

What Does a 21st-Century Tax System Look Like?

By Clinton Stretch

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Chair Volcker:

You and your task force have been burdened with a difficult but imperative task: to shape much-needed federal tax reform in a period of unprecedented fiscal and economic turmoil. The very charge that the president has given you — to reduce tax evasion and loopholes, to simplify the code, and to “reduce corporate welfare” — bespeaks the central challenge that you face. Our income tax systems, both corporate and individual, which are the product of mid-20th-century policy thinking, are ill-suited to 21st-century domestic and global economies.

Although there is no single correct approach to fundamental tax reform, we believe the path to a competitive future for U.S. workers and businesses lies before us, not behind us in the policy and rhetoric of the past. Your principal challenge will be to find new solutions, rather than recycle old ideas that no longer fit the realities in which individuals and businesses conduct their affairs. In particular, we offer three recommendations.

First, the task force should recognize the limitations of the current system, which are many. The spending triggered by the economic downturn, as well as long-term structural deficits, will require a comprehensive review of both spending priorities and taxes. The tax gap issue aside, the current income and wage tax systems cannot and should not raise sufficient revenue to fund additional programs or reduce long-term deficits.

President Obama, during his campaign, suggested aggregate cuts in individual income tax collections. This was a realistic

recognition of the system's limitations. The president also proposed to substantially shift the tax burden toward higher-income taxpayers by restoring the rates that existed during the last Democratic administration.

Although restoration of those rates appears to be a foregone conclusion, more tax increases on higher-income taxpayers would seem unwise. Any set of proposals that would impose a combined effective marginal federal, state, and local tax rate even approaching 50 percent would likely be broadly perceived as unfair. Unfair tax systems are unsustainable over time and are bad short-term policy.

The corporate income tax presents an even less promising source of revenue to address our long-term fiscal needs. Our corporate income tax has become a global oddity. Its rates are substantially higher than those of our major trading partners and competitors. If anything, corporate taxes, which burden domestic and multinational firms as they seek to grow in the United States, should be reduced by any meaningful reform.

While we do not suggest abandoning the tax system, recognizing its limitations will necessarily lead the task force to ask the harder and more compelling question: If not a 20th-century tax system, then what?

Second, the task force's tax reform recommendations must seek to level the playing field between U.S. multinationals and their foreign competitors. To do this, the task force must engage the business community in an open dialogue that seeks to understand the competitive pressures faced by U.S. firms without prejudging the tax policy outcome. To compare the U.S. tax burden on multinationals with the burden on purely domestic enterprises harkens back to the 1960s when more than 90 percent of cross-border investment was outbound from the United States.

Today most major U.S. businesses face competition more from foreign-based companies than from other U.S. firms. To blame the tax system for the loss of U.S. jobs is to pretend that the U.S. tax system somehow created globalization and international competition. Besides imposing rates far in excess of those in other major economies, the United States attempts to impose worldwide taxation in a rapidly expanding global economy. This

persistently disadvantages U.S. multinationals as they compete with firms headquartered in countries with largely territorial tax systems. Any corporate tax reforms must:

- result in a substantial reduction in rates;
- prevent double taxation of foreign earnings by reducing extraterritoriality or by providing foreign tax credits free of artificial limitations;
- avoid creating barriers to outbound investment by U.S. firms; and
- encourage repatriation of earnings.

The free flow of capital across borders and a competitive tax system are essential to a strong global and domestic economy.

Third, the task force must engage in an honest examination of the tax gap. Attacking “corporate welfare” is not a new idea and does not change the discussion to move it in a constructive direction. Those attacks often distract from the deeper compliance challenges in the tax system. The corporate income tax and compliance with it are not perfect, but our professional experience is that large companies with the sophisticated accounting systems required by their investors have a substantially higher compliance rate than any other taxpayer group.

According to IRS studies, some 80 percent of the tax gap is attributable to underreporting of income by individuals and small businesses. Indeed, some sectors of the small-business community report less than half of their income. To date, the response to this challenge has been greatly tempered. The costs, both in dollars and in taxpayer goodwill, seemingly have discouraged aggressive enforcement of the tax laws in the farm, small-retail, and other small-business sectors. Some highly creative approaches will be necessary to address this problem.

The task force should ask whether it is realistic to expect small businesses to comply fully with present law. A couple running a small business with net earnings from self-employment as low as \$87,000 will face a combined tax burden on the next dollar of reported income of 38 percent (25 percent income tax plus self-employment taxes, half of which are deductible against the income tax).

This high marginal rate does not encourage voluntary compliance. Perhaps the task force should explore replacements for the current wage tax system that remove compliance burdens from small businesses as well as from individuals hiring household help. ■