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Raising Revenue: The Least Worst Options

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With the fiscal cliff looming, lawmakers are looking for new revenues as a component of any bipartisan deal to reduce the federal deficit. While raising new revenues may be politically necessary to seal a deal, lawmakers must keep in mind that not all revenue raisers are equal. Some will have far more harmful economic consequences than others.

Indeed, after careful study, OECD economists have established a hierarchy of which taxes are most and least harmful for long-term economic growth. They determined that the corporate income tax is the most harmful for long-term economic growth, followed by high personal income taxes. Consumption taxes and property taxes were found to be less harmful to economic growth relative to taxes on capital and income.

Why this hierarchy? It is determined by which factors are most mobile and, thus, most sensitive to high tax rates. Capital is the most mobile factor in the economy and therefore most sensitive to a hike in tax rates. Naturally, land is the least mobile and less sensitive to high tax rates. This is not to say that high taxes won't affect consumption and property patterns but their impact will simply be less than the impact of taxes on capital and income.

With these rules of thumb in mind, here is a short list of ways to raise new revenues ranking from least harmful to most harmful:

#1 Least Harmful—Economic growth: This may seem obvious, but whether or not we have enough new economic growth to generate more revenues for the Treasury is directly dependent upon some of the policy choices listed below.

#2 Asset sales: The U.S. federal government owns hundreds of billions worth of assets that it can, and should, sell off in order to pay down the national debt. As of 2008, the Office of Management and Budget (OMB) reported public lands worth $833 billion and loans worth $209 billion. Other state-owned enterprises such as Amtrak, the Power Marketing Administration utilities, and the Tennessee Valley Authority could all generate considerable cash on the open market. The biggest benefit of asset sales is turning tax-subsidized enterprises into tax-generating ones.

#2a: As a second-best option to asset sales, require Government Sponsored Enterprises (GSEs) and federally-owned businesses to pay federal income taxes. TVA, for example, has operating revenues of $11 billion and $47 billion in assets. It should pay federal income taxes.

#3 User fees and leases: Lawmakers could raise billions with no harm to the economy by raising user fees for many of the goods and services it provides (such as flood insurance, inland waterways, National Parks, and loan originations) and opening up more public lands for oil and mineral leasing. In 2008, OMB reported that federal mineral rights were worth $1.062 trillion. They are probably worth more today.

#4 Tax certain non-taxed business activities: There are a number of non-taxed businesses or industries that compete directly with private businesses but have the advantage of not paying federal income taxes. These include: credit unions; rural electric coops; nonprofit hospitals; and certain types of insurance firms. These businesses should be taxed as any for-profit enterprise. The tax benefit to credit unions has been estimated at $2 billion to $3 billion per year.

Moreover, there are a growing number of nonprofit organizations that operate for-profit enterprises. While nonprofits are supposed to pay income tax on their unrelated business income, many receive royalties, rents, and other income that is considered exempt from income taxes on these profits. For example, college sport organizations earn billions in revenues from hosting tournaments and TV and radio rights, but the IRS has exempted these profits from tax. Other nonprofit organizations such as AARP earn hundreds of millions of dollars in income tax-free from royalties and other sources. All of this income should be subject to income tax.[1]

#5 Premium and co-pay increases: Increasing Medicare premiums and co-payments are not likely to be politically popular, but asking seniors to contribute more toward their federal health insurance would be far less harmful to the economy than a broad-based income tax. Even if these policies were means-tested, they might actually add a measure of market forces into a system that has few. According to CBO, increasing the Medicare premium for Part B to 35 percent from 25 percent could raise more than $240 billion over ten years. (Again, Congress's arcane budget rules count these payments as a reduction in mandatory spending, not new revenues, but the effect is the same.)

#6 Federal employee contributions: As most private employers are now doing, the federal government should ask federal employees to contribute more to their own health care and retirement costs. Currently, federal employees pay 25 percent of the costs of a basic health plan (some pay more for more expensive plans). This share should be increased to at least 30 to 35 percent. (Congress's arcane budget rules would likely count these contributions as a reduction in mandatory spending, not new revenues, but they are good policy anyway.)

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[1] *See* Representative Wally Herger & Representative Dave Reichert, *Behind the Veil: The AARP America Doesn't Know*, U.S. House Committee on Ways and Means Investigative Report (March 2011), http://waysandmeans.house.gov/uploadedfiles/aarp_report_final_pdf_3_29_11.pdf.

In February 2012, lawmakers increased the amount that new federal employees must contribute to their pensions from 0.8 percent to 3.1 percent of each paycheck. This measure was expected to raise $15 billion toward the cost of extending unemployment insurance. However, current federal employees were exempted from the contribution increase. Lawmakers would do well to extend the 3.1 percent contribution to current employees.

#7 Sales/Excise taxes: Unlike the states, the federal government does not rely much on sales or excise taxes—excise tax revenues amount to about 3 percent of total federal revenues. The largest federal excise taxes are the federal gasoline tax ($38.7 billion), tobacco taxes ($16.5 billion), airport and ticket taxes ($11.6 billion), and alcohol taxes ($9.6 billion). Increasing current excises or creating a new one would not be costless, but less so compared to higher income taxes. For example, according to CBO, increasing the federal gas tax by 25 cents could raise about $30 billion per year.

#8 "Base-broadening": This is a tricky one because while everyone talks about broadening the tax base and eliminating "spending" in the tax code, the truth is that not all tax preferences are created equal (see discussion about untouchables, below). From an economic perspective, eliminating tax preferences produces less harm than increasing marginal tax rates, but caution is also in order.

- **Eliminate industry subsidies, targeted tax preferences, and refundable credits first:** Industry subsidies can include such things as the special exemption for credit unions; credits for hybrid vehicles and energy efficient windows; and tax-exempt bonds for private nonprofit educational facilities. The IRS now gives out over $100 billion in refundable credits to taxpayers who have no income tax liability. Limiting those to the neediest could save billions.

- **Tax employer-provided health care benefits:** This exemption is the single largest tax preference at roughly $128 billion per year. Taxing this currently untaxed employee compensation would be good policy, but should be paired with other market-based reforms.

- **Restoring PEP and Pease:** Tax Foundation economists have estimated that restoring the phase-outs of personal exemptions and itemized deductions (the PEP and Pease provisions) for taxpayers with more than $250,000 in AGI (joint filers) and $200,000 (single filers) would lower GDP by 0.03 percent over a five to ten year period. These measures typically raise the effective marginal tax rates by about 1 to 4 percent for families of various sizes while their incomes are in the phase-out range, above which rates return to the normal statutory levels.

- **Capping deductions:** Mitt Romney's proposal to cap itemized deductions at $17,000 or $25,000 may have been crude tax policy, but it had the political advantage of avoiding a direct fight with powerful interest groups and it gave taxpayers the choice in deciding which deductions were best for their situation.

- **Untouchables:** For individuals, do not eliminate or scale back broad-based savings vehicles such as 401ks, Roth IRAs, or investment incentives such as the reduced rates on dividends and capital gains. For businesses, do not lengthen depreciation schedules, eliminate business expensing or depletion, or eliminate deferral. These provisions offset double taxation and move the tax system toward a consumption base.

#9 Raising the payroll tax rate and/or raising the wage base to which it applies: The payroll tax raises about $1 trillion per year, about the same as the individual income tax. But because it applies to wages only, and the Social Security portion applies only to the first $110,000 in wages, the payroll tax has little impact on saving, investing, entrepreneurship, and high-productivity labor. Empirically, we find across countries no relationship between the payroll tax and economic growth. This is why the payroll tax holiday, which cut the rate 2 points in 2011 and 2012, has failed to improve the economy or reduce chronic unemployment. It did, however, cost the treasury $125 billion per year, more than 10 percent of the deficit. That's a bad deal.

#10 Raising the Alternative Minimum Tax and/or a "Buffet Rule"-type minimum tax: The AMT began in the 1960s as a way to ensure high income earners don't slip through the regular income tax system. Instead, it has become an alternative tax code with its own problematic complexities. Because it has failed to ensure a minimum tax rate, the "Buffet Rule" has been proposed as a minimum tax on millionaires, but there is no reason to expect this to work any better. Minimum taxes merely complicate the code, introduce uncertainty for taxpayers, and invite special interests to lobby for exemption. In the end, they raise little revenue.

#11 Allowing "temporary" expensing to expire: The 2010 tax deal gave businesses full expensing in 2011 and 50 percent expensing in 2012. These temporary measures are considered tax cuts, but in reality they are more like tax shifts. Instead of businesses taking their deductions in future years, they take them now. This timing shift actually produces a long-term revenue loss of nearly zero. The idea behind bonus depreciation is to encourage capital purchases earlier and hopefully encourage the use of that capital to increase production. This is what happened in 2003, leading to an immediate rebound in investment and GDP. But because it was temporary, it mainly borrowed investment from future years when it expired. Full expensing on a permanent basis would permanently shift investment forward, leading to permanently increased production and income. Making full expensing permanent could boost GDP by more than 2.7 percent over the long run, while 50 percent expensing could boost GDP by 1.36 percent.

#12 Raising top individual income tax rates: In an analysis of President Obama's tax proposals, Tax Foundation economists estimated that increasing the marginal tax rates in the top two tax brackets from 33 percent to 36 percent and from 35 percent to 39.6 percent would lower long-term economic growth by 0.44 percent. Our model also showed that for every $1 such a policy would raise for the treasury, GDP would fall by 2.77 percent. That's a poor tradeoff.

#13 Raising the tax rate on estates: This ranks worse than raising top individual rates because it is a revenue loser not a revenue gainer. President Obama's budget proposed increasing the federal estate tax from the current 35 percent top rate with a $5 million exempt amount to the 2009 levels of a 45 percent top rate and a $3.5 million exempt amount. Tax Foundation economists estimated that this policy would lower GDP by 0.23 percent. While this may seem like a small effect, the loss in GDP is nearly five times the amount of new tax revenue gained from this policy.

#14 Raising tax rates on capital gains and dividends: When Tax Foundation economists modeled the long-term effects of increasing the capital gains top rate to 20 percent and letting the tax rate on dividends revert to 39.6 percent for people in the top two brackets, they found that this policy would lower GDP by 2.15 percent and that it would not raise any new tax revenues because of its depressive effects.

#15 Most Harmful—Raising corporate income tax rates: Because the U.S. currently has the highest corporate income tax rate in the industrialized world, no one is proposing to boost the corporate tax rate. However, President Obama's Framework for Corporate Tax Reform did contain a number of base-broadening measures to offset his proposed reduction in the corporate tax rate. After modeling these proposals, Tax Foundation economists concluded that these measures would more than erase any of the positive economic benefits of cutting the corporate tax rate.

Conclusion

If lawmakers decide that new revenues must be part of any long-term effort to solve the budget crisis, they must choose the least harmful way of raising new revenues or else they risk compounding the crisis by slowing economic growth. The above list of revenue measures is hardly complete, but it should give lawmakers some rules of thumb on how to avoid the most economically harmful revenue options.

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