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The U.S. Tax System: Where Do We Go From Here?

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The U.S. Tax System: Where do we go from here?

Adele C. Morris, Ph.D.
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March 27, 2012

Sources and Further Reading:

- Congressional Budget Office
 - » www.cbo.gov
- Urban – Brookings Tax Policy Center
 - » <http://www.taxpolicycenter.org/index.cfm>
- Committee for a Responsible Federal Budget
 - » <http://crfb.org/>
- Tracy Gordon, The Brookings Institution

Outline

- Basics of the U.S. fiscal system
- What problems are we trying to solve with tax reform?
- Proposals

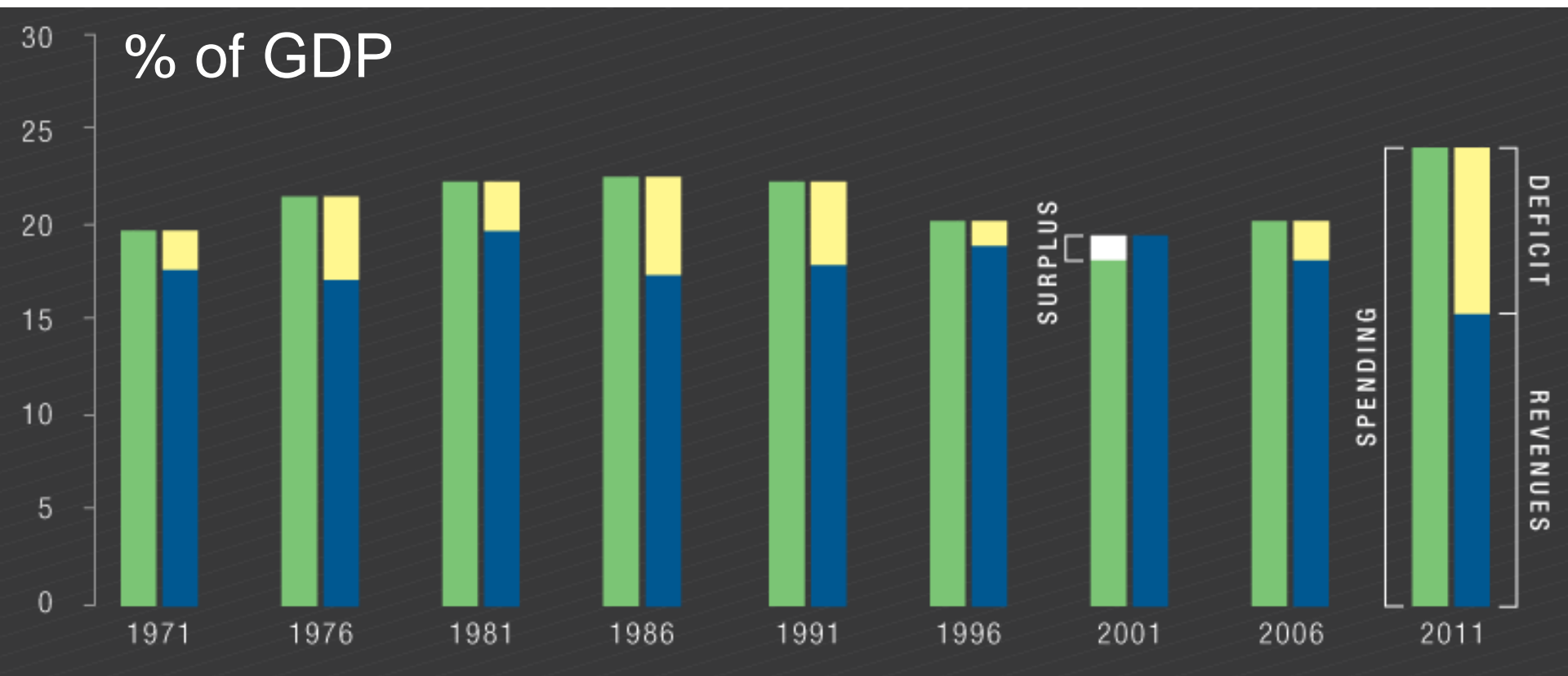
What Are Taxes?

- Involuntary payments to support collective provision of certain goods and services
- Not a payment for services rendered
- Focus in this talk: U.S. federal taxes
 - » Personal income taxes
 - » Payroll taxes
 - » Corporate income taxes
 - » Estate taxes

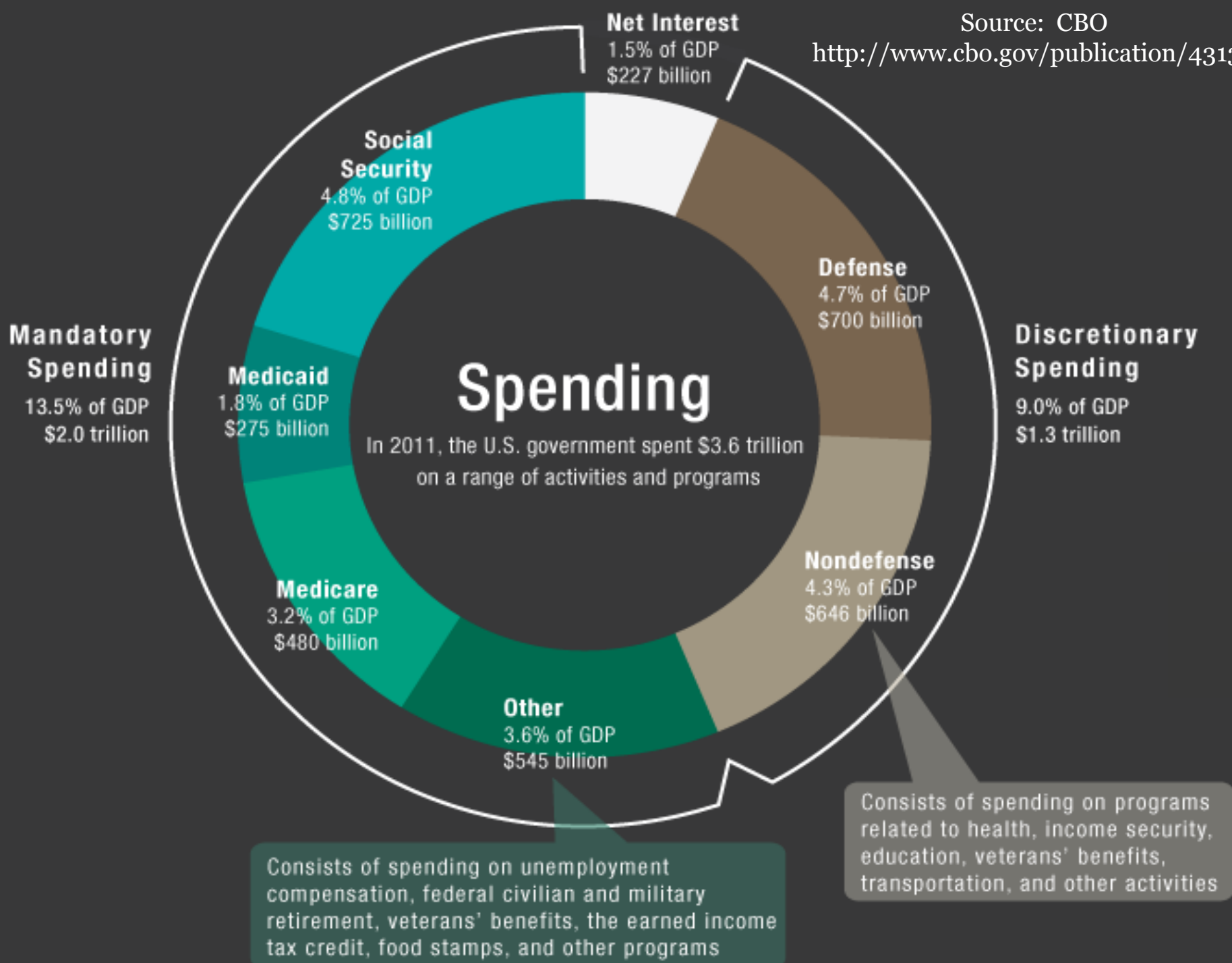
Where is here?

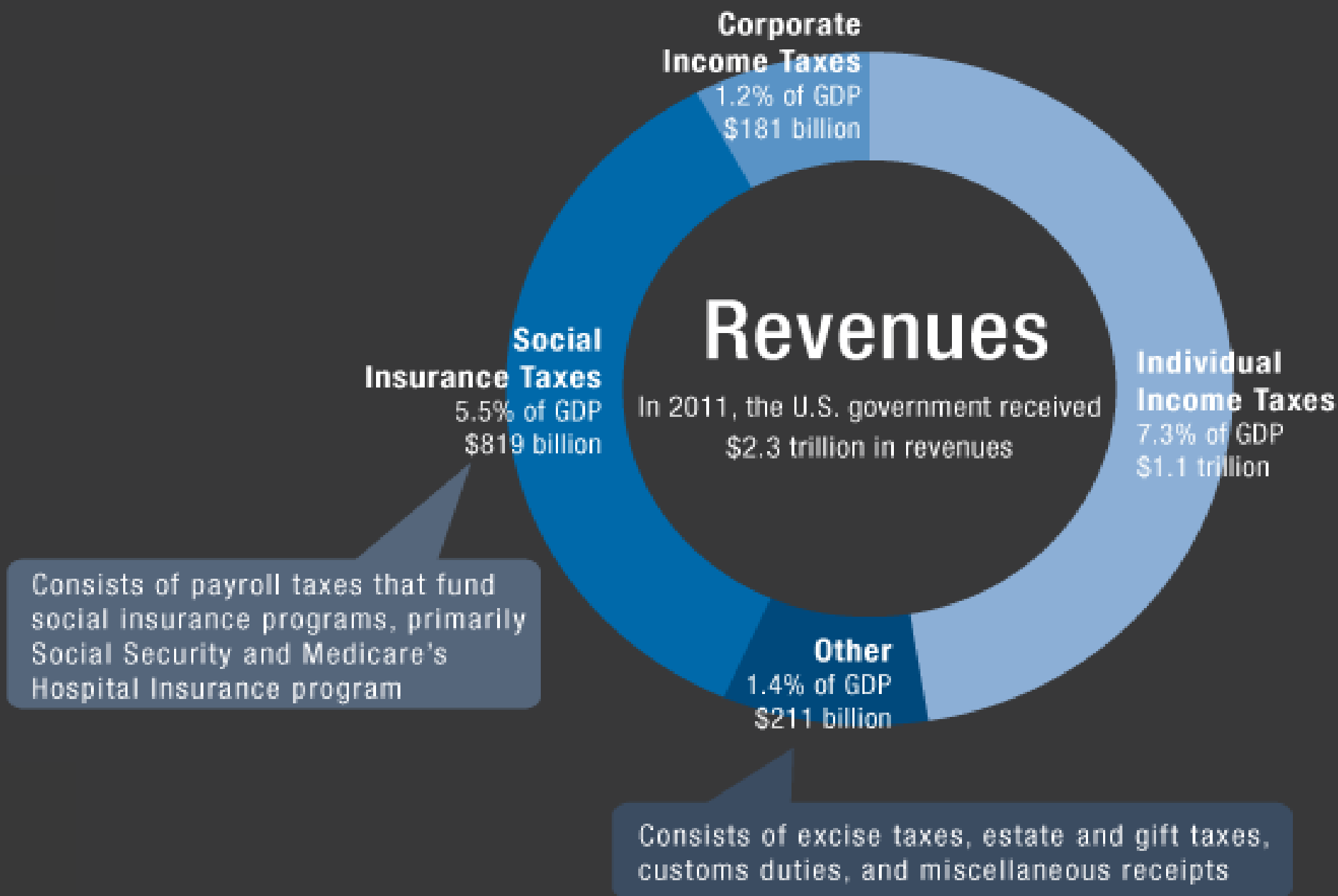
- Fiscal facts
 - » Spending
 - » Revenues
 - » Deficits
 - » Debt
- Historic data and projections

The U.S. Federal Budget 1971-2011



Source: CBO <http://www.cbo.gov/publication/43134>





What should a tax reform reform?

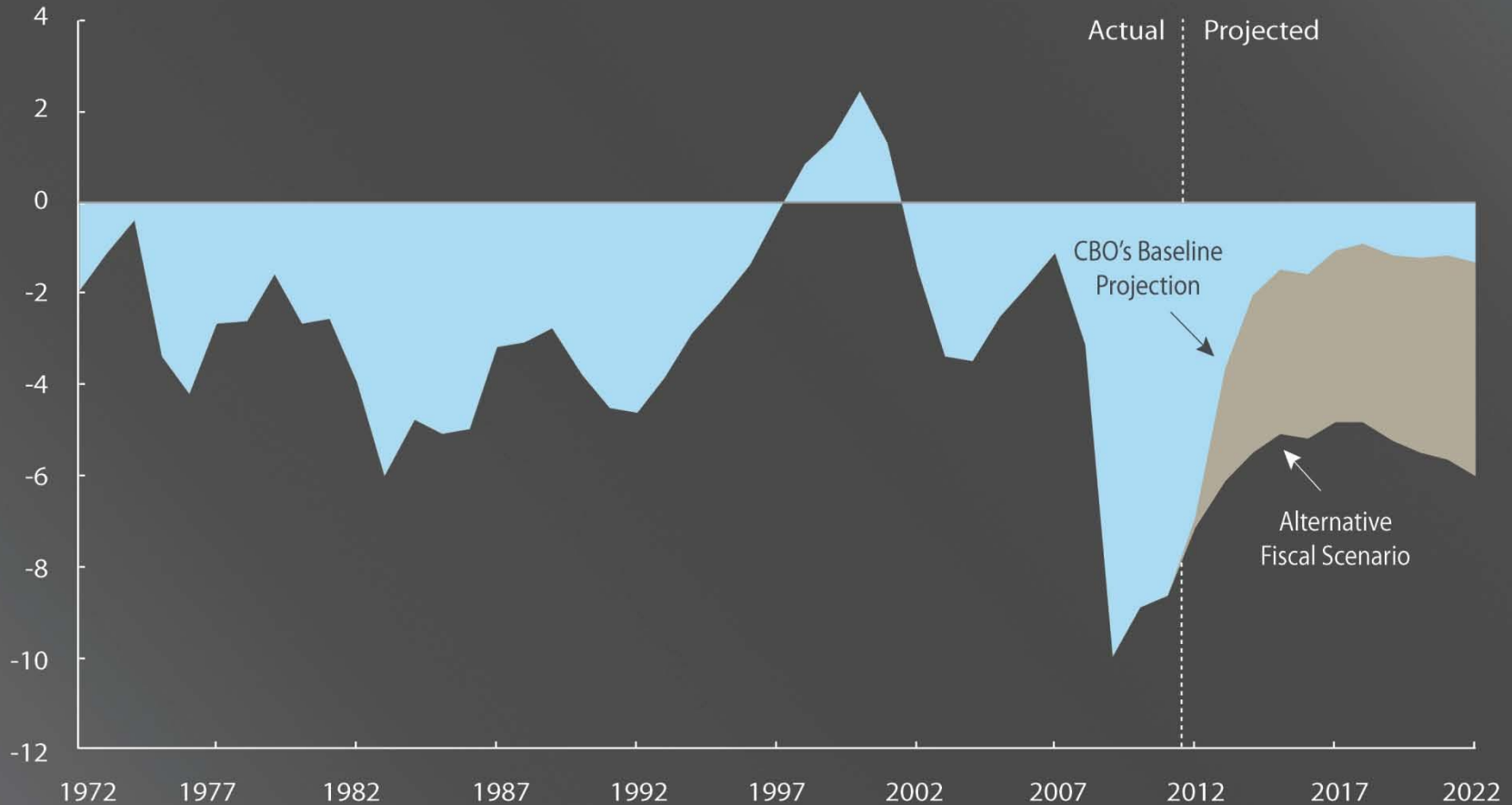
- How much revenue should the tax system raise?
- Is the tax system fair?
- Does it influence behavior in ways that hurt the economy or raise the cost of collecting revenue?
- Is the tax system too complicated?

Do we need more revenue?

- Debates about tax levels are often proxy fights about the appropriate size and scope of government.

Deficits or Surpluses, Historically and As Projected in CBO's Baseline and Under the Alternative Fiscal Scenario

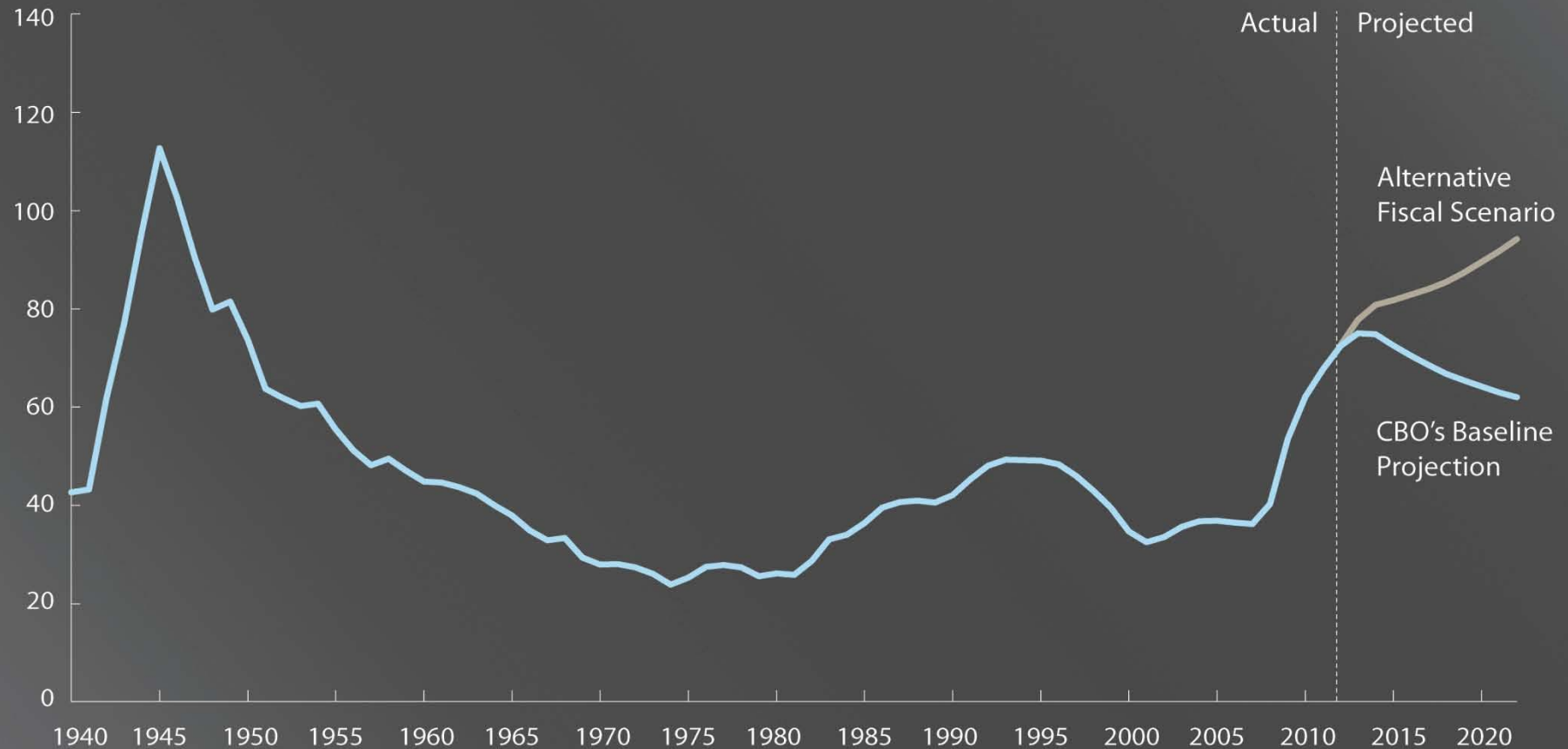
(Percentage of GDP)



Estimates from *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012).

Federal Debt Held by the Public, Historically and Projected in CBO's Baseline and Under the Alternative Fiscal Scenario

(Percentage of GDP)



Estimates from *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012).

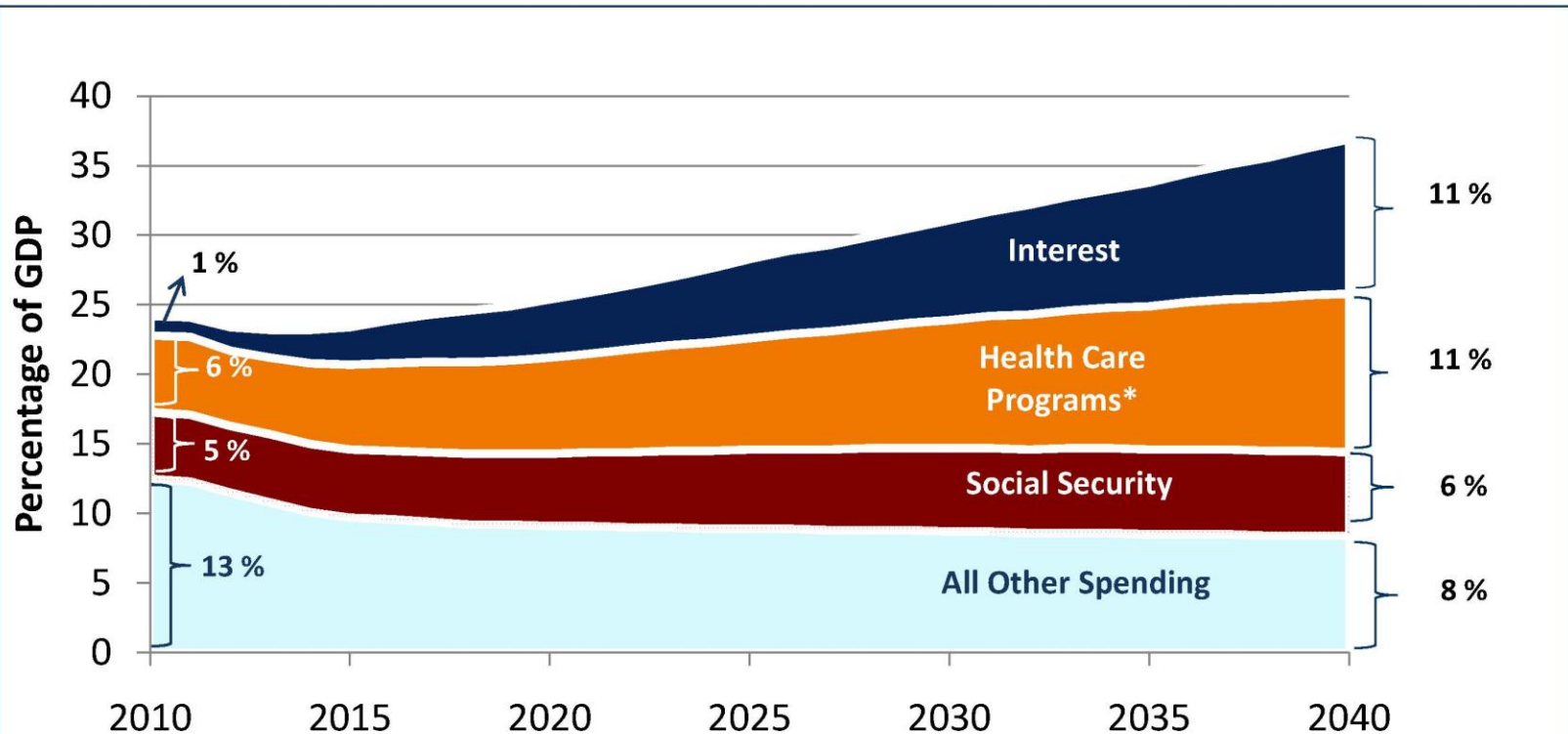
CBO Alternative Fiscal Scenario

- Arguably more probable than current law
 - » Current tax cuts extended
 - » Alternative minimum tax inflation-adjusted
 - » Medicare payments to doctors held constant
 - » No Budget Control Act automatic cuts

Why care about high federal debt?

- Borrowing costs for everyone go up and makes the problem worse
- U.S. beholden to foreign buyers of U.S. debt
- People buy Treasury bonds instead of making other productive investments
- Reduces the option to spend more later

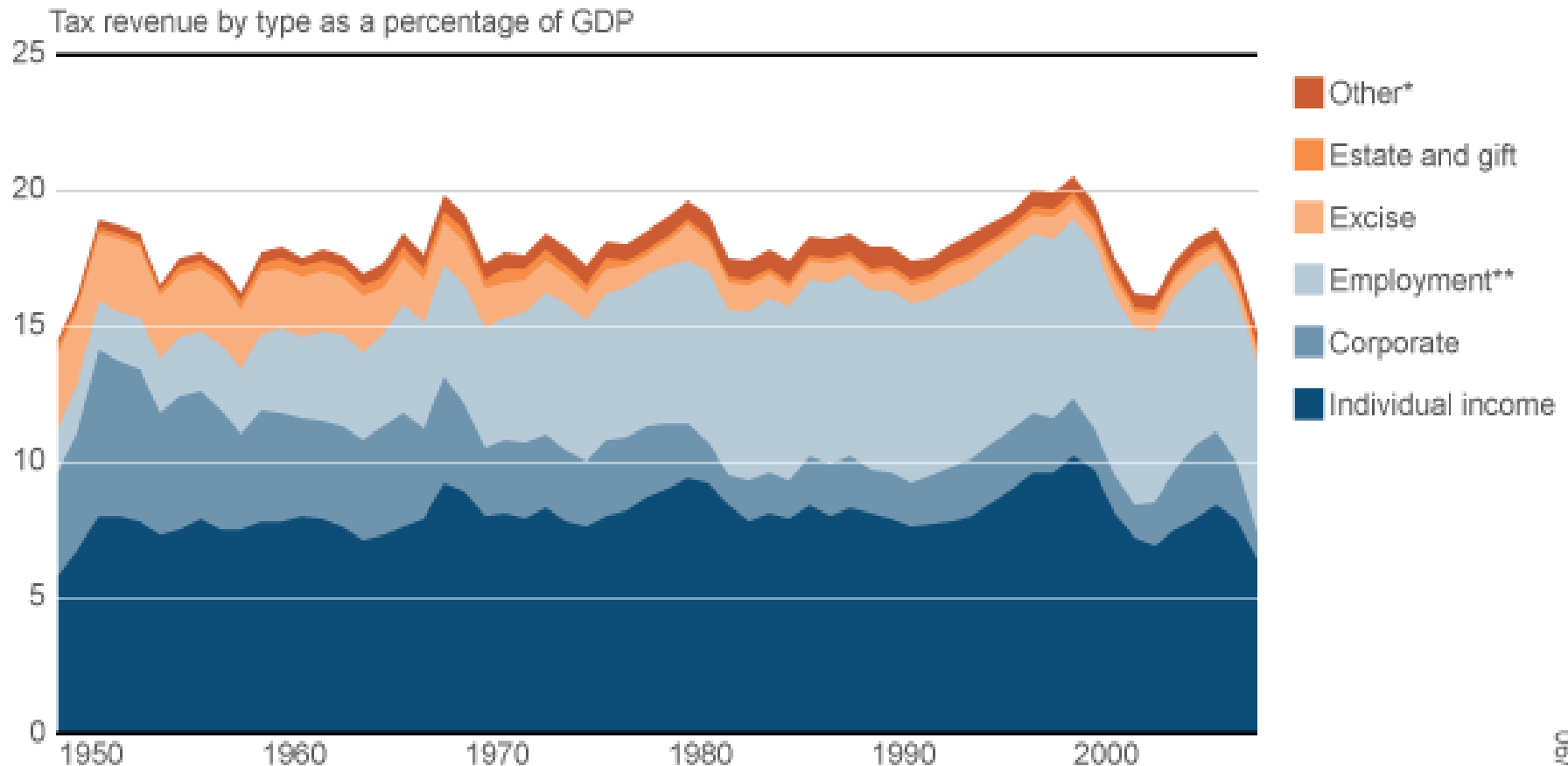
All of the projected future growth in the federal budget will come from entitlements and interest costs



SOURCE: Data from the Congressional Budget Office, *The Long Term Budget Outlook*, June 2011, alternative fiscal scenario. Compiled by PGPF.

*Health care programs include Medicare, Medicaid, Children's Health Insurance Programs (CHIP), and the health care exchange subsidies.

Federal taxes as a percentage of GDP

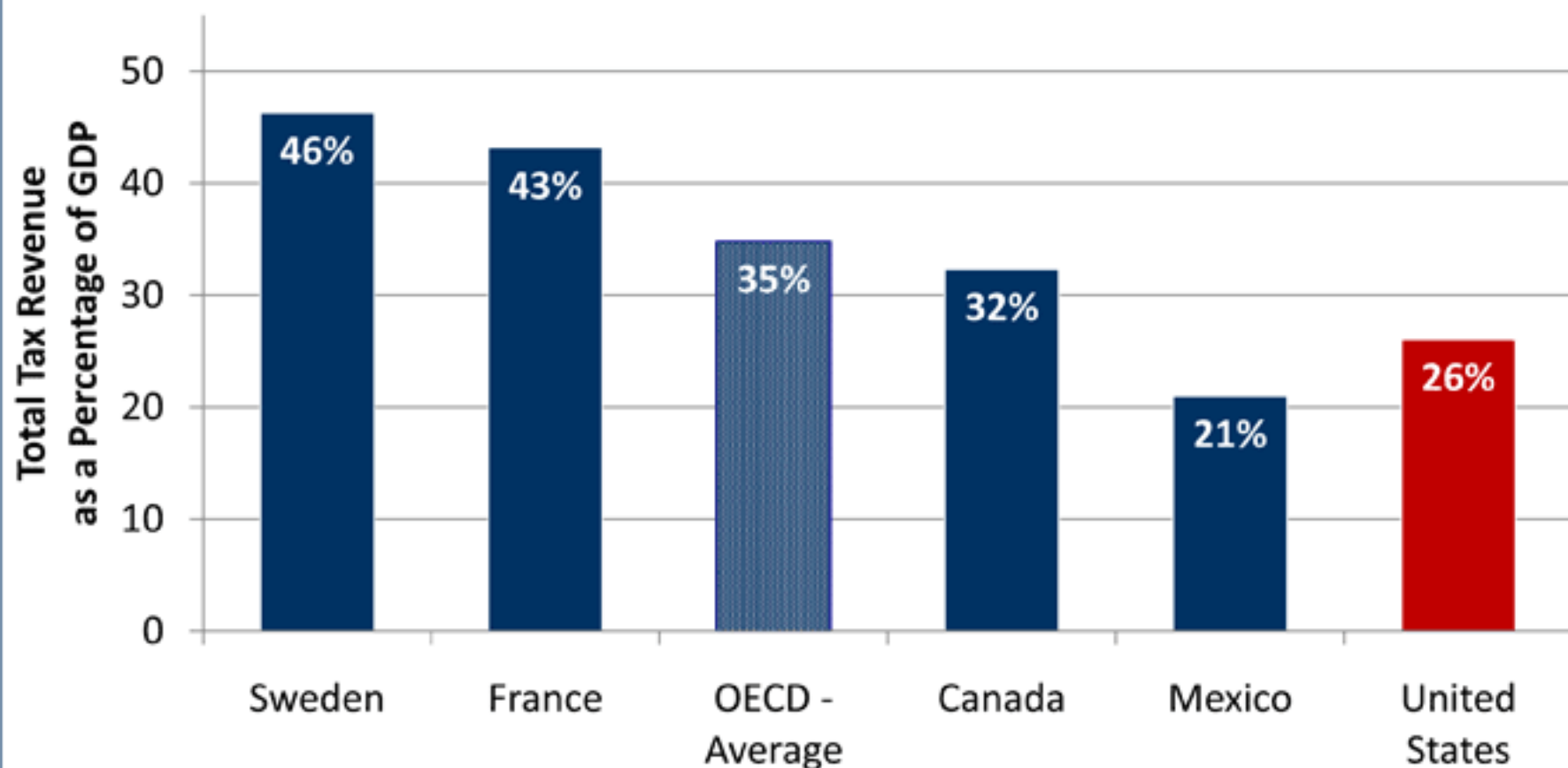


* Primarily composed of customs/duties fees and deposits of earnings by the Federal Reserve system.

** Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad Social Security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

Source: U.S. Senate Joint Committee on Taxation

Total tax burdens are lower in the U.S. than many other industrial countries



SOURCE: Data from OECD Statistics Extract. Compiled by PGPF.

NOTE: Data for each country is as of 2008. OECD is the Organization of Economic Cooperation and Development. Total tax revenue includes federal, state and local. Numbers shown are as percent of GDP.

Is the tax system fair?

- Concepts of tax equity
- Equity across income classes
- Tax burdens over time

Concepts of Equity

- Horizontal
- Vertical
- *Effective tax rate* (ETR) = taxes paid as % of income

How does this vary with income?

- » Progressivity: ↑
- » Proportionality: =
- » Regressivity: ↓

Graduated Rate Structure

- Marginal income tax rates in 2007 for two types of filers:

If your filing status is Single

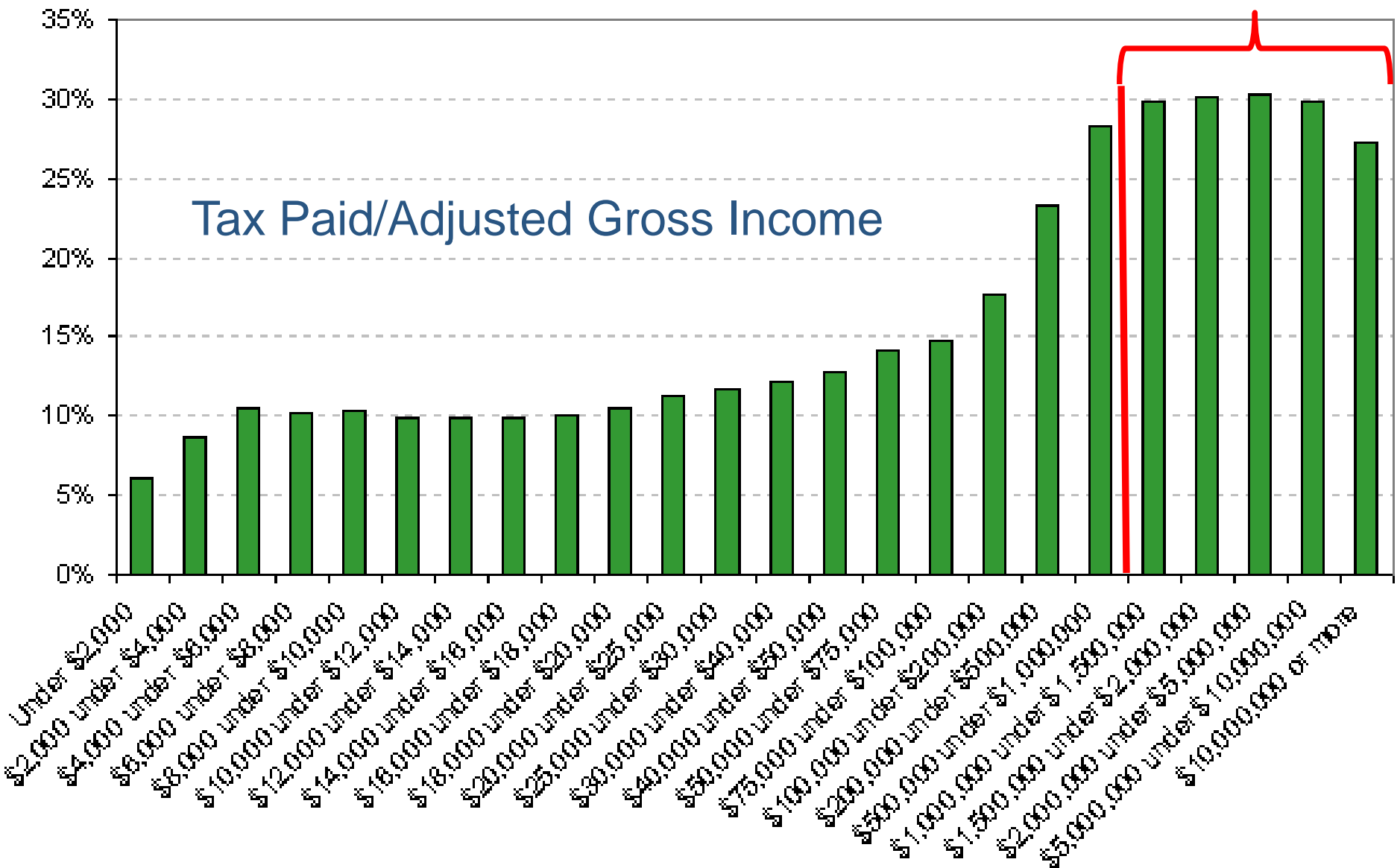
<u>Taxable Income</u>		
<u>But not</u>		
<u>Over ---</u>	<u>over ---</u>	<u>Marginal Rate</u>
\$0	\$7,825	10%
\$7,825	\$31,850	15%
\$31,850	\$77,100	25%
\$77,100	\$160,850	28%
\$160,850	\$349,700	33%
\$349,700	and over	35%

If your filing status is Married filing jointly

<u>Taxable Income</u>		
<u>But not</u>		
<u>Over ---</u>	<u>over ---</u>	<u>Marginal Rate</u>
\$0	\$15,650	10%
\$15,650	\$63,700	15%
\$63,700	\$128,500	25%
\$128,500	\$195,850	28%
\$195,850	\$349,700	33%
\$349,700	and over	35%

Average Effective Tax Rates for Various Income Ranges in 2009

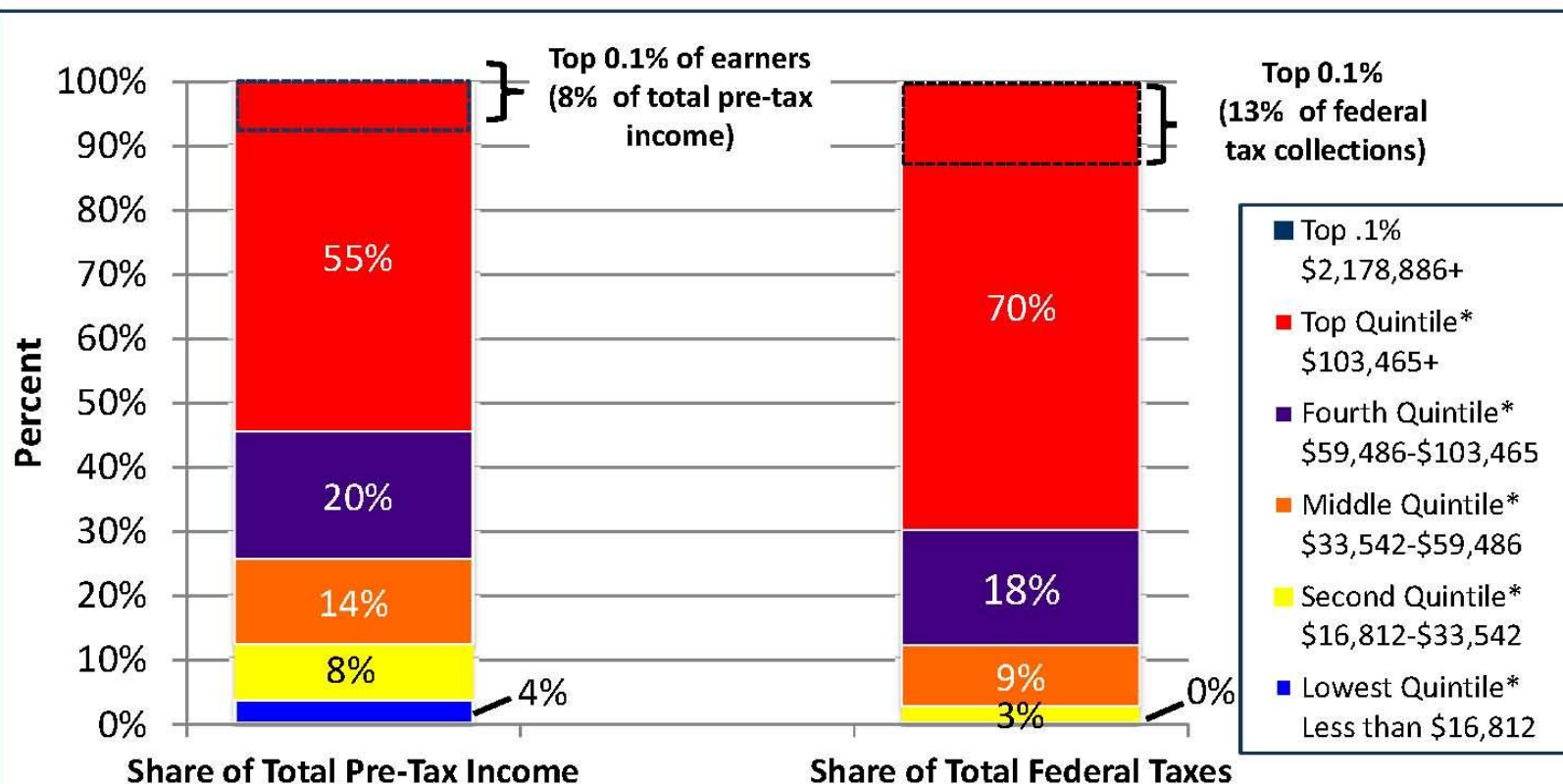
Above \$1M



Source: Daniel Indiviglio, *The Atlantic*, Sept 22, 2011

<http://www.theatlantic.com/business/archive/2011/09/chart-of-the-day-do-the-rich-really-pay-less-in-taxes/245531/>

High-income households earn a disproportionate share of pre-tax income and pay an even larger share of total federal taxes

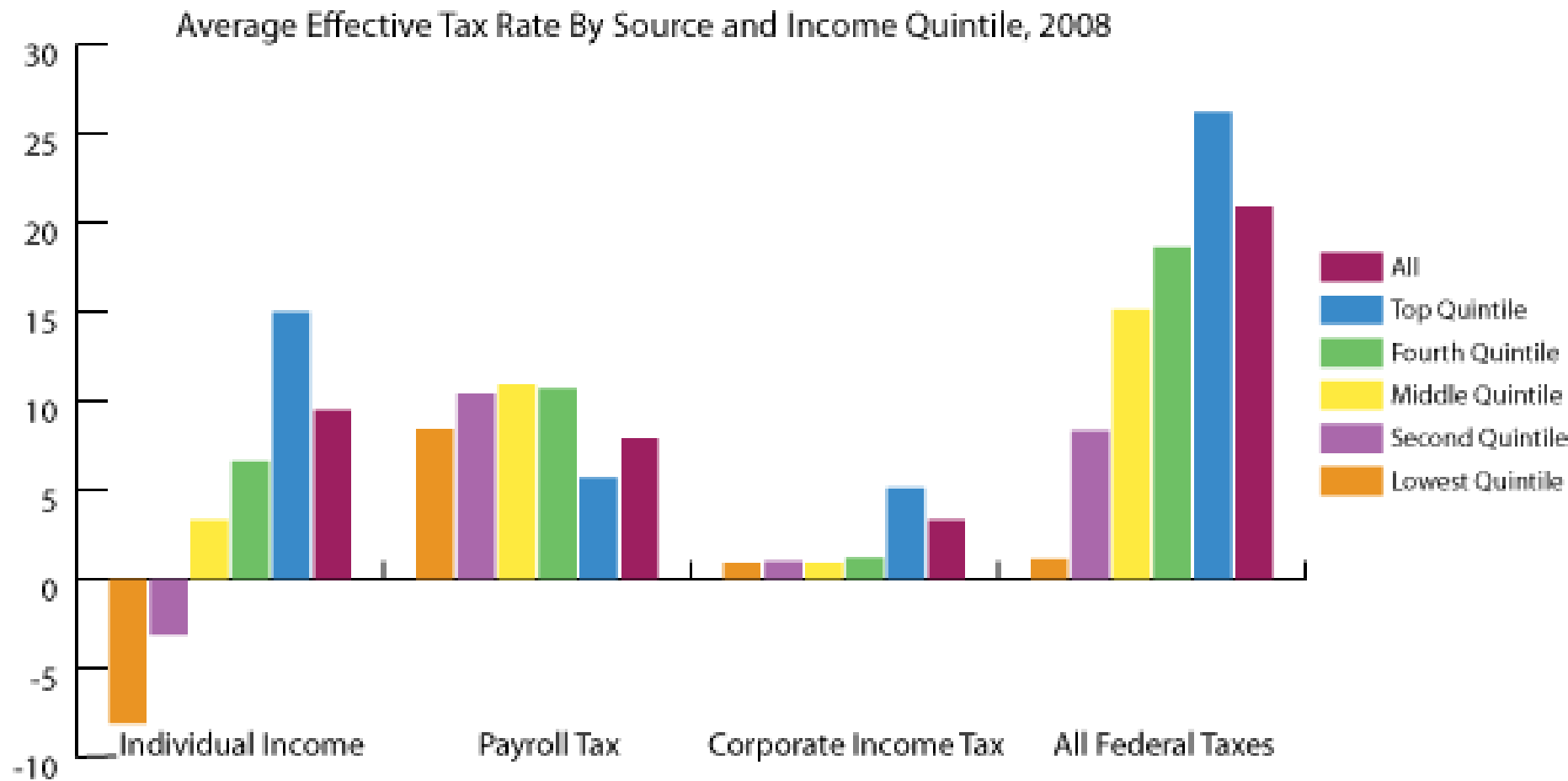


*A quintile is one fifth of the distribution. The top quintile is the richest 20% of households, while the bottom is the poorest 20%.

SOURCE: Tax Policy Center, *Share of Federal Taxes Under Current Law, By Cash Income Percentile*, 2010; August 2009. Compiled by PGPF.

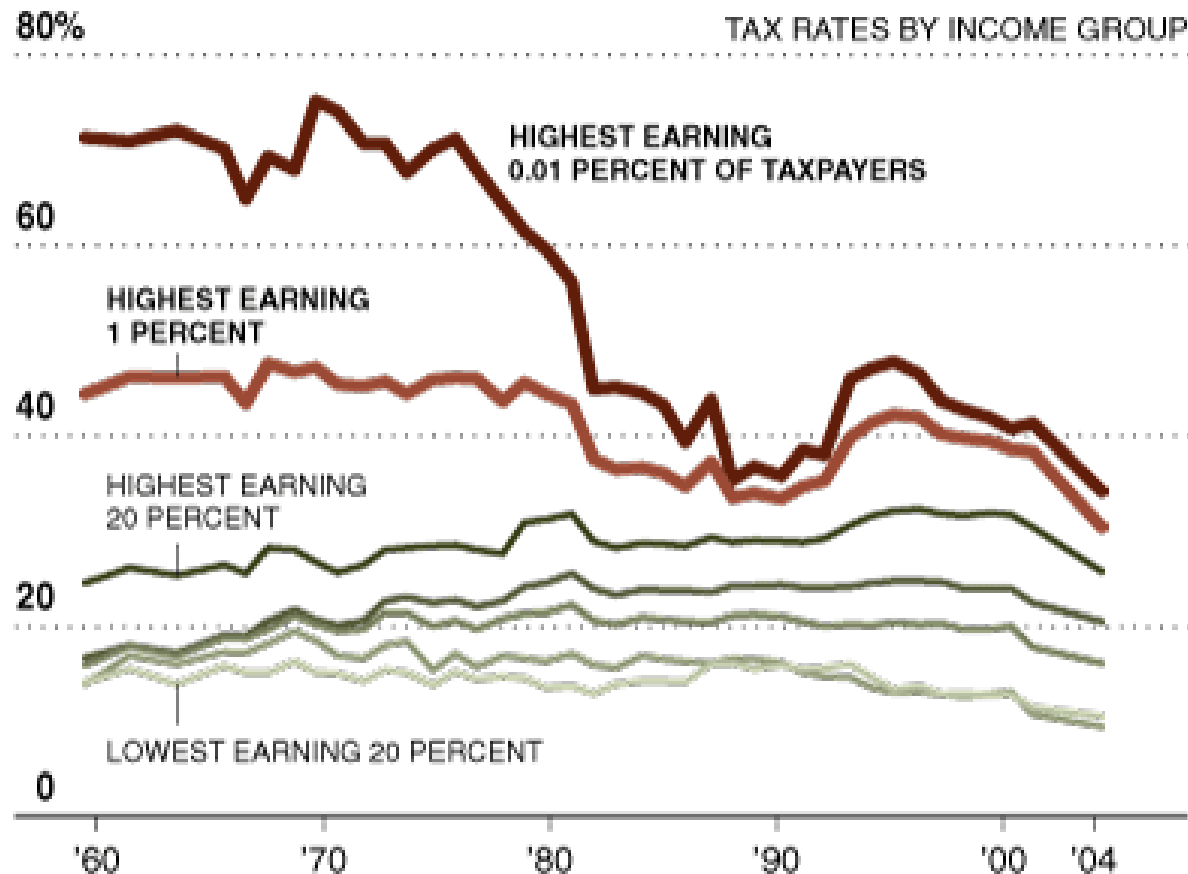
NOTE: Data for Cash Income in 2010, but in 2009 dollars.

How Do Federal Taxes Compare?



Lower Taxes for the Highest Earners

Since the 1960s, the total federal tax rate has fallen for low earners, risen for relatively high earners and fallen significantly for very high earners.



Numbers include income taxes, capital-gains taxes, payroll taxes, estate taxes, gift taxes and corporate taxes (which are effectively paid by stockholders). 2004 tax rates are based on 2004 tax law applied to 2000 income adjusted for income growth.

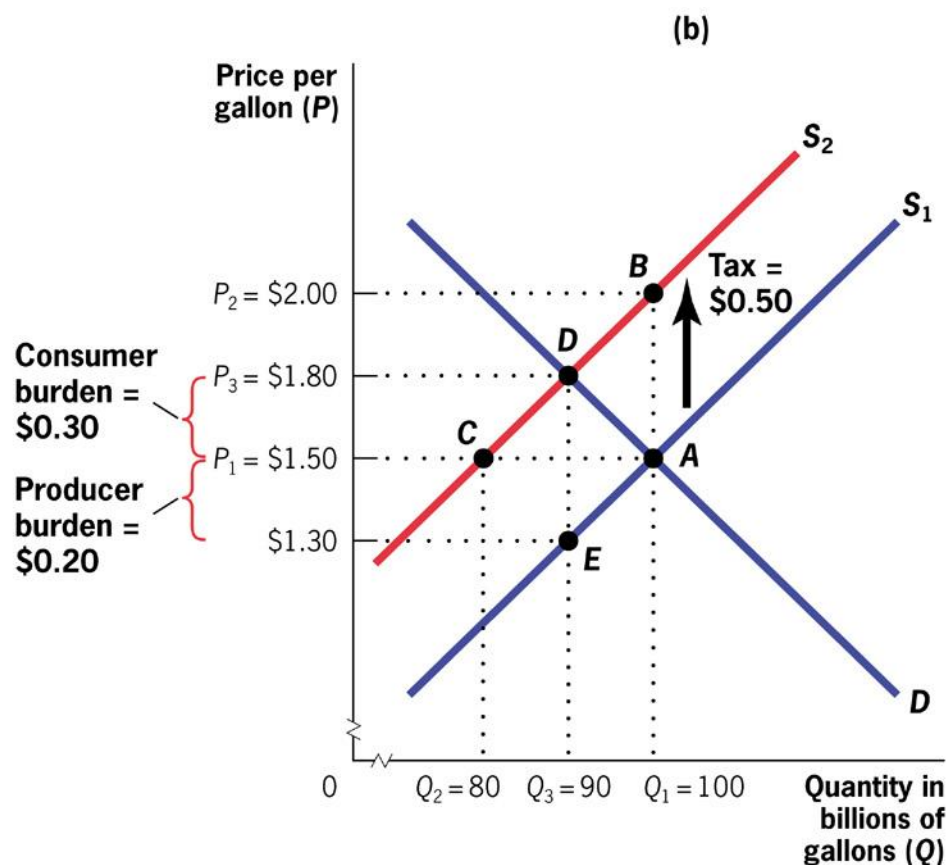
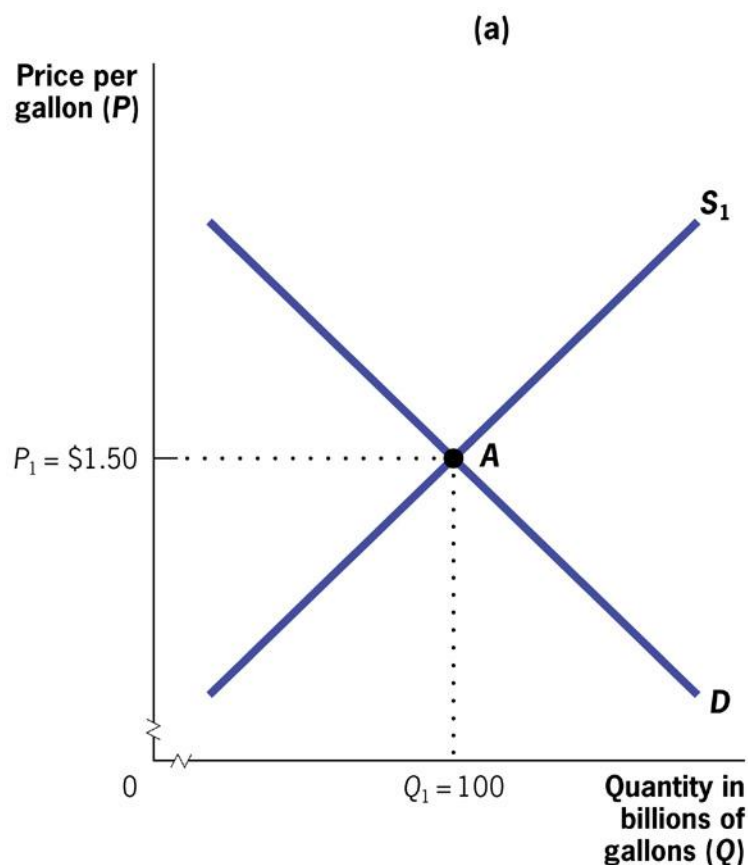
But Who Pays, *Really*?

- Who pays
 - » Payroll tax?
 - » Sales tax?
 - » Corporate income tax?
- Statutory and economic incidence are NOT the same thing
- Can shift taxes forward (to buyers) or backward (to suppliers)
- Affects distribution of tax burdens

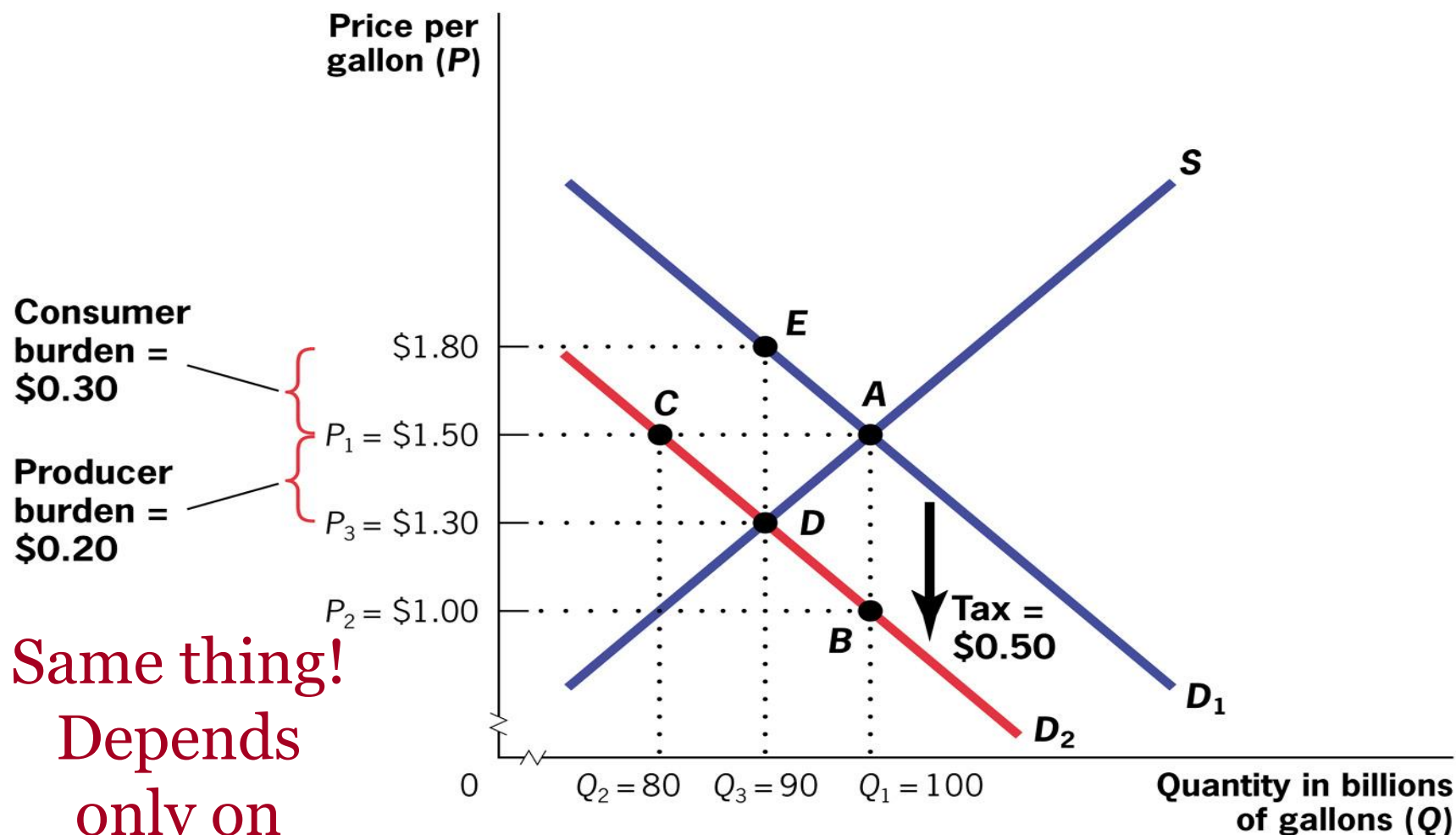
What Determines Tax Incidence?

- Depends on *elasticities*
= % change in quantity supplied or demanded relative to % change in price
 - » Taxes are a hot potato
 - » Parties with *inelastic* supply or demand bear taxes
 - » Parties with *elastic* supply or demand avoid taxes
- Corporations aren't people in the tax world

Example: Who Bears a \$0.50 Gas Tax on Sellers?



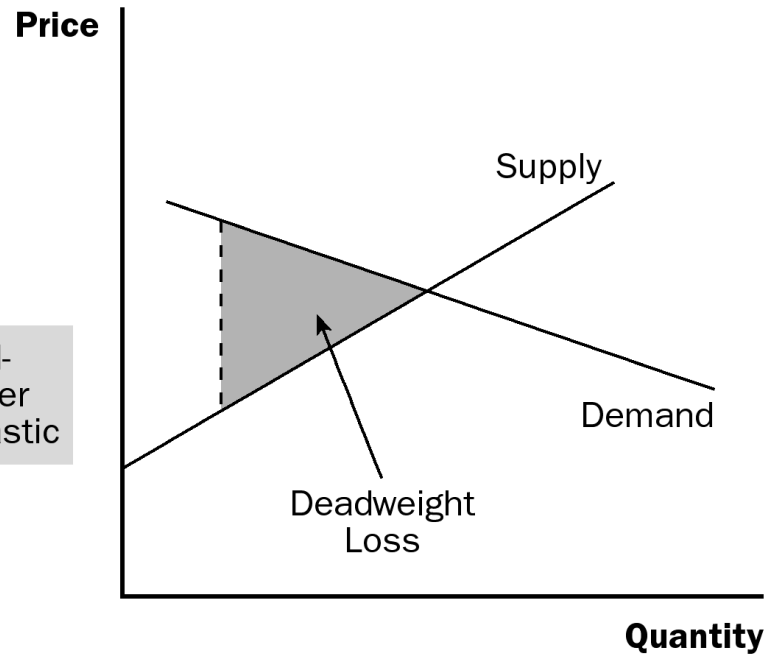
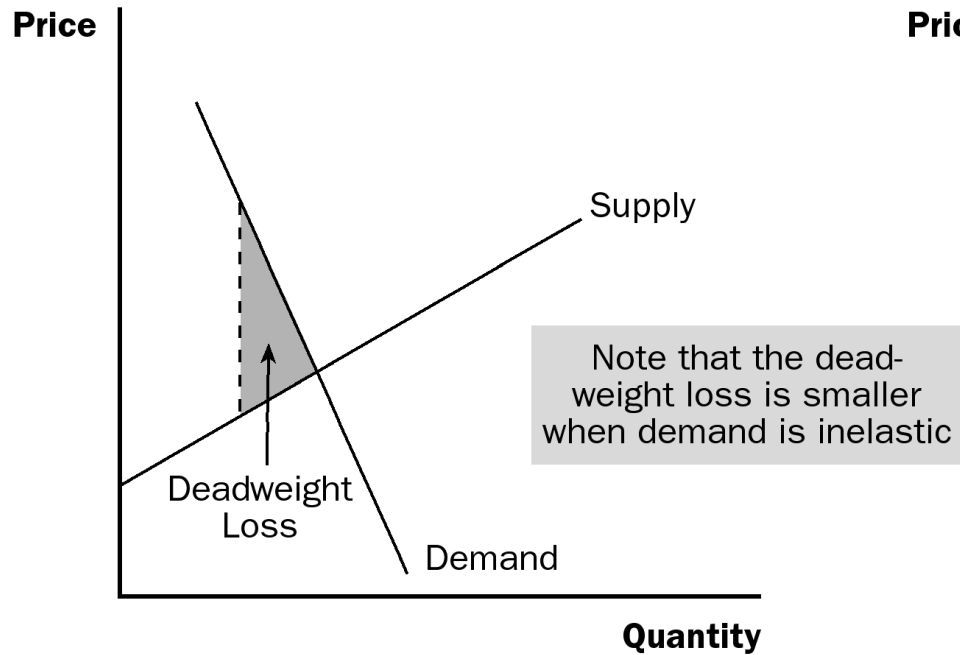
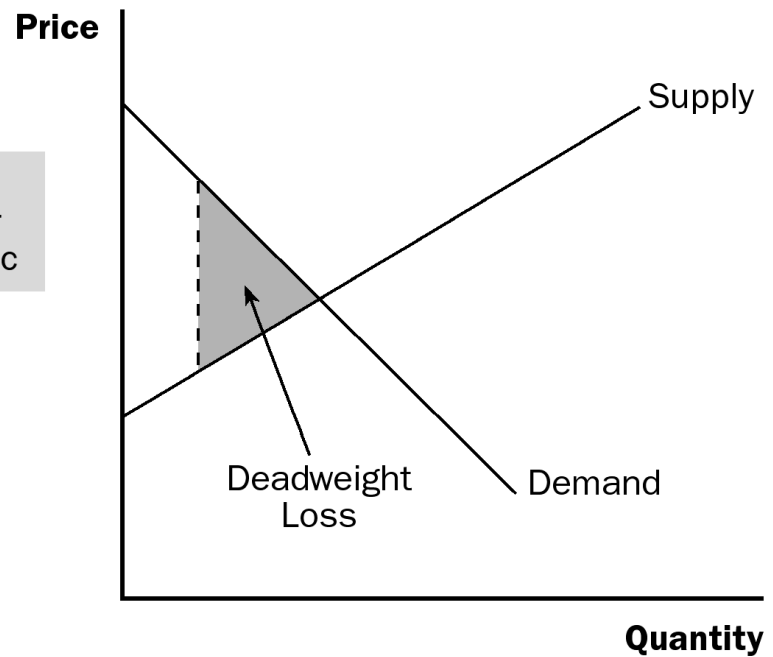
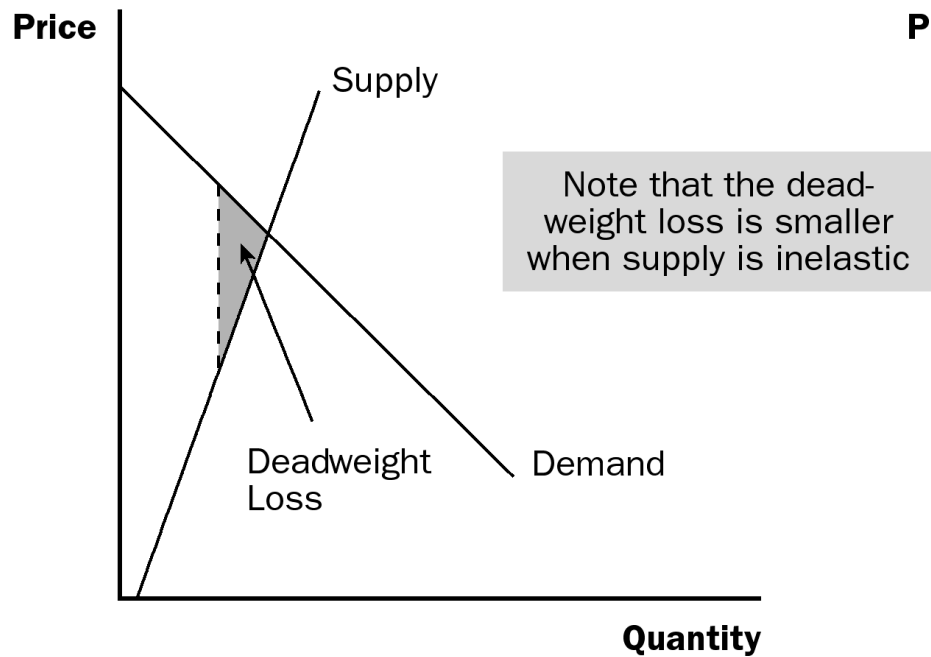
What If \$0.50 Gas Tax on *Buyers*?



Same thing!
Depends
only on
elasticities

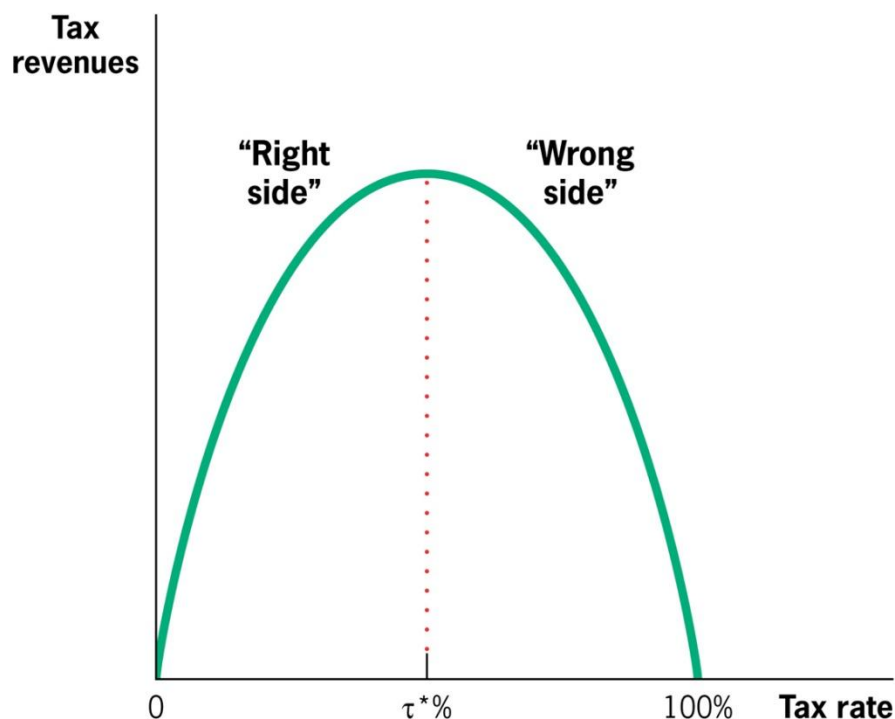
Does the tax system create inefficient incentives?

- Taxes can change behavior in many ways:
 - » Labor vs. leisure
 - » Business organization
 - » Business location
 - » Consumption choices (health insurance, home purchase)
 - » Investment and savings
- Why do we care?
 - » Behavioral responses can reduce revenue and promote inefficient consumption patterns



Taxes and Labor Supply

- Relationship between tax revenue and tax rates is not linear
- At the extreme, it may be *negative* (Laffer curve)



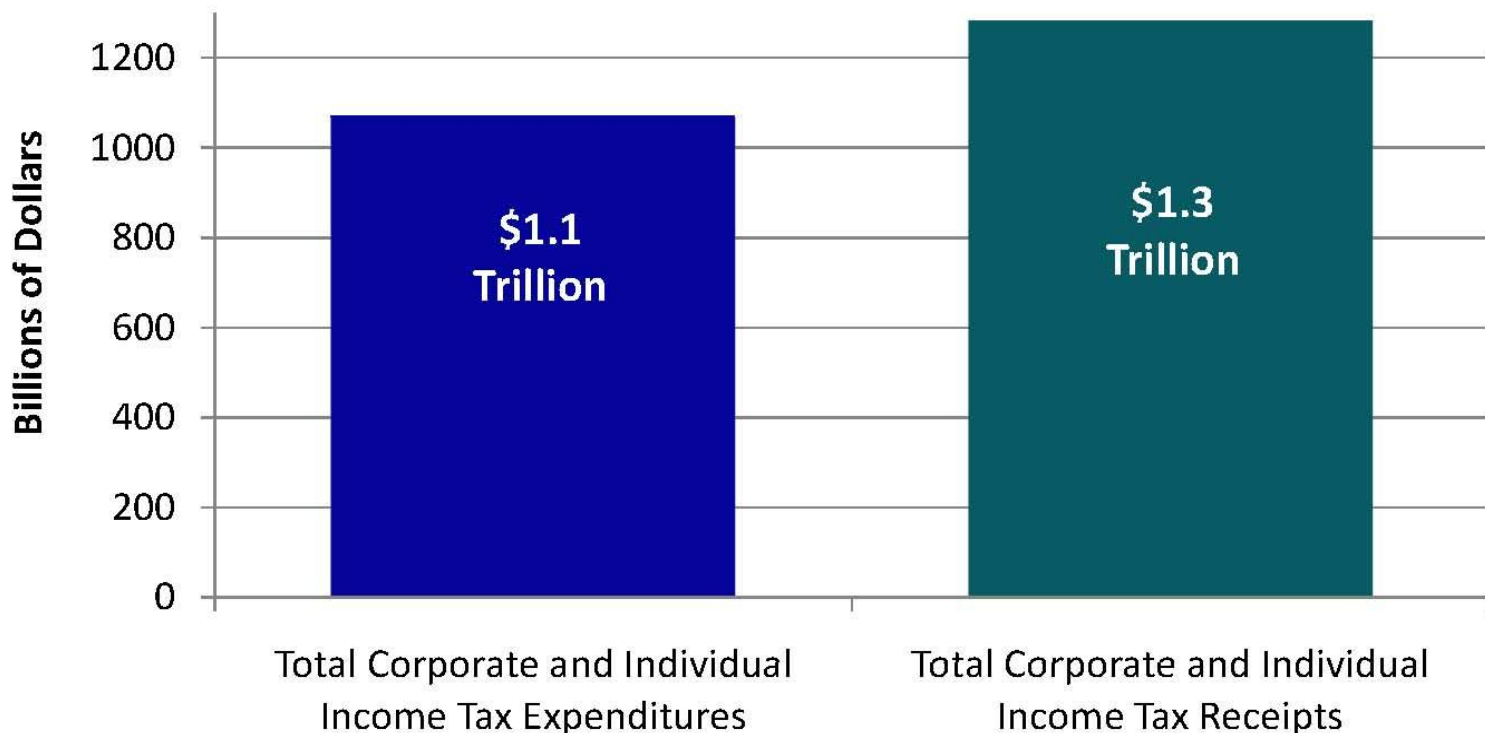
Corporate Income Tax Issues

- “Double taxation” of dividends
- Capital depreciation
- Defining the base
 - » Transfer pricing
 - » Advance pricing agreements
 - » Income apportionment

Reducing the cost of raising revenue

- Size of dead weight loss depends on:
 - » Tax rate
 - » Size of market
 - » Elasticities or sensitivity of demand and supply to prices
- We want to:
 - » Use *broad-based* taxes with *low rates*
 - » Limit tax expenditures
 - » Tax those who are least responsive

We lose about as much revenue from tax expenditures as we receive in individual and corporate income taxes



SOURCE: Data derived from a Tax Policy Center paper, "How Large Are Tax Expenditures?" by Donald Marron (March 2011), and the Congressional Budget Office, *Budget and Economic Outlook: An Update*, August 2011. Compiled by PGPF.

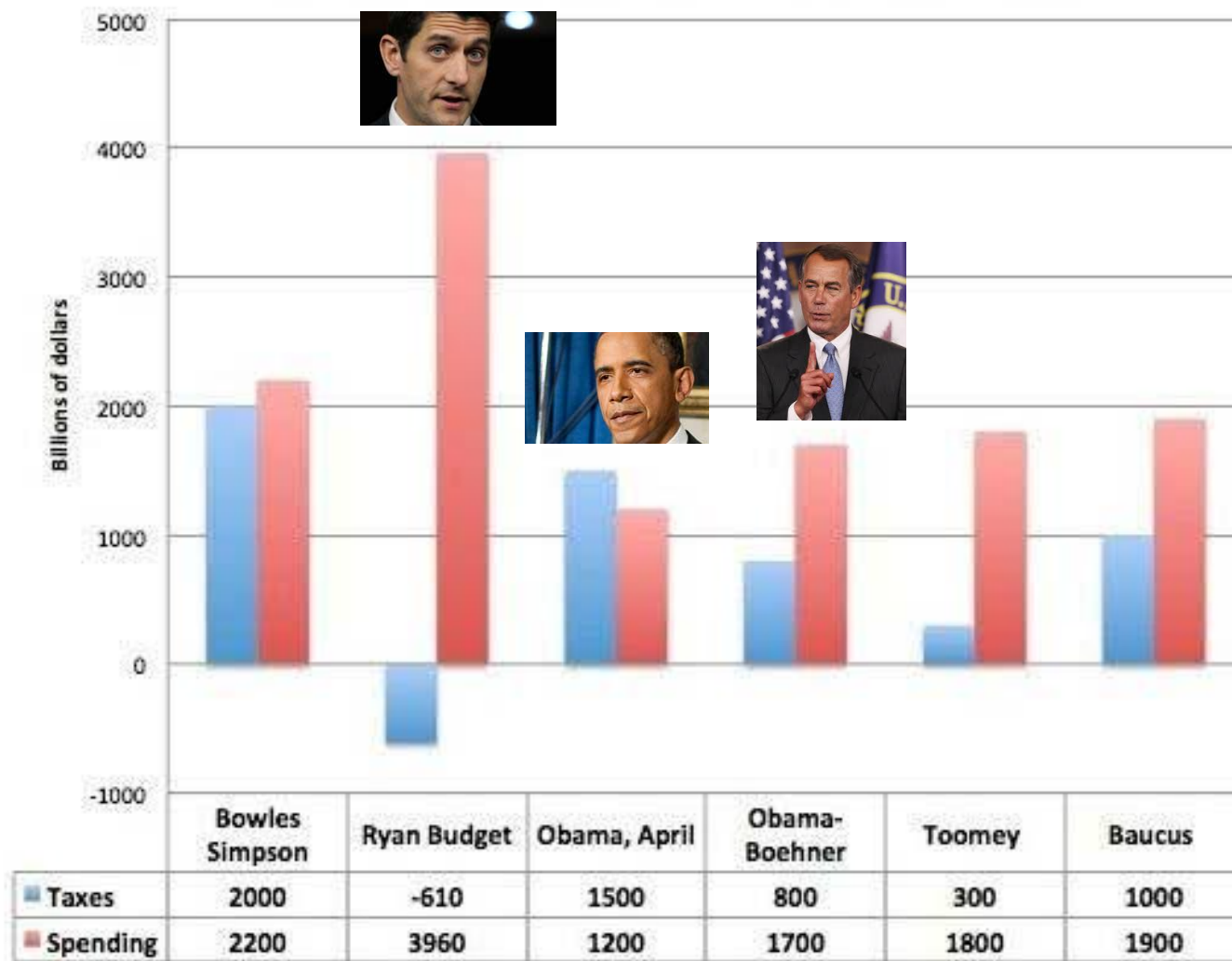
NOTE: All figures reflect fiscal year 2011 projections.

Five individual tax provisions account for more than half of annual income tax expenditures

Top 5 Tax Expenditures	Estimated Tax Revenue Foregone (FY 2011)
1. Exclusion of employer provided health insurance from taxable income.*	\$282 billion
2. Exclusion of pension contributions and earnings.**	\$134 billion
3. Deduction of mortgage-interest on a primary residence.	\$89 billion
4. Deduction of non-business state and local taxes (includes income, property and sales taxes)	\$57 billion
5. Step-up basis of capital gains at death	\$51 billion
Total of Top 5	\$612 billion
<p>SOURCE: Data from the Office of Management and Budget, <i>Budget of the United States Government: Fiscal Year 2012, Analytic Perspectives</i>, February 2011. Compiled by PGPF.</p> <p>NOTE: Numbers may not add due to rounding.</p> <p>* Includes the exclusion from payroll taxes and income taxes.</p> <p>** Includes employer pension plans, employee and employer contributions to 401k plans, IRAs, and Keough plans.</p>	

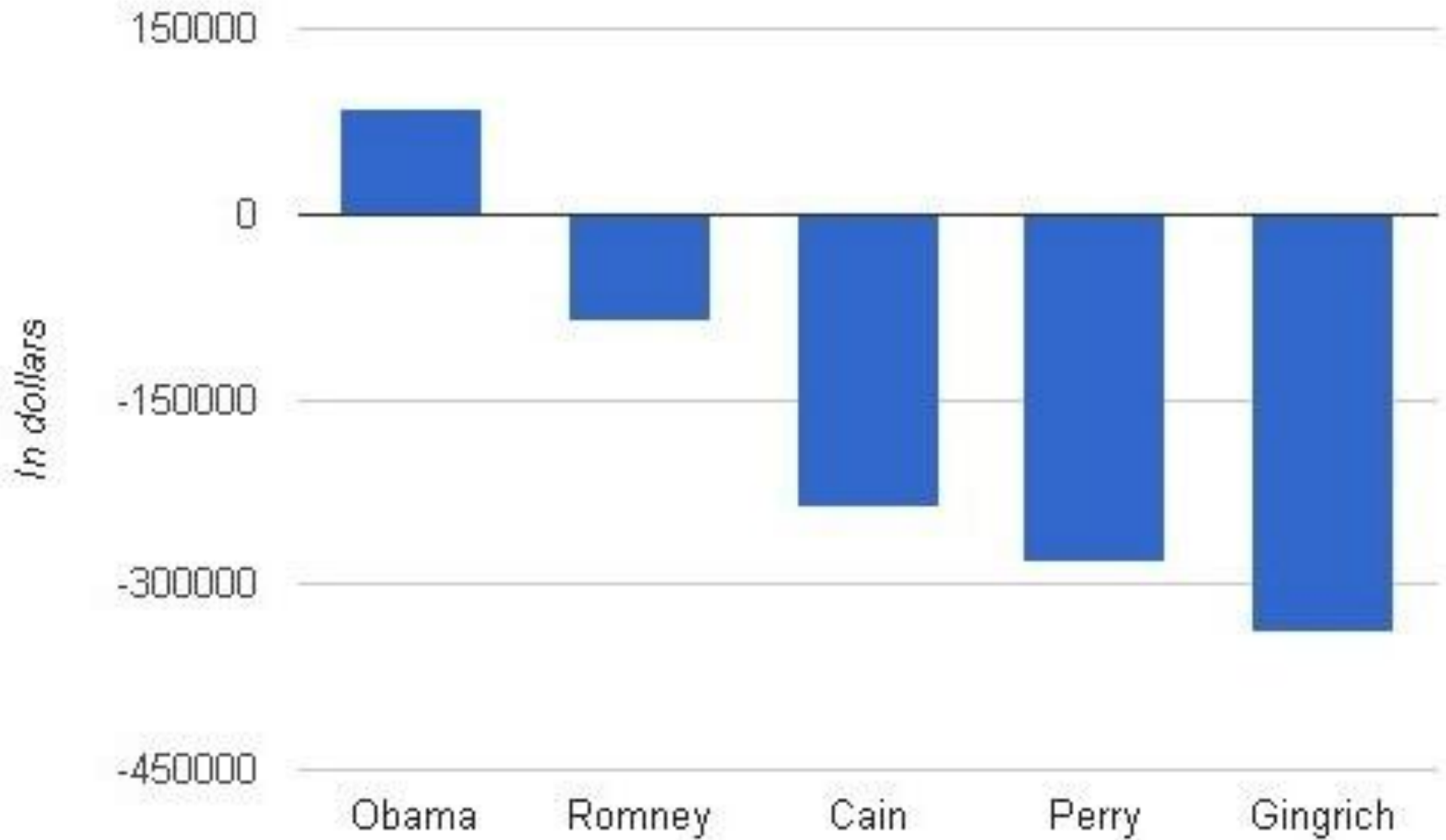
So what do we do?

- Simpson-Bowles
 - » Bipartisan tax commission appointed by President Obama
 - » Failed super-majority vote and didn't win White House support
- Rivlin-Domenici
 - » Bipartisan Policy Center project
- Republican candidates



Source: Ezra Klein, Washington Post

Tax change for the top 1%



Data: Tax policy center

The Bowles-Simpson Commission's recommendations show that broadening the tax base by eliminating tax expenditures would permit lower tax rates **and** higher revenue

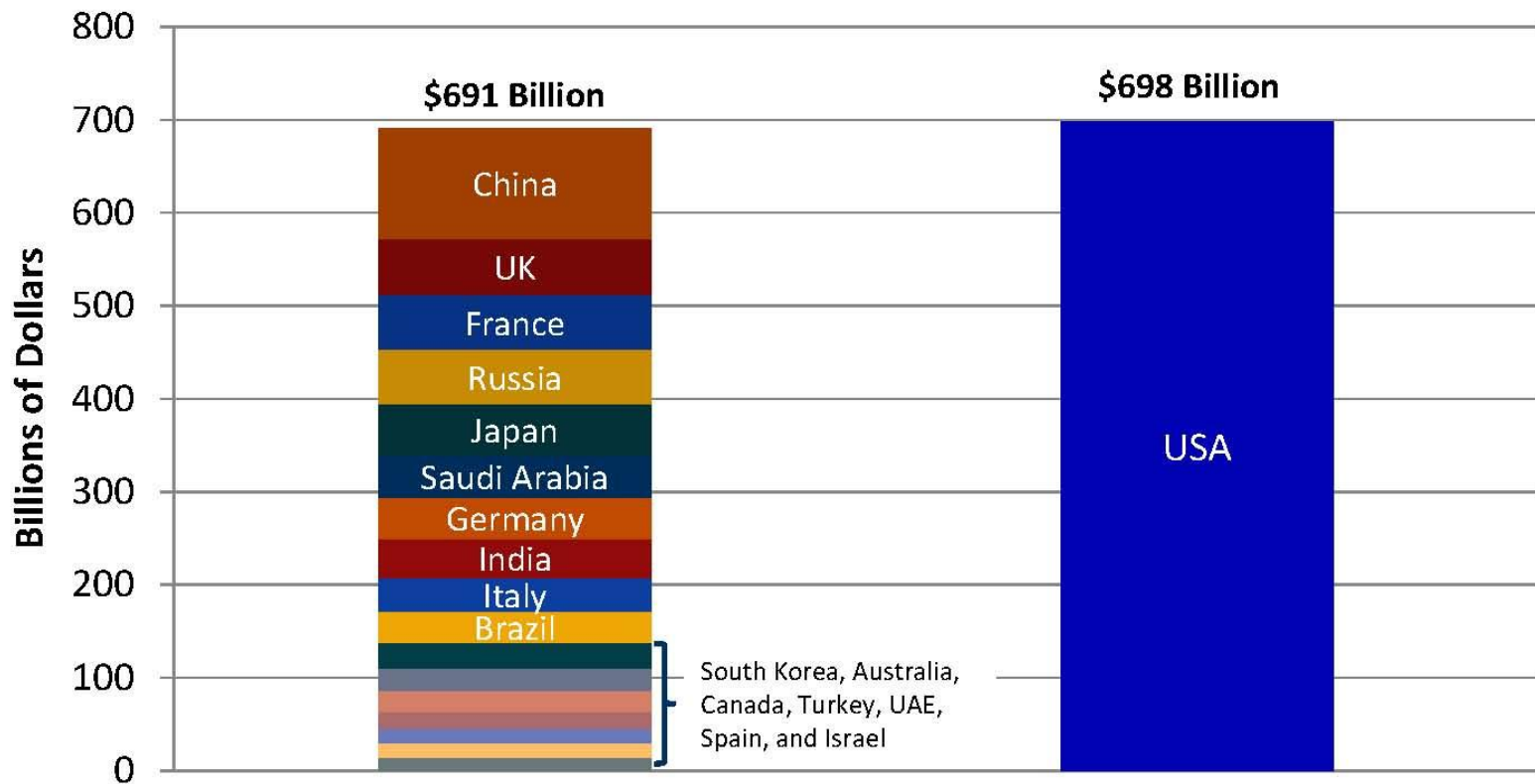
	Current: Through December 2012	Scheduled: Beginning January 2013	Eliminate All Tax Expenditures ^{a/}	Eliminate all but child tax credit and EITC ^{a/}	Eliminate all but selected tax provisions ^{a/b/}
Lowest Rates	10% 15%	15%	8%	9%	12%
Middle Rates	25% 28%	28% 31%	14%	15%	22%
Top Rates	33% 35%	36% 39.6%	23%	24%	28%
Top Corporate Rate	35%	35%	26%	26%	26%

SOURCE: National Commission on Fiscal Responsibility and Reform, December 2010.

^{a/} Dedicates \$80 billion to deficit reduction in 2015, growing to \$180 in 2020, and taxes capital gains as ordinary income.

^{b/} The Commission's illustrative plan permanently repeals the alternative minimum tax, eliminates itemized deductions, provides a non-refundable tax credit of 12% to all taxpayers and caps the interest deduction to mortgages no larger than \$500,000 for primary, owner-occupied residences, caps exclusion of for employer-sponsored health insurance at 75th percentile of premiums, frozen in nominal dollar terms through 2018, and limits deductions for charitable contributions and interest from state and local bonds.

The U.S. spent more on defense in 2010 than did the countries with the next 17 highest defense budgets combined



SOURCE: Data from Stockholm International Peace Research Institute, *SIPRI Military Expenditure Database*. Compiled by PGPF.

NOTE: Dollar figures are in billions of 2010 constant U.S. dollars.

Add a new revenue instrument?

- Value Added Tax (VAT)
 - » Recommended by Rivlin-Domenici
 - » Collected at intermediate stages of production
 - » Every firm gets to claim refund for taxes paid on purchases
 - » Final burden borne by consumer
- Carbon tax

Conclusion

- Current fiscal path poses damaging levels of federal debt
- “No new taxes” equals “Yes new deficits” without massive spending reductions
- Tax composition and levels matter
- Broader base, lower rates are more economically efficient
- Good luck