Taxation

11/19/07

1

Tax Policy: Indictment of current system

• “Nightmare of complexity”
  – 1955 Income Tax code had 172,000 words with another 547,000 words of Federal Tax Regulations explaining the code. By 2005 those numbers had grown to 1,286,000 words with another 5,778,000 words for the Tax Regulations (growth of about 4.5% per year).
  – Many more thousands of pages of Tax Court cases
    • These detail the courts’ findings when the IRS and taxpayers disagree on what the tax laws mean, or what the regulations mean.
  – 480 separate tax forms, plus 280 more publications to explain how to fill out the 480 forms.
    • This may be an exaggeration, if it counts publications in Spanish as different from those in English.
  – A few years back, the US Income Tax used 336 feet of shelf space in Stanford library.

11/19/07

2

Tax Policy: Indictment of current system

• Who benefits?
  – Members of Congressional tax writing committees, who get much higher campaign contributions than other senators and representatives.
  – 70,000 Washington lobbyists
  – Several hundred thousand tax lawyers, tax accountants, sellers of tax shelters and tax software, tax preparers.

• Who loses?
  – Public, in 3 main ways:
    • The hundreds of thousands of bright people working on tax avoidance and deterring tax avoidance, instead of doing productive work.
    • The cost of tax compliance
    • The cost of distorted choices as people respond to economic signals distorted by taxes

11/19/07

3

Tax Policy: Indictment of current system

• Direct cost of compliance
  – Average time spent on completing individual tax returns (including maintaining records needed): 25.5 hours per taxpayer (in 2000)
  – Average amount spent for tax professionals, software, etc., per taxpayer: $149 (in 2000)
  – Must add cost of audits, litigation, correcting errors made by IRS advisors (wrong answers to taxpayer inquiries).

11/19/07

4

Tax Policy: Indictment of current system

• Indirect cost of compliance
  – Disincentive costs
    • Corporate income tax leads to double taxation of dividend income but not of interest income.
      – Encourages corporate debt over equity investment.
      – Overall, discourages saving
    • Discourages work
      – Consider the problem facing awife whose kids are growing up, thinking of returning to work.
      – If husband has high earnings, her first $ of earnings can face a marginal tax rate of 31% or 39% (plus state tax rate, plus social security tax rate).
    • Best estimates of cost to economy of one extra dollar of taxes is 30%, or more.

(continued)

11/19/07

5

Tax Policy: Indictment of current system

Indirect cost of compliance (cont.)

• Tax evasion
  – Not a direct social cost, though it carries indirect costs as cheating becomes socially acceptable and voluntary compliance goes down.
  – “Legal sector tax gap” that can be discovered by Federal auditors (Failure to pay taxes on legal activities that auditors could catch with intensive audit) is estimated to be about $80 billion in 2001.
  – Much of the cheating, and of social acceptance of cheating, comes from perceived high rates and unfairness of system.

11/19/07

6
Indirect cost of compliance (cont.)

• Tax avoidance
  – Taking advantage of tax law to save on taxes.
  • Distorts expenditure choices.
  • E.g., if I buy a new computer, deductible as a business expense, rather than a new TV, which isn’t. Or I buy a new chair for my home office, also deductible, rather than a new armchair for my bedroom.
  • I buy a house rather than rent an apartment (property tax deduction, mortgage interest deduction).
  • I buy a car with a loan financed by home equity loan (interest deduction).
• Total cost about $280 billion on $625 billion tax (1993 numbers): 45% of funds collected.

History of income tax

• Not important before 20th century
  – Government spending was about 3% of GNP
  – Financed mainly by excise taxes and customs duties
  – Civil War led to first income tax (1861):
    • $600 exemption
    • 3% on first $10,000 of income, 5% over that.
    • Expired in 1872.
  – Later attempt in 1894
    • $4,000 exemption, 2% on higher incomes
    • Held unconstitutional: Art. 1, §2, ¶3 says that all direct taxes must be levied among the states in proportion to population.

History of income tax

• Led to 16th Amendment, introduced in 1909 and ratified in 1913, allowing Congress to tax incomes
  – “from whatever source derived,” without apportionment among the several States, and without regard to any census or enumeration.”
• Tax introduced the same year, 1913:
  – $3,000 exemption for singles, $4,000 for married couples.
  – 1% on first $20,000, up to 7% on income over $500,000.
  – Corporate profits taxed at 1%.
  – Personal exemptions protected 99% of population from paying taxes.

History of income tax

• WWI led to amendments one year later
  – Lowered the exemption so that about 20% of people owed taxes
  – Raised minimum rate from 1% to 6%.
  – Raised maximum rate from 7% to 77% on income over $1 million.
• Lowered maximum rate in ’20s, which led to a more progressive system
  – In 1921, incomes over $100,000 paid 28% of tax. In 1926, they paid 51%.
  – In 1921, those with income under $10,000 paid 23%. In 1926, they paid 5%.
  – What possible explanations?

History of income tax

• Raised rates in the depression of the 1930s, and then again in WWII.
  – Top bracket increased to 94%. Was at 91% until the early 1960s.
• Since WWII:
  – Was at 91% from Korean War (early 1950s) until the early 1960s.
  – Kennedy lowered rates from 20% - 91% to 14% - 70%.
  – In 1981, Reagan lowered rates to 11% - 50%.
  – In 1986, simplified tax, eliminated deductions, and changed to just 2 rates, 15% and 28%.
  – An additional 31% rate was added under George H. W. Bush, then
  – A maximum rate of 39.6% was added by Clinton.
  – Current rates range from 10% to 35%.

Fairness and economists

• Economists aren’t able to make professional judgments on “what’s fair”.
• So, as any competent expert would do, we change the terms of debate:
  – What’s equitable?
    • Horizontal equity: Equal treatment of equals
    • But, who are equals?
    • Current tax law distinguishes
    • Higher income means higher tax
    • (continued on next slide)
Fairness and economists (cont.)

- Among those with equal income (horizontal equity):
  - Taxpayers with high medical costs should be given a tax break.
  - Taxpayers with more children should be given a tax break.
  - Taxpayers with high casualty loss (e.g., flood or wind damage) should be given a tax break.
  - Taxpayers who donate to charity should be given a tax break.
  - Taxpayers who invest in municipal bonds should be given a tax break!
  - Taxpayers who face higher commuting cost should not be given a tax break.
  - Taxpayers who had to invest thousands of $ in education cost to get their job should not be given a tax break.

Vertical equity: “Appropriate” increase in tax with increasing [taxable] income, based on ability to pay.
- Equal treatment of equals is easy to agree on.
- There is no comparable standard that all would agree on, to judge ability to pay.
- “Ability to pay” has led to the highest tax rate being 39.6%, as today, and 28%, and 96%.

Terminology of Taxation

- Two [four] concepts of tax rate
  - Average rate (total tax divided by total [taxable?] income, = tax burden.
  - Marginal rate (additional tax per $1 of additional [taxable?] income)

Progressive tax system v. graduated tax rates
- Our system has graduated rates on taxable income. 
  - Graduated rates do not necessarily mean a progressive tax system because of tax deductions for the rich.
  - A constant marginal rate can mean a progressive tax system:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
<th>Tax burden</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$500</td>
<td>5%</td>
</tr>
<tr>
<td>20,000</td>
<td>2,500</td>
<td>12.5%</td>
</tr>
<tr>
<td>30,000</td>
<td>4,500</td>
<td>15%</td>
</tr>
</tbody>
</table>

comes from a 20% constant tax rate and $7,500 exemption.

But notice that the progressivity drops off fast:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
<th>Tax burden</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,00</td>
<td>$18.50</td>
<td>18.5%</td>
</tr>
<tr>
<td>200,000</td>
<td>38,500</td>
<td>19.25</td>
</tr>
<tr>
<td>300,000</td>
<td>58,500</td>
<td>16.5%</td>
</tr>
</tbody>
</table>

The tax base
- “Total income” could mean Gross domestic product.
  - Gross?
  - Domestic?
- Economist’s usual definition (Henry Simon):
  - Amount the taxpayer could spend without diminishing wealth.
    - Capital gains?
    - Inflation?
    - Doesn’t consider issue of fairness, of whether or not all income should be taxed.
Terminology of taxation

• Difference between tax base and economic income (loopholes if you disapprove, tax preference items if you approve).
  – Exemptions
    • $3,400 per person in 2007, less for high incomes
    • Raises marginal tax rates above the official top marginal tax rate of 35%
  – Standard deductions
    • Std. deduction $5,350 for single, $7,850 for HH, $10,700 for married filing jointly; more for old or blind.
    • Std. deductions are intended to save most people the bother of keeping track of receipts for deductible expenses.

Or (continued on next page)

Difference between tax base and economic income

– Exclusions (Unrealized capital gains, retirement contributions, health costs paid through employer etc.)
– Credits
  • Government in effect pays these expenses since they give a $1 for $1 reduction in tax liability.
  • Child and dependent care credit (maximum of 35% of capped care expenses, declining to 20% for those with AGI over $43,000).
  • Some education expenses for those with income under $110,000.
  • Other misc. credits: adoption credit, foreign tax credit, alternatives from AMT credits as qualified electric vehicle credit, residential energy credits …
  • And, perhaps most significant, the Earned Income Tax Credit: (see next page)

Current impact of AMT

<table>
<thead>
<tr>
<th>Bottom of income range</th>
<th>Top of income range</th>
<th>% of taxpayers affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$500,000</td>
<td>93%</td>
</tr>
<tr>
<td>$75,000</td>
<td>$100,000</td>
<td>73%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$75,000</td>
<td>37%</td>
</tr>
</tbody>
</table>
Alternative Minimum Tax

• For the AMT taxpayer must recalculate taxable income to include
  – Personal exemptions
  – State income tax or sales tax
  – Real estate taxes
  – Home loft interest
  – Miscellaneous deductions
  – Profit on stock options received (not taxed under ordinary income tax until sold)
  – Exemption of $62,500 for married couple, then taxed at 26% (28% for very high income)
  – Pay difference between ordinary income tax and AMT as additional tax.

Alternative Minimum Tax

• Since AMT started to bite, Congress has provided annual “patches” to give temporary, 12-month relief to soften the impact.
  • House has passed bill to do so again in 2007, but Senate has not agreed.
    – Problem is that House has taken a pledge to preserve a balanced budget.
    – So to finance reduction in AMT, they must find a tax increase.
      • Settled on eliminating a tax break now given to investment fund managers.
      • Senate doesn’t support it, and President doesn’t support it (lobbying pressure from investment funds)
      • President argues that they should simply ignore the deficit that changing the AMT will create.

Alternative Minimum Tax

• Proposals to fix AMT on reading list are from Tax Policy Center, of the Urban Institute and Brookings Institution (both liberal think tanks)
  • Says that extending the 2006 “temporary fix” to 2007 would keep no. of taxpayers at about 4 million for 1 more year
    – But would cost $40 billion, with amount increasing in subsequent years.
  • Alternative is to design permanent fix.

Alternative Minimum Tax

• We will not review the alternative permanent fixes in detail.
  • However I will ask:
    – Why has Congress not undertaken a permanent fix in the past, but simply postponed the problem by a year?
    – Why did Congress set President Bush’s tax cuts of 2001 to expire in 2010?

Fair tax

• Initially designed by Church of Scientology
  – Engaged in fight with IRS, who were challenging the church’s status as a (non-taxable) religion.
  – Were proposing a tax that would do away with the IRS.
• Proposes substitution of retail sales tax for income tax and FICA payroll taxes, with “prefund” check based on income.
  • See chart on next slide.

\[
\begin{array}{|c|c|c|c|}
\hline
\text{Family Size} & \text{Annual Income} & \text{Monthly Income} & \text{Family Size} & \text{Annual Income} & \text{Monthly Income} \\
\hline
1 \text{ person} & 13,310 & 1,109 & N/A & N/A & N/A \\
1 \text{ child} & 19,990 & 1,666 & N/A & N/A & N/A \\
& 389 & 32 & N/A & N/A & N/A \\
& 778 & 64 & N/A & N/A & N/A \\
& 1,356 & 113 & N/A & N/A & N/A \\
& 2,034 & 169 & N/A & N/A & N/A \\
& 2,712 & 226 & N/A & N/A & N/A \\
& 3,390 & 280 & N/A & N/A & N/A \\
& 4,068 & 336 & N/A & N/A & N/A \\
& 4,746 & 390 & N/A & N/A & N/A \\
& 5,424 & 445 & N/A & N/A & N/A \\
& 6,102 & 500 & N/A & N/A & N/A \\
& 6,780 & 555 & N/A & N/A & N/A \\
& 7,458 & 610 & N/A & N/A & N/A \\
& 8,136 & 665 & N/A & N/A & N/A \\
& 8,814 & 720 & N/A & N/A & N/A \\
& 9,492 & 775 & N/A & N/A & N/A \\
\hline
\end{array}
\]
Fair tax

• Bartlett article (from reading list) says
• Claim that 23% tax would be revenue neutral is misleading
  - 23% of (tax base plus tax) = 30% on tax base
  - Assumes all sales pay tax, including sales to government, all
    purchase of services (not now taxed under state sales taxes)
  - Sales to govt built in to revenue, not built in as cost.
  - Includes sales of capital goods (houses).
  - Cost of “prebates” ($600 billion) is ignored in claim of
    revenue neutrality.
• Claim of simplicity is misleading.
  - The prebates are based on income.
  - Need to keep track of everyone’s income (not just those who
    pay taxes now).

• However one competent economist
  disagrees.
• Laurence Kotlikoff (Boston University) estimates that tax would only need to be
  23.8% (as the Fair Tax sponsors measure it) or 31.3% (as sales taxes are normally
  measured) for revenue neutrality.
• Claims that the difference is made up by
  taxing purchases from income that is now
  hidden (wider tax base) and stimulus to
  business from lower rates.

Presidential candidates’ positions

• Biden: Cut spending by ending war; cut
tax breaks for wealthiest.
• Clinton: Tax relief for middle income
  families; end marriage penalty; raise
  income level at which tax rates rise;
deduction for college tuition; refundable
  child tax credit and adoption tax credit.

• Edwards: Overhaul tax code with new
tax breaks for middle class. Simplify tax
code and eliminate tax shelters and
loopholes for rich.
• Gravel: Supports “Fair tax” proposal.
• Other Democratic candidates (Dodd,
  Kucinich, Obama, Richardson):
  No stance provided

• Giuliani: Believes in supply-side
economics (i.e. cut tax rates to increase
revenue).
• Huckabee: Supports "Fair Tax"
• Hunter: Reform AMT; points out that
  reforming income tax means nothing
  without fixing AMT. Eliminate some old
  and now unjustified special taxes
  (telephone excise tax is the example he
  offers).
<table>
<thead>
<tr>
<th>Presidential candidates’ positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>• McCain: Lower spending and cut tax rates.</td>
</tr>
<tr>
<td>• Paul: Lower taxes to increase revenues.</td>
</tr>
<tr>
<td>• Romney: Keep taxes low and simplify the tax code.</td>
</tr>
<tr>
<td>• Tancredo: Lower taxes, preferably by scrapping present system and substitute a national sales tax (“Fair tax”? or a flat tax.</td>
</tr>
<tr>
<td>• Thompson: Lower taxes, simplify tax code, encourage saving and investment, and dissolve “the IRS as we know it.”</td>
</tr>
</tbody>
</table>