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Editorial

Why the Economy Needs Tax Reform

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Over the next four years, tax reform, done right, could be a cure for much of what ails the economy. Higher taxes, raised progressively, could encourage growth by helping to pay for long-neglected public investment in education, infrastructure and basic research. More revenue would also reduce budget deficits, helping to put the nation's finances on a stable path. Greater progressivity would reduce rising income inequality, and with it, inequality of opportunity that is both an economic and social scourge.

The big obstacle to comprehensive tax reform is the persistent Republican myth that spending cuts alone can achieve economic and budget goals. That notion was soundly rejected by voters during the election. Yet it still has adherents among many Republicans, which will make it that much harder for Congress to grapple with the bigger and more complex issue at the heart of tax reform: how to pay for government in the 21st century.

The main problem is that the current tax code is incapable of raising the revenue needed to pay for the goods and services of government. Over the last four years, federal revenue as a share of the economy has fallen to its lowest level in nearly 60 years, a result of the recession, the weak recovery and a decade's worth of serial tax cuts. Even with deep spending cuts, the chronic revenue shortfall is expected to continue, swelling the federal debt — unless taxes go up. To stabilize the debt over the next 10 years while financing more investment would require at least $1.5 trillion to $2 trillion in new revenue, above what could be raised by letting the top income tax rate revert to its pre-Bush-era level of 39.6 percent.

A logical way to help raise the additional needed revenue would be to tax capital gains at the same rates as ordinary income. Capital gains on assets held for more than a year before selling are taxed at about the lowest rate in the code, currently 15 percent and expected to rise to 20 percent in 2013. That is an indefensible giveaway to the richest Americans. Research shows that the tax breaks do not add to economic growth but do contribute to inequality. Currently, the top 1 percent of taxpayers receive more than 70 percent of all capital gains, while the bottom 80 percent receive only 6 percent.

Another sensible approach is to cap deductions at 28 percent, or to convert deductions, which disproportionately benefit high-bracket taxpayers, to tax credits, which would provide the same benefit to all taxpayers, regardless of tax bracket. President Obama must also pursue other revenue raisers, including a restoration of the estate tax, higher tax rates or surcharges on multimillion-dollar incomes, and higher corporate taxes, including an end to the deferral of tax for American companies that stash their earnings abroad.

All that would only be a start, because the new revenue would only slow the growth of the debt in the near term. After 10 years, the pressures of an aging population and health care costs would cause the debt to accelerate again.

With that in mind, Mr. Obama would be wise to instruct the Treasury Department to start work on tax reform now, exploring carbon taxes, both to raise revenue and to protect the environment; a value-added tax, coupled with provisions to protect lower-income taxpayers from higher prices, to tax consumption and encourage saving; and a financial transactions tax, to ensure that the financial sector, whose profits have substantially outpaced those of nonfinancial corporations, pay a fair share.

Not all of the proposed new taxes would gain support, but all deserve to be part of the debate. Controlling the terms of that debate, and then advancing from debate to action, could well be the toughest challenge of Mr. Obama's second term and, if met, his defining economic legacy.