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Raising Revenue: The Options - Opening Remarks

Alright thank you very much Jane. It's a pleasure to be here. I do want to note this was a historic occasion. Jane said she was going to say what she said and she wasn't going to say anything else, so we're going to hold her to that. This has been a great conference—it's the right topic at the right time.

And don't get me wrong—lunch was really good, but when I think about tax policy these days, I think about the joke about two inmates in a jail eating food in the dining hall and one of them said “this food is really lousy” and the other one said “yeah, and there's not enough of it.” And that's sort of our tax system. The taxes are really lousy and they're not enough of them. And so what do we do about that? Well, the way I think about it is that the most useful way to characterize our current tax system is that we have a narrow tax base. Normally you want to tax on a consistent, comprehensive basis. If you're taxing income, you want to tax all forms of income. If you're taxing consumption, you want to tax all forms of consumption.

That's not what we do. We have a lot of loopholes in the system. There are types of income that are just not taxed. There are an enormous number of deductions, exemptions, credits, exclusions, etc. The result of that is that you get very uneven tax burdens across different types of income. Some income is taxed twice; some income is not taxed at all. Some is taxed once at the regular rate, some is taxed once at a non-regular rate. Some is probably taxed three or four times if we look carefully. So in some sense we don't even have, I mean we call it an income tax, but whether it really qualifies as an income tax at this stage, I think is open to question. So on top of the loopholes and the uneven tax burdens across different forms of income and different forms of spending, the narrow tax base causes you to need a higher tax rate than you would otherwise need because you have a narrower base you need a bigger rate to get the same amount of revenues. And on top of that a narrower tax base generates a complicated tax system. With the exception of capital gains tax rates, almost all the complications of the tax system comes from the base, from the definition of the base. Generally once you go through all these machinations to get to taxable income, once you do, you can look up your tax on the table and then apply credits and stuff like that all. But most of your complexity is in the tax base.

So what's the problem with this? Well, it undercuts everything you want to do in tax policy, to have a narrow tax base. It reduces revenues, obviously, because there are loopholes and exemptions and exclusions. That makes it hard to finance government and government spending, given the size of the economy.

The second thing is that it reduces the size of the economy. It causes uneconomic allocation of resources and activities and effort. So even if you kept taxes as a share of the economy the same, this distortionary tax system—the issues created by the tax

system—reduces the size of the economy, which again makes it harder to finance government spending.

Third, and this is a really important point, it makes the actual system less redistributive and presumably less fair than you would think, just looking at the tax rate numbers. The official tax rates don't give you a good guide to who's paying how much in taxes, what the redistribution is, because there are so many exclusions or exceptions to the notion that we tax income.

And fourth, I think it's fair to say that it undermines support to taxes in general, and that in turn implies undermined support for government spending. Taxes and spending are flip sides of the same coin. I'm going to talk about that more in a second. But if you have a tax system that people hate, it's going to be very difficult to do anything on the spending side, no matter how valuable that spending is, because it'll have to be financed by this tax system that is undesirable.

So, what needs to happen? Well I would say four things. First of all, it's shocking to me how distinct the discussion of government spending and government taxes are. Government spending creates a necessity to tax, either now or later. The only reason we tax is to spend. So you would think that spending and tax debates occur at the same time, but for some reason they don't. I think that one of the things that could be done to raise the level of public awareness and presumably get better public policy is to have the American public understand better what they're getting for their tax dollars. Because if you look at surveys, if you ask people "would you like a tax cut," 80 percent say yes, roughly. If you ask them, "would you like a tax cut if it meant the government would have to cut education or healthcare or retirement or environmental efforts," 80 percent say no. So the linking of the spending side and the tax side could be sort of a quantum leap forward in tax policy debates.

The second thing we do, we have to, have to, have to simplify taxes. I honestly think—and I'm sure I'll get mail about this—that most people understand that they have to pay taxes but they just don't understand why it's so complicated. I have been a tax expert for 20 years and I have that feeling every year when I fill out my tax return. So we need to simplify taxes.

The third is that we need to focus on the redistribution of the whole system, taxes and spending, not individual features. The notion that every single thing that the government does has to redistribute income from high-income to low-income households is a mistake and it gets in the way of good policy time and time again, and I'll get to that in a second.

And lastly, we need to stop talking about tax cuts and start talking about raising revenues.

So how do we do that? There are only three ways to raise revenues, and the first one is to make sure the economy is in good shape. There's this unfortunate split between people who think about the economy as a whole and people who think about the budget. It's unfortunate because you will never get to where you need to go in the budget if the

economy is not strong. The economy is more important than the budget, and a strong economy is a necessary but not a sufficient condition to generate fiscal responsibility. So it's absolutely essential, especially right now, that we keep our eye on the economy even more than we keep our eye on the budget.

The second way to raise taxes is to clean up existing taxes, and this is what Ed and Lilly are going to talk about a lot, so I'll just skim over this. Basically you can close the loopholes. If the concern is loopholes, the obvious answer is that you can close the loopholes. Or you can reform the way the tax system uses deductions, credit exemptions, and I'll just leave it at that. Except to say two things. One is that there is a lot of money in these options that can be raised. And two, these are much better ways to raise revenue than raising tax rates. In fact, I think they are under-discussed in the policy debate, and I'm glad that Ed and Lilly are going to follow up on this. Lastly, you can develop new revenue sources, and here the obvious answer is VAT—the value added tax. It's hard for me to see how we are going to avoid needing to implement a value added tax at some point in the future. Although you can get a lot of money out of the existing system through the reforms that Ed and Lilly are going to talk about, you really can't get there from here in terms of closing the fiscal gap, even the tax part of the fiscal gap—if you will, if you want to think of it as half and half or some interior allocation. You really can't get there without a new revenue system. The VAT is the obvious choice—it's what countries all around the world use. Climate change taxes would be also helpful policy for all the tax reasons, as well as the environmental reasons. And Jane is not talking, but she's telling me to stop. Thank you.