# Inside America's tax battle

By Laura Tyson
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America's recent presidential election answered the question of whether an increase in revenues will be part of the country's long-run deficit-reduction plan. The answer is yes: there is now bipartisan agreement on the need for a "balanced" approach that includes revenue increases and spending cuts.

But there are still deep political and ideological divisions about how additional revenues should be raised and who should pay higher taxes. If a preliminary agreement on these questions is not reached by the end of the year, the economy faces a "fiscal cliff" of $600 billion in automatic tax increases and spending cuts that will shave about 4% from GDP and trigger a recession.

The majority of citizens agree with President Barack Obama that tax increases for deficit reduction should fall on the top 2-3% of taxpayers, who have enjoyed the largest gains in income and wealth over the last 30 years. That is why he is proposing that the 2001 and 2003 rate cuts for these taxpayers be allowed to expire at the end of the year, while the rate cuts for other taxpayers are extended.

So far, Obama's Republican opponents are adamant that the cuts be extended for all taxpayers, arguing that increases in top rates would discourage job creation. This claim is not supported by the evidence. Recent research finds no link between tax cuts for top taxpayers and job creation. In contrast, tax cuts for the bottom 95% have a positive and significant effect on job growth.

During the past three decades, income inequality in the United States has increased significantly; indeed, the US now has the fourth-highest level of income inequality in the OECD, behind Chile, Mexico, and Turkey. At the same time, as the largest tax cuts have gone to high-income taxpayers, the US tax system has become considerably less progressive. The US needs fiscal measures that both curb the deficit and contain rising income inequality – and the inequality of opportunity that it begets.

But how should additional revenues be raised from top taxpayers to achieve these two goals? Most economists believe that increasing revenues by reforming the tax code and broadening the tax base is "probably" better for the economy's long-term growth than raising income-tax rates. The analytical case for this belief is strong, but the empirical evidence is weak.

In theory, higher marginal tax rates have well known negative effects – they reduce private incentives to work, save, and invest. Yet most empirical studies conclude that, at least within the range of income-tax rates in the US during the last several decades, these effects are negligible.

A recent Congressional Research Service report, withdrawn under pressure from Congressional Republicans, found that changes in the top income-tax rate and the rate on capital gains had no discernible effect on economic growth during the last half-century. A recent review of the economic literature by three distinguished academics found no convincing evidence that real economic activity responds materially to tax-rate changes on top income earners, although such changes do affect their tax-avoidance behavior. So Obama has evidence on his side when he says that allowing the tax cuts for high-income taxpayers to expire at the end of the year will not affect economic growth.

Republicans have proposed tax reforms in lieu of rate hikes on high-income taxpayers to raise

revenues for deficit reduction. Obama has signaled that he is willing to consider this approach, provided it increases tax revenues from the top 2-3% by at least the same amount as higher rates while protecting other taxpayers.

The federal tax system is certainly in need of reform. Tax expenditures – which include all deductions, credits, and loopholes – account for about 8% of GDP. Indeed, the US tax code is riddled with special preferences and contains large differences in effective tax rates across individuals and economic activities. These differences distort decisions about investment allocation and financing. Reforms that made the tax system simpler, fairer, and less distortionary would have a beneficial effect on economic growth, although economists concede that the size of this effect is uncertain and impossible to quantify.

Because tax expenditures are so large, limiting them could raise a significant amount of additional revenue that could be used both for deficit reduction and to finance across-the-board cuts in income-tax rates. Analysis of the Simpson-Bowles and Domenici-Rivlin deficit-reduction plans by the nonpartisan Tax Policy Center confirms that this approach is arithmetically feasible. Reducing large regressive tax expenditures like preferential tax rates for capital gains and dividends and deductions for state and local taxes, and replacing deductions with progressive tax credits, could generate enough revenue to finance rate cuts for all taxpayers, increase the tax code's overall progressivity, and contribute meaningfully to deficit reduction.

But the odds of such an outcome are very low: what is arithmetically feasible is unlikely to be politically possible. Efforts to cap popular tax expenditures will encounter strong opposition from Republicans and Democrats alike. Nonetheless, some tax reforms are likely to be a key component of a bipartisan deficit-reduction deal, because they provide Republicans who oppose increases in tax rates for high-income taxpayers with an ideologically preferable way to increase revenue from them.

Unfortunately, it will take time to negotiate tax reforms – more time than remains until the end of the year, when the 2001 and 2003 tax cuts are scheduled to expire for all taxpayers. But there is still time to negotiate an agreement that extends these cuts for the bottom 98%, and that contains temporary measures to cap deductions and credits for high-income taxpayers in 2013. Such an agreement could help to break the political impasse over whether and how much these taxpayers' rates should rise next year, thereby preventing the US from falling over the fiscal cliff and back into recession.

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