

Testimony Submitted
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Chairman Serrano, Ranking Member Regula, Members of the Committee; it is an honor to appear before you today to discuss, “Tax Fairness: Policy and Administration.”

I would like to make four points:

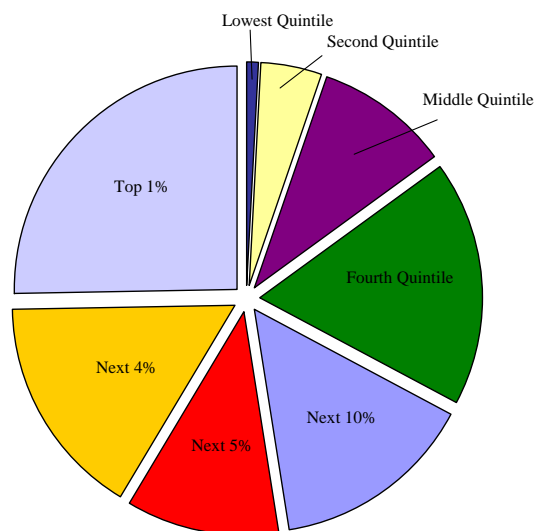
- The federal tax system is highly progressive.
- The 2001 and 2003 tax cuts are not “tax cuts for the rich.”
- Attempting to promote progressivity by taxing saving and investment is harmful and counter-productive.
- Well-designed policies can increase progressivity while strengthening the economy.

The Federal Tax System Is Highly Progressive

Those Americans who have reached the top of the economic ladder have clearly derived great benefit from our country’s institutions. It is certainly reasonable to ask them to pay a substantial share of the costs of government, including the costs of supporting the less fortunate. It is often not recognized, however, that the current tax system already places most of the cost of government on higher-income households.

This can be seen from **Figure 1**, which depicts the allocation of the federal tax burden across income groups in 2004, as computed in a recent Congressional Budget Office (CBO) publication. The data include nearly all federal taxes – individual and corporate income taxes, social insurance taxes (primarily the Social Security-Medicare payroll and self-employment taxes), and excise taxes. CBO classifies households into different income groups, based on household income divided by the square root of household size.

Figure 1: Shares of Federal Tax Liabilities, 2004



Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2004*, December 2006. Data include federal individual and corporate income taxes, social insurance taxes, and excise taxes. Income groups are classified by household income divided by square root of household size.

Figure 1 reveals that the federal tax system is highly progressive. The lowest quintile, the 20 percent of households with the lowest incomes, bears less than 1 percent of the federal tax burden. The next 20 percent bears less than 5 percent of the burden. The burden is higher for the next income groups, as the middle 20 percent bears 10 percent of the burden and the fourth 20 percent bears more than 17 percent.

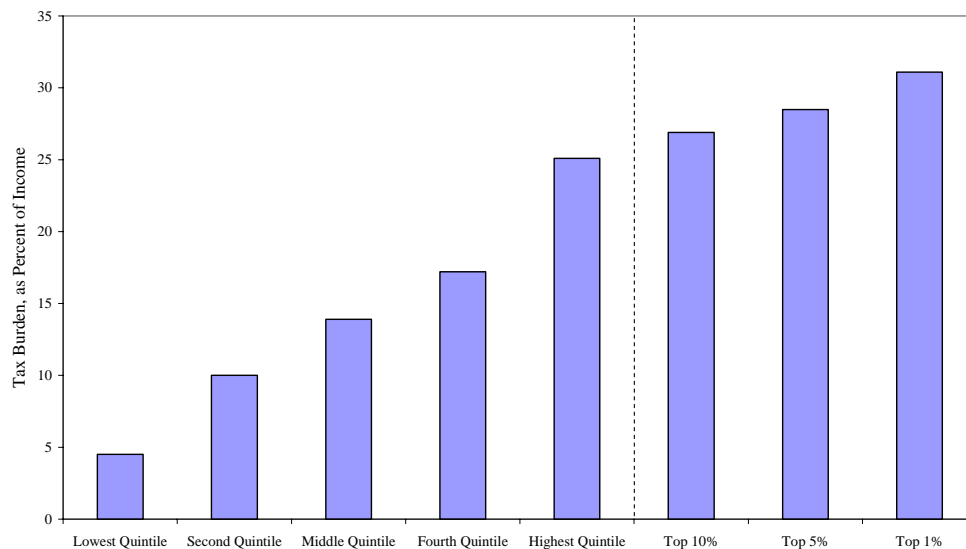
That leaves the top 20 percent paying 66 percent of the cost of government; one fifth of the population pays two-thirds of the cost. The breakdown within that 20 percent is even more striking. Most notably, the top 1 percent of the population bears a staggering 25 percent of the tax burden.

So, when we think about the various services that the federal government provides – Social Security, Medicare, national defense, the FBI, and so on – we need to remember that a mere 1 percent of the population shoulder one-quarter of their cost. The notion that high-income groups are escaping their fair share of the fiscal burden is flatly contradicted by the facts.

Furthermore, the shares of the tax burden borne by high-income groups exceed their shares of national income. In other words, these groups are paying bigger portions of their incomes to the government than other Americans.

This is demonstrated in **Figure 2**, which shows each group’s tax burden as a percentage of its income. These effective tax rates rise steadily as we move up the income scale. For example, the bottom 20 percent pays less than 5 percent of its income in federal taxes while the top 20 percent pays 25 percent of its income.

Figure 2: Effective Federal Tax Rates, 2004

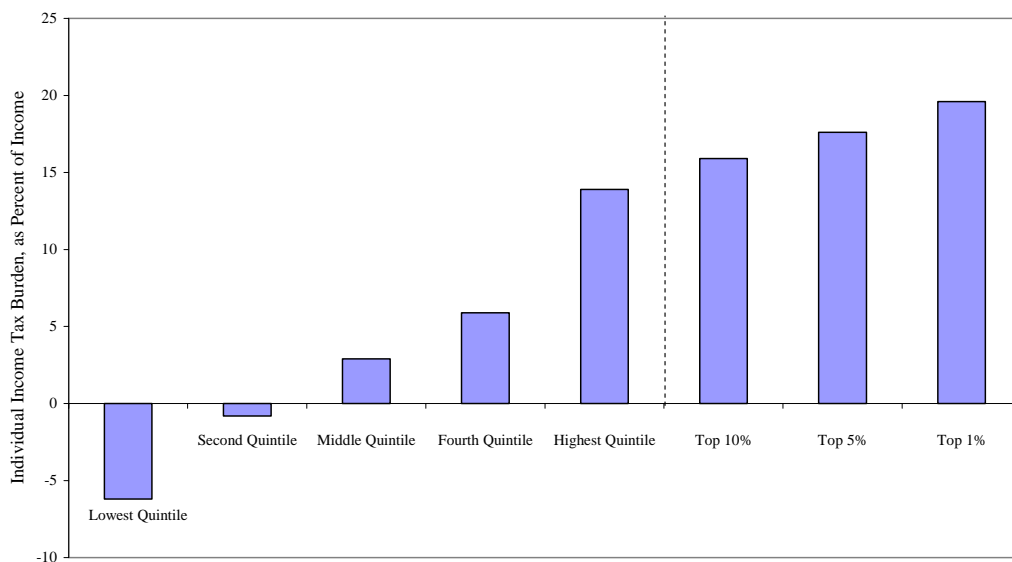


Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2004*, December 2006. Data include federal individual and corporate income taxes, social insurance taxes, and excise taxes. Income groups are classified by household income divided by square root of household size.

The effective tax rates for sub-groups within the top 20 percent are shown to the right of the dashed horizontal line. The tax rates continue to rise with income, with the top 1 percent paying 31 percent of its income in federal taxes.

The increase in effective tax rates is even more dramatic if we look only at the individual income tax, as shown in **Figure 3**. Strikingly, the federal income tax burdens for the two bottom quintiles are actually negative. For these income groups, the earned income tax credit and the refundable child credit outweigh the income tax that they would otherwise owe.

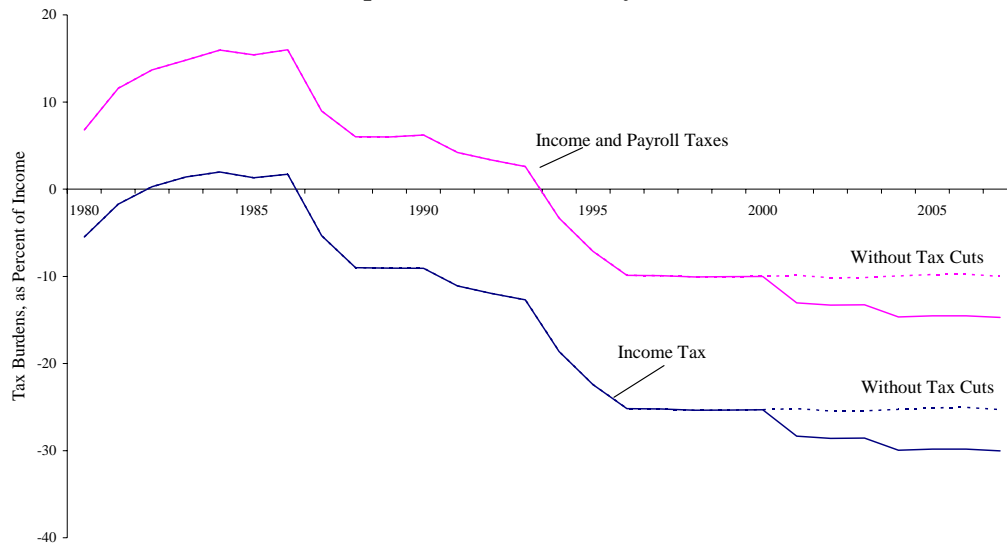
Figure 3: Effective Federal Individual Income Tax Rates, 2004



Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2004*, December 2006. Income groups are classified by household income divided by square root of household size.

Figure 4 takes a closer look at tax liability at lower income levels. It plots the tax burden, as a percentage of income, for a hypothetical low-income household; a single parent with two children and labor earnings equal to the federal poverty income guideline. The figure shows that the tax burden on this household has steadily fallen over the last three decades, becoming more and more negative.

Figure 4: Tax Burden, as Percent of Income: Single Parent with Two Children, Income Equal to Federal Poverty Guideline, 1980-2007



Source: Author's calculations. All income is labor earnings, head-of-household filing status applies, earned income tax credit is claimed, and children are 16 or younger and qualify for child credit. Household has no child-care costs (with such costs, tax burden would be slightly lower in 1980-1987 and unchanged in other years). Payroll taxes are employee-and-employer-combined Social Security-Medicare payroll taxes.

This hypothetical household's income tax burden has been negative since 1987. Even when payroll taxes (both the employee and the employer portions) are included, the tax burden has been negative since 1994. In 2007, this low-income household's income tax burden is negative \$5,154, which is negative 30 percent of its \$17,170 income. After adding in \$2,627 of employer and employee payroll taxes, the household's tax burden is negative \$2,527, which is negative 15 percent of its income.

Clearly, low-income households are not picking up the tab for the wealthy.

The 2001 and 2003 Tax Cuts Are Not "Tax Cuts for the Rich"

Because the above figures refer to 2004 or later data, they reflect the effects of the 2001 and 2003 tax laws. After these laws, as well as before, the tax system is extracting most of its revenue from those with higher incomes and lower-income households enjoy refundable tax credits. Because these tax laws are often attacked as "tax cuts for the rich," though, it is worth taking a closer look at them.

The 2001 and 2003 tax laws had the primary purpose of improving economic incentives and boosting economic growth. To lower tax penalties on saving and investment, these laws reduced tax rates on dividends and long-term capital gains, as well as other marginal tax rates. The direct benefits of these provisions are, obviously and unavoidably, greater for those with higher incomes.

These tax laws included, however, a number of important provisions designed to reduce tax burdens for those with low or moderate incomes. These provisions include:

- An increase in the child credit from \$500 to \$1,000
- Making the child credit partly refundable for households with one or two children and increasing its refundability for those with three or more children
- Lowering the tax rate from 15 percent to 10 percent for the lowest levels of taxable income
- Increasing the standard deduction, the earned income tax credit, and the length of the 15 percent bracket for married couples

These provisions accounted for approximately half of the revenue loss from the 2001 tax law, according to Joint Tax Committee estimates.¹

The impact of these provisions can be seen by referring back to Figure 4. The dashed lines show the tax burdens that this hypothetical low-income household would have faced without the 2001 and 2003 tax cuts. As can be seen, the tax burden would have remained roughly constant as a percentage of income, if the tax cuts had not been adopted. Due to the tax cuts, however, the tax burden on this household fell significantly.

In 2007, this household receives a tax savings of \$813 from the 2001 and 2003 tax laws, in the form of a refundable child credit that would not have been available under prior law. This tax savings is equal to 4.7 percent of income.

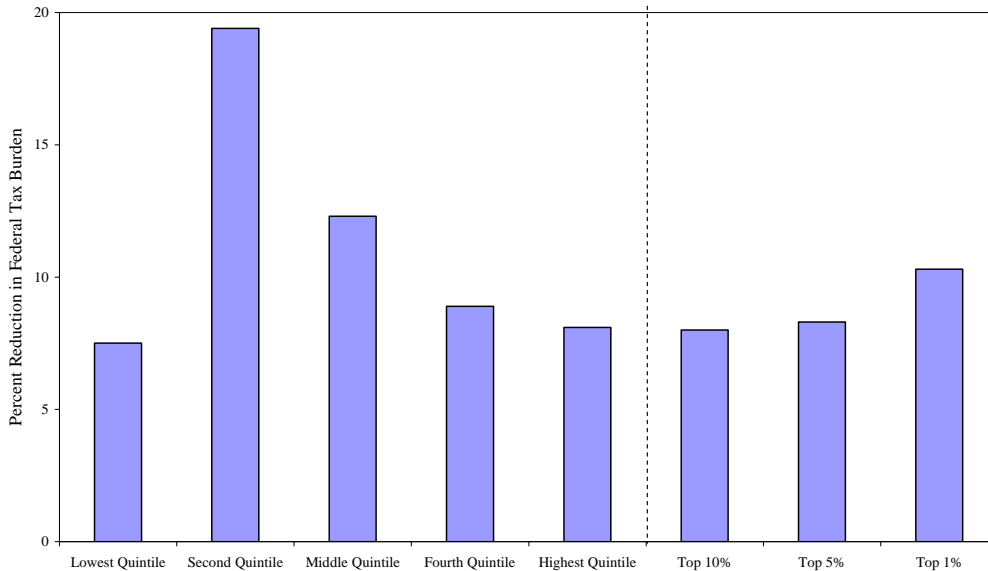
Married couples receive larger savings than those in this example. Households with somewhat higher, but still modest, incomes also receive larger benefits. On the other hand, tax savings are smaller for households without children.

Looking at the income distribution as a whole also reveals that the tax cuts are not confined to the wealthy. As shown in **Figure 5**, data from the Urban-Brookings Tax Policy Center reveal that the 2001 and 2003 tax cuts (and the other minor tax legislation adopted in 2001 through 2006) generally, though not always, give larger percentage tax cuts to groups with lower incomes. The largest reduction is for the second quintile.

Nevertheless, critics of the tax cuts complain that they are insufficiently progressive. Although groups with lower incomes receive larger percentage reductions in their tax liabilities, their tax savings are generally smaller as a percentage of income, indicating that the tax cuts make the distribution of after-tax income more unequal. Moreover, the spending cuts ultimately required to finance the tax cuts, if they are made permanent, may fall more heavily on groups with lower incomes.

¹ Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1836: Fiscal Years 2001-2011*, JCX-51-01, May 26, 2001.

Figure 5: Percentage Reduction in 2007 Federal Taxes, from 2001-2006 Tax Legislation



Source: Greg Leiserson and Jeffrey Rohaly, Urban -Brookings Tax Policy Center, *The Distribution of the 2001-2006 Tax Cuts: Updated Projections*, November 2006, Table 8.

These critics also point out that the tax cuts could have been more progressive. For example, the tax provisions that apply to lower income groups could have been adopted without the other provisions. For that matter, more progressive spending increases could have been adopted in place of the tax cuts.

Those things would have been done if the driving goal had been to make the income distribution more equal. Instead, however, the driving goal was to improve economic incentives and to promote economic growth. An exclusive focus on progressivity would have undermined that objective.

Attempting to Promote Progressivity by Taxing Saving and Investment is Harmful and Counterproductive

More generally, a misguided focus on progressivity can be harmful and even counterproductive.

Progressivity, as officially measured, can always be increased by putting larger tax burdens on saving and investment. But, such policies are likely to reduce saving and investment. With a lower capital stock, labor will be less productive and real wages will fall. The economic harm from trying to increase progressivity in this manner can be severe.

Such efforts to increase progressivity can even be counterproductive. If wages fall, including the wages of workers at the bottom of the economic spectrum, it is low-income rather than high-income groups who are harmed.

A recent study by two of my AEI colleagues, Kevin Hassett and Aparna Mathur, provides evidence of these effects.² Their statistical findings indicate that countries with higher corporate income taxes tend to have lower real wages in manufacturing, after controlling for a number of other factors that might affect real wages. They conclude that raising corporate income tax rates drives capital out of a country, lowering the productivity of its workers and depressing their real wages. While this study is not absolutely definitive, it is suggestive of what can happen when taxes on investment are increased.

This point needs to be kept in mind when deciding whether to extend provisions like the capital gains and dividend tax cuts adopted in the 2003 tax law. By increasing investment, these provisions help workers throughout the economy, including workers who do not have any dividend or capital gains income.

Well-Designed Policies Can Promote Progressivity While Strengthening the Economy

Some policies, however, can promote a more progressive tax system while also advancing economic efficiency. President Bush submitted one such proposal in the Fiscal 2008 Budget. Under this proposal, an additional standard deduction would be offered to individuals with private health insurance. The standard deduction, which would be \$15,000 for family coverage and \$7,500 for individual coverage in 2009, would apply to payroll taxes, as well as individual income taxes. At the same time, employer-provided health insurance would become subject to individual income tax and payroll taxes.

Allowing a standard deduction under the payroll tax would greatly increase its progressivity. Workers with modest health insurance policies would receive tax cuts and some of those without health insurance would be able to buy insurance. At the same time, the proposal removes the tax bias toward more elaborate health insurance plans, which has helped fuel the rise in health care costs.

A similar approach could be adopted with respect to the deduction for home mortgage interest. In its November 2005 report, the President's Advisory Panel on Federal Tax Reform proposed converting the deduction into a refundable 15 percent credit, thereby increasing its attractiveness to lower income taxpayers, while capping the deduction for large amounts of mortgage interest. Such a change would lower the tax burden for those with modest homes while curtailing the tax subsidy that artificially encourages investment in high-cost homes.

Ultimately, fundamental tax reform offers the most promising way to advance progressivity without harming economic growth. This goal can best be achieved by replacing the income tax system with a Bradford X tax, a consumption tax under which households are taxed at graduated rates on labor earnings and firms are taxed at a high rate on business cash flow. This type of tax reform can maintain or even increase the

² Kevin A. Hassett and Aparna Mathur, *Taxes and Wages*, AEI Working Paper 128, June 2006, http://www.aei.org/publications/filter.all.pubID.24629/pub_detail.asp.

progressivity found in the current income tax system while eliminating all of the current tax system's penalties on saving and investment. The President's Advisory Panel considered, but ultimately did not adopt, a Progressive Consumption Tax plan that took this approach.

Summary

Trying to maintain an appropriately progressive tax system is a worthy goal. It is important to keep in mind, however, that the federal tax system is already highly progressive. Moreover, attempting to advance progressivity by taxing saving and investment can be harmful or even counterproductive. Fortunately, it is possible to advance progressivity in ways that strengthen the economy, such as by refocusing tax subsidies for health insurance and homeownership on those in greater need.