Safe, Fair & Sustainable

Do President Obama's Tax Proposals Measure Up?

By Mike Prokosch, Karen Kraut, and Lee Farris

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UNITED FOR A FAIR ECONOMY™

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United for a Fair Economy is a national, independent, nonpartisan, 501(c)(3) nonprofit organization. UFE raises awareness that concentrated wealth and power undermine the economy, corrupt democracy, deepen the racial divide, and tear communities apart. We support and help build social movements for greater equality.

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Introduction

In 2008, one of the biggest bubbles in financial history collapsed and took the rest of the U.S. economy with it. Reviving the economy has already cost some $1.5 trillion in bank bailouts and stimulus spending. Who will pay for the bailouts, the stimulus bill, and our growing national debt?

It is morally inconceivable that a financially battered and increasingly jobless population could be made to pay for a six-year binge that rewarded only the very wealthiest Americans. That will happen, however, if our tax laws are not changed. **This report examines our increasingly regressive federal tax system, its contribution to reckless financial behavior on Wall Street, and changes in tax laws that could make our economy safer, fairer, and more sustainable.**

Among the federal blunders that led to the Great Crash of 2008, two stand out. The first was deregulation. Deregulation of the banking industry and non-regulation of exotic new financial instruments are generally recognized as causes of the crash.

Equally toxic, however, was de-taxation: changes in the IRS code that ended up taxing Wall Street managers and extremely wealthy investors at lower rates than the people who answered their phones. The resulting concentration of great wealth exacerbated extreme risk-taking by the people who run our financial system. Reckless tax policies contributed to an incentive system that proved irresistible for the few and disastrous for the rest of us.

If foolish tax policies helped wreck our economy, smart taxes have to be among the first tools in President Obama's tool box as he moves to repair the damage. Is President Obama proposing smart taxes?

During his campaign for President, candidate Obama spoke about his desire to make the federal tax system more fair, more safe and more sustainable. The Institute for Policy Studies (IPS), a nonprofit that conducts independent research, put forth such a package of tax proposals in their recent report "Reversing the Great Tax Shift: Seven Steps to Finance Our Economic Recovery Fairly."[1] In March, President Obama submitted to Congress his fiscal year 2010 budget proposal. How close did Obama come to his intentions?

We analyzed and compared the tax proposals in President Obama's FY2010 budget that focus on higher-income taxpayers[2] with the alternative set of tax proposals from the Institute for Policy Studies report. We used three criteria:

1. Do the tax proposals make our financial markets safer and help prevent future crashes? (See “Financial Security Rating” column in Tables 1 and 2 on pages 9 and 10.)
2. Do they increase the progressivity of our tax system? (See “Fairness Rating” column in Tables 1 and 2)
3. How much revenue do they raise to pay for the bailout and stimulus necessitated by this financial crash? (See “Revenue Rating” column in Tables 1 and 2)

In compiling overall ratings, we assigned a value of 1 to proposals that have a low impact, 3 to proposals with a medium impact, and 5 to proposals that have a high impact. We then calculated the average score in each category. If one proposal raised significantly more revenue in a given category (for example, estate taxes or capital gains and dividends taxes), that gave it a higher score. Total scores were assigned the following values: 1=Poor, 2=Fair, 3=Average, 4=Good, 5=Excellent.

Key Findings

- President Obama’s tax proposals raise $266.6 to $326.6 billion a year less than the Institute for Policy Studies (IPS) proposals. This enormous shortfall is risky and potentially crippling, given our weakened economy and the demands of our international creditors.

- The IPS tax proposals received an overall Financial Security rating of Good, compared to a rating of Average for the President’s proposals. As such, President Obama’s plan only begins to make our financial future secure. It does not end the perverse incentive system that led to extreme risk-taking on Wall Street, and so leaves in place a hazardous environment that is likely to create future bubbles and busts.

- The IPS tax proposals received an overall Fairness rating of Excellent compared to a rating of Good for the President’s tax proposals. The President’s plan moderately increases the progressivity of our tax system, and the IPS plan shows that much more can be done.

Smart Taxes? Rating the Tax Proposals

FINANCIAL SECURITY: Does the plan take away the incentives for financial managers and investors to take extreme risks?

It is widely agreed that the causes of the financial meltdown included: deregulation and non-regulation of the banking industry at the highest levels of government; self-delusion and irresponsible, greedy behavior by those managing the financial services industry; and reckless investment decisions made by individuals at the very top of the economic ladder.

The Obama Administration is proposing new regulations to control such reckless behavior. Excessive risk-taking, however, cannot be contained through this route alone. Over the past three decades, "financial innovators" have relentlessly invented new ways around the rules in place.[3] The dance of regulation and evasion will continue. It can only be limited by decreasing today's extreme rewards for taking risks. Smart tax policies have the power to drastically cut the incentive to take risks by making them less profitable.

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Regressive tax reforms helped fuel the housing bubble because they encouraged risk-taking in mortgage and financial markets. The managers who turned home lending into a high-risk casino were rewarded immediately with very large compensation packages, and then taxed at the 15% capital gains rate rather than the top 35% rate on personal income. The top 50 hedge fund and private equity firm managers in 2007 took home an average of $588 million each.[4] They paid taxes at lower rates than the people who answered their phones.

By letting investment bank and fund managers keep so much of these huge payouts, low capital gains tax rates spurred them to abandon prudent investment practices. For those managers, one insider commented, hedge funds became “a remuneration strategy, not an investment strategy.” Managers put the entire economy at risk to create “returns that [were] high enough to justify their outrageous fees.”[5]

Meanwhile, for their part, the wealthiest investors realized yearly returns of 20% or more at the height of the bubble. Extreme leveraging made their extraordinary income growth possible, while putting the entire financial system at risk. They, too, realized fast fortunes, thanks to low capital gains tax rates. Now that the bubble has collapsed, we are all paying for the risk they took.

The IPS tax proposal addresses this systemic problem by raising capital gains and dividends rates to the same level as ordinary income. President Obama addresses it in a far more limited way, by taxing only “carried interest’ (Wall Street fund managers’ compensation) as ordinary income and by increasing the capital gains tax rate for the wealthiest from 15% to 20%. The President’s proposal will change risk-taking incentives for some financial managers, but will not affect the behavior of the investors whose concentrated wealth was driving financial markets. We can see the greater reach of the IPS proposal by comparing the revenue effect of the two proposals. The President’s proposal will bring in $2.4 billion per year; IPS’s, $80-100 billion.

IPS also proposes one reform that directly targets financial speculation: a micro-tax on financial transactions. Hardly noticed by those who are investing for medium- or long-term appreciation, this tax would discourage the rapid "flipping" of financial assets for immediate gain, and would collect significant revenue that ultimately supports government regulation and oversight.

FAIRNESS: Does the plan build a fair and stable economy?

Progressive taxation – people paying taxes based on their ability to pay – is fundamental to a fair society and true democracy. Society needs some of everyone’s wealth to reproduce the infrastructure, services, public safety, education, and other public investments that support the economy and create prosperity. However, because the free market system within which we operate is both imperfect and produces harsh economic inequality, the market’s distribution of income cannot be the final word on economic justice. Progressive taxation changes the market’s distribution of income and therefore advances equality of opportunity.[6]

Progressive taxation is also healthy for the economy. It is a powerful and efficient way to direct surplus high income away from speculation and accumulation and into the hands of institutions and people, where it can be spent in the economy. Progressive taxation helps prevent the dangerous extremes of wealth and debt that created today’s economic crisis.

Finally, progressive taxes help keep a wealthy minority from warping the rules in their favor. A recent report says: “The financial sector invested more than $5.1 billion in political influence purchasing over the last decade.”[7] This stunning figure – which helps explain the deregulation and lack of regulation the industry enjoyed – shows what happens when excessive wealth is allowed to concentrate at the top of the economy.

Like many other industries, the financial industry is enjoying a self-reinforcing cycle between favorable tax treatment and political influence. The more the industry profits from low taxation, the richer it grows. The richer it grows, the more it invests in politicians who will deliver favorable regulations and taxes. This cycle will continue to expand until both the regulatory and tax rules are changed. Progressive taxation is a powerful tool to help break this cycle.

President Obama's proposals take small steps toward progressive taxation by taxing carried interest at the same rate as ordinary income, limiting itemized deductions, and closing overseas loopholes. IPS takes bigger steps by taxing financial speculation, restoring a more progressive estate tax, creating a new top tax rate on incomes over $2 million, and eliminating tax subsidies for excessive executive compensation.

President Obama's proposals also make income taxes more progressive by reducing them for low- and moderate-income taxpayers. This raises the challenging question: to make taxes progressive, which income classes' taxes should be lowered and which should be raised? The President chose as his cutoff point families earning $250,000 (the top 2.5%) – if you earn more, your taxes go up, compared to the current rates set by President Bush; if you earn less, they go down. United for a Fair Economy (UFE) believes this cutoff point is too high. As a candidate, Obama said he was going to cut taxes for 95% of workers and their families. Yet, his budget cuts taxes for 97.5%. At a minimum, UFE believes those in the top 5%, and even the top 10%, could afford to have their taxes restored to pre-Bush levels.

Strengthening progressive taxation has a particular urgency as we pick our way through the wreckage from Wall Street's latest speculative binge. Those who profited most from the binge, and who bore the most responsibility for the bust, were among the highest income earners. The top fifty hedge and private equity fund managers averaged $588 million of income in 2006. The top three together took in $10 billion.[8] Progressive taxation would ensure that those who profited the most pay substantially for the bailout and stimulus, rather than lower-income taxpayers who had almost nothing to do with the crash and, in fact, have been devastated by it.

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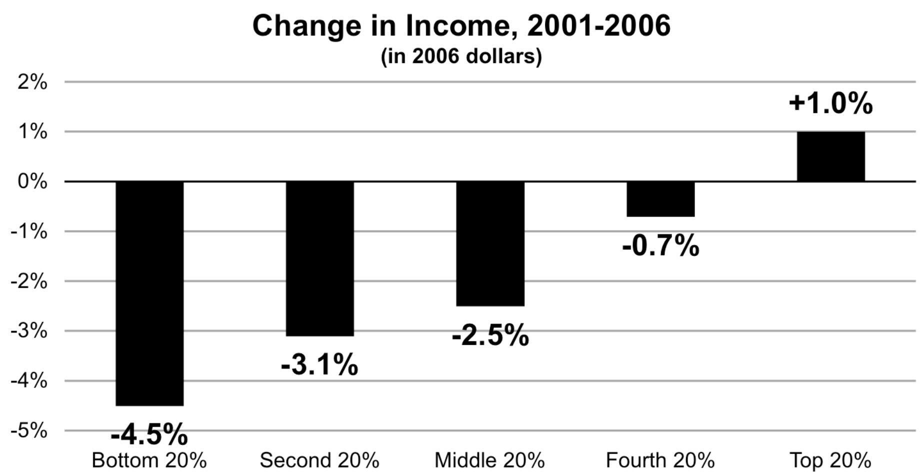
Raising taxes on investment income is the first way to tax those who profited from the bubble and provoked the melt-down. "Capital gains are the most highly concentrated form of income, with just 10,000 or so taxpayers earning a third of all profits from selling investments," notes tax expert David Cay Johnston.[9] IPS proposes restoring the capital gains and dividends tax rate to the same level as income earned from work, increasing federal revenue by $95 billion a year.

IPS's proposals to establish a new tax rate on incomes above $2 million, tax speculative transactions, end overseas tax havens and eliminate tax subsidies for excessive CEO compensation would likewise shift the burden to the income classes most responsible for our present plight. All these proposals primarily tax the top 1% or fraction of one percent of taxpayers.

Both President Obama's and IPS's tax proposals make great strides in reintroducing the concept of 'progressivity' to the tax debate. Since 1980, that debate has been dominated by "trickle-down" economics ideology. "Let rich people keep more of their money," this ideology said; "they will invest it in enterprises that employ the rest of us, and all will prosper." Following that ideology, the Reagan and Bush II administrations repeatedly lowered taxes on the highest income earners, which greatly exacerbated income disparities.

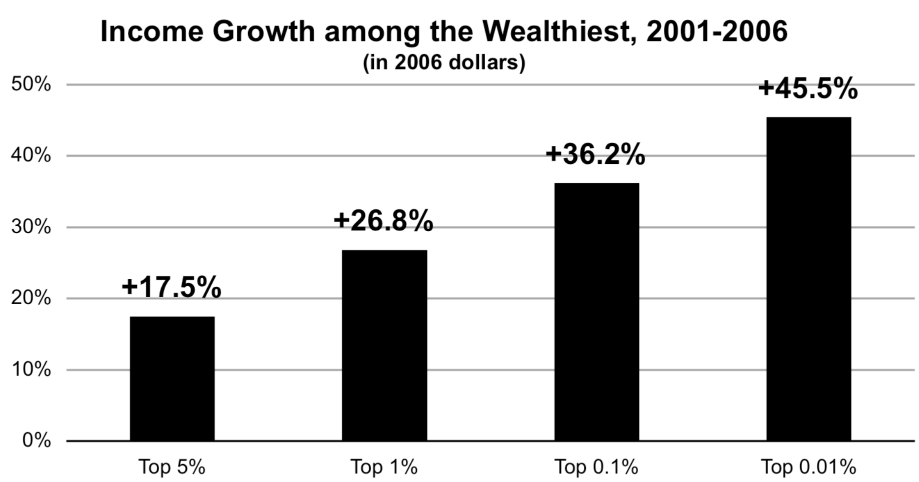
The following charts show income growth from 2001-2006 for different income groups.[10]

Chart 1



Source: Center for Budget and Policy Priorities, "Pulling Apart: A State-by-State Analysis of Income Trends," April 9, 2008, unnumbered table, p. 37.

Chart 2



Source: Thomas Piketty and Emmanuel Saez analysis of IRS data, Table A5, http://elsa.berkeley.edu/~saez/TabFig2006.xls

Highly concentrated wealth did not lead to shared prosperity, higher incomes for most people, or a healthier economy. Instead it created a dangerous imbalance between investment capital and investment opportunities. An investor class had too many dollars for the legitimate investments available. Meanwhile, the consumer majority had too few dollars to buy the goods and services they required. The unbalanced distribution of our national income led to runaway debt for the majority and runaway financial speculation by the few. The consequences are harsh:

- Economic inequality in the United States is at its highest level since the Great Depression. The top 10% of families own 68% of the country's wealth and 84% of its stocks and bonds. The top 1% own 44% of all stocks and bonds.[11]

- It is estimated that there will be 2.2 million home foreclosures from late 2008 to the end of 2009 and that homeowners will lose $2.7 trillion in housing wealth in the overall housing bust. Home foreclosure rates are higher than during the Great Depression, and in communities of color they are nearly twice as high as the national average.[12]

- Half of all households in communities of color have no assets. Nearly 30% of Blacks have zero or negative wealth, double the rate for whites. 11.9% of Blacks are unemployed, a rate that is expected to rise to nearly 20% by 2010. For Black males age 16-19 the unemployment rate is 32.8%; for their white counterparts, 18.3%.[13]

- 22 million households spend more than half their income on housing. In nearly half of low-income households, after housing costs are paid, families have only $257 a month left for food, $29 for clothing, and $9 for medical care.[14]

- The President and Congress are discussing cuts in Social Security and Medicare, and other measures to contain the growing deficit will limit social spending far into the future.

The economic meltdown is widely acknowledged as the last nail in the intellectual coffin of "trickle-down" economics ideology. To put that coffin in the ground, the Obama Administration will have to win steeply progressive taxation and break the cycle of growing inequality that threatens our economy and democracy.

REVENUE: Does the plan stabilize the federal budget?

Bloomberg reported in September 2008 that the total funds committed by federal institutions to address the financial crisis amounts to $7 trillion, a figure that has almost certainly grown since then. Added to this bailout tab is almost $800 billion of federal stimulus, which is a small down payment on long-deferred repairs to our infrastructure and social safety net. Where will all this money come from?

"[T]here is a huge flaw in the [Obama] budget proposal," says a recent study by Citizens for Tax Justice. "It does not raise enough revenue to pay for public services."[15] The study notes that:

- On the plus side, the President's proposal would close the "carried interest" loophole that allows Wall Street managers to count their compensation as capital gains instead of ordinary income. This would raise $2.4 billion in 2011 alone and almost $24 billion over ten years. Other "loophole-closers" would bring in $330 billion of revenue over ten years.

- On the minus side, the President would raise the capital gains and dividends tax only from 15% to 20% for the wealthiest people. This would raise $67.6-$87.6 billion less in 2009 than if capital gains and dividends were taxed at the same rate as ordinary income from wages.[16]

- The President would keep the estate tax at today's Bush-reduced levels, costing the federal budget another $62 billion over ten years compared to the IPS proposal.

By contrast, IPS's tax package raises $309-369 billion per year, about $300 billion more per year than Obama's tax proposals on the wealthy. Further, it eliminates the special tax breaks – for unearned income, excessive CEO pay, financial speculation, overseas tax havens, and extreme wealth – that encouraged and enabled the financial meltdown. Because it raises more revenue and creates a far smaller deficit, IPS's tax package is more fiscally responsible than the President's.

Results

Following is a comparative analysis of the higher-income tax proposals in President Obama's budget with an alternative set of tax proposals from the Institute for Policy Studies report, " Reversing the Great Tax Shift: Seven Steps to Finance Our Economic Recovery Fairly." In compiling overall ratings, we assigned a value of 1 to proposals that have a low impact, 3 to proposals with a medium impact, and 5 to proposals that have a high impact. We then calculated the average score in each category. If one proposal raised significantly more revenue in a given category (for example, estate taxes or capital gains and dividends taxes), that gave it a higher score.

Total scores were assigned the following values: 1=Poor, 2=Fair, 3=Average, 4=Good, 5=Excellent

Table 1. Analysis of higher-income tax proposals in President Obama's budget

What it does	Who pays	Financial security rating	Fairness rating	Revenue raised or (lost) per year[17]
1. Estate tax: $3.5 million exemption, 45% rate	Top 0.3%	1	3	($25.6 billion)*
2. Limit itemized deductions to 28% for filers in upper tax brackets	Top 5% (pays 99% of tax increase)	1	5	$31.8 billion
3. International tax reform	Corporations	3	3	$21 billion
4. Tax carried interest as ordinary income	Mainly private equity, real estate, and venture capital managers	5	5	$2.4 billion
5. Raise capital gains and dividend tax rate from 15% to 20% for families with income over $250,000	Top 1% receive 75% of gains from capital gains and dividends	5	5	$12.4 billion**
Total Score		**3.0**	**4.2**	**$42 billion**

Sources: Citizens for Tax Justice, "Tax Proposals in President Obama's First Budget," March 18, 2009, pp. 1-9. The figures for proposals 2 through 4 are per-year averages of the 10 year figures CTJ supplies for tax revenue (or loss) from 2010 to 2019.

*The revenue figure for proposal 1 comes from a per-year average of the 10 year figures (2010-2019) provided by Joint Committee on Taxation, “Estimated Budget Projections Contained in the President’s FY 2010 Budget Proposal,” March 30, 2009.

**The revenue figure for proposal 5 comes from separate calculations by CTJ for United for a Fair Economy (March 31, 2009 analysis by CTJ Legislative Director Steve Wamhoff); the figure shows how much revenue would result in 2009 if President Obama’s capital gains and dividends proposal were in effect in 2009.

Table 2. Analysis of higher-income tax proposals from Institute for Policy Studies

What it does	Who pays	Financial security rating	Fairness rating	Revenue raised or (lost) per year[18]
1. Tax speculative financial transactions	Investors with enough wealth to invest in hedge funds and investment banks	5	5	$100 billion
2. Tax capital gains and dividends the same as ordinary income (at 35% for top taxpayers under present rates)	Top 1% currently get 75% of benefits from lower tax rates; average tax savings for top 1% = $91,469; for top 0.1% = $616,071	5	5	$80-100 billion
3. Estate tax: $2 million exemption per spouse; rates progressive from 45-55%.	0.6% of estates	1	5	($19.4 billion)
4. Create a new top tax bracket of 50% for incomes over $2 million	Top 1%	5	5	$60-70 billion
5. End overseas tax havens for individuals & corporations	Corporations and some high-income individuals	3	5	$70-100 billion
6. Eliminate tax subsidies for excessive executive compensation	Corporations	5	5	$18 billion
Total Score		**4.0**	**5.0**	**$308.6-368.6 billion**

Sources: John Cavanagh, Chuck Collins, Alison Goldberg, Sam Pizzigati, "Reversing the Great Tax Shift: Seven Steps to Finance Our Economic Recovery Fairly," Institute for Policy Studies and Wealth for the Common Good, April 6, 2009; except for proposal 3, where the revenue figure comes from a per-year average of the 10 year figures (2010-2019) provided by Joint Committee on Taxation, "Estimate of the "Sensible Estate Tax Act," Feb. 18, 2009.

Endnotes

[1] John Cavanagh, Chuck Collins, Alison Goldberg, Sam Pizzigati, "Tax the Top," Institute for Policy Studies and Wealth for the Common Good, April 6, 2009.
[2] We analyzed only the tax proposals in President Obama's budget that affect the top income earners. Selecting these items allowed us to directly compare the President's tax proposals to the Institute for Policy Studies proposals. The Citizens for Tax Justice report cited in the endnotes analyzes all of the President's tax proposals.
[3] See Nicholas Hildyard, "A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power," The Corner House, October 8, 2008.
[4] "Executive Excess 2008: How Average Taxpayers Subsidize Runaway Pay," United for a Fair Economy and IPS, p. 1.
[5] Bill Gross, a bond fund manager at Pimco, a leading global investment management firm, quoted in D. Brewster, "Perils of having a hedge fund on the side," *Financial Times,* April 27, 2007; E. Reguly, "Hedgies, arbs, trusts – Greed runs the show", Toronto *Globe and Mail Update*, October 26, 2006. Both citations are from Nicholas Hildyard, "A (Crumbling) Wall of Money," The Corner House, October 8, 2008, pp. 36 and 42.
[6] Robert Shapiro, "Why Fairness Matters: Progressive Versus Flat Taxes," Progressive Policy Institute, April 1, 1996.
[7] Robert Weissman, "Sold Out: How Wall Street and Washington Betrayed America," Essential Information, March 2009, p. 17.
[8] "Executive Excess 2008," United for a Fair Economy and IPS, p. 1; Ellen Frank, forum on the economic crisis, Cambridge, Massachusetts, January 25, 2009.
[9] David Cay Johnston, "Surprising Finding in Capital Gains Study," *New York Times*, May 5, 2007.
[10] Data for Charts 1 and 2 come from two different data series, neither of which covers the entire income spectrum.
[11] Amaad Rivera, Jeannette Huezo, Christina Kasica, Dedrick Muhammad, "The Silent Depression: State of the Dream 2009," United for a Fair Economy, January 2009, pp. 4, 9.
[12] *Ibid.,* pp. 11, v.
[13] *Ibid.,* pp. 2, vi, iii, v.
[14] *Ibid.,* p. v.
[15] "Tax Proposals in President Obama's First Budget," Citizens for Tax Justice, March 18, 2009, p. 1.
[16] Additional analysis supplied by Steve Wamhoff, Citizens for Tax Justice, March 25, 2009. The President's proposal to raise the capital gains and dividends rate would increase federal revenue by $12.4 billion in 2009. The IPS proposal would increase federal revenue by $77.2 billion in 2009 by eliminating the capital gains and dividends preference and raising the rate to the same level as ordinary income.
[17] The "Revenue" columns in Tables 1 and 2 compare the revenue that these tax proposals would bring in to the revenue the government will receive if current tax laws are not changed.. The President's estate tax proposal would bring in $25.6 billion less per year than would current tax law, so proposal 1 carries a revenue figure of -$25.6 billion.
[18] These revenue figures come from the IPS report, except for proposal 3, where the revenue figure comes from a per-year average of the 10 year figures (2010-2019) provided by Joint Committee on Taxation, "Estimate of the "Sensible Estate Tax Act," Feb. 18, 2009. In addition, UFE estimates the revenue loss would be roughly $15 billion per year if a state estate tax credit were not included. IPS supplied a figure of $40-$60 billion in absolute estate tax revenue, without comparison to current law.