example, capital gains, dividends and interest are all exempt from the Medicare tax. That means that someone who lives mainly on these types of income pays no Medicare tax, while someone whose only income is wages will pay Medicare taxes even if her income is much lower. Expanding the Medicare tax to cover more income would be a very progressive tax reform.

Conclusion

In normal circumstances, the federal government should raise enough in taxes to pay for the services it provides. This is a fair tradeoff because most of the public services funded through taxes actually enhance our economic output far more than taxes that pay for those services could possibly reduce it.

Of course, there are abnormal circumstances in which deficit-spending is a justifiable way to boost the economy to mitigate a recession, and we are probably facing this sort of situation right now. So it's reasonable in the short run to spend more than we collect in taxes, so long as the deficit-spending is temporary and properly targeted to those likely to increase their consumption and thus give a boost to the economy.

The budget does need to be roughly balanced in the long-term, and any permanent new spending programs or permanent tax cuts should be paid for. To accomplish this, Congress and the new President should consider progressive tax changes, starting with reversing many of the tax cuts and tax loopholes recently enacted to benefit the very wealthy.