Taxing Choices: The Economics of Tax Policy
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In this session

- The economics of taxation
- Complications to achieving tax fairness
- Solutions?
- Sum it up!
A Global Perspective: Change in tax to GDP ratios 1975 to 2003 – OECD data

*) 1975 to 2002
Federal Receipts – FY 2005

- Personal income taxes: 43%
- Excise, customs, estate, gift, and miscellaneous taxes: 6%
- Corporate income taxes: 13%
- Borrowing to cover the deficit: 6%
- Social Security, Medicare, and unemployment and other retirement taxes: 32%

Total: $2.6 Trillion
Federal Outlays – FY 2005

Social programs: 19%
Physical, human, and community development: 9%
Net interest on the debt: 9%
Law enforcement and general government: 2%
National defense, veterans, and foreign affairs: 23%
Social Security, Medicare, and other retirement: 38%

Total: $2.7 Trillion
Federal Receipts Over Time
(in billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>39.4</td>
</tr>
<tr>
<td>1960</td>
<td>92.5</td>
</tr>
<tr>
<td>1970</td>
<td>192.8</td>
</tr>
<tr>
<td>1980</td>
<td>571.2</td>
</tr>
<tr>
<td>1990</td>
<td>1,032.2</td>
</tr>
<tr>
<td>2000</td>
<td>2,025.2</td>
</tr>
<tr>
<td>2008</td>
<td>2,047.3</td>
</tr>
</tbody>
</table>

Legend:
- Other
- Excise Taxes
- Corporation Income Taxes
- Social Insurance and Retirement
- Individual Income Taxes
Corporations vs. Flowthroughs – 30 Million Returns - 2005

- Corporations: 7%
- Other: 93%
- S Corporations: 12%
- Partnerships: 9%
- Sole Proprietorship: 72%
Corporations vs. Flowthroughs – $29.6 Trillion Total Receipts - 2005

- Corporations: 67%
- Other: 33%
- S Corporations: 18%
- Partnerships: 11%
- Sole Proprietorship: 4%
Corporations vs. Flowthroughs – $2.6 Trillion - Net Income - 2005

- Corporations: 53%
- Other: 48%
- S Corporations: 14%
- Partnerships: 21%
- Sole Proprietorship: 12%
C Corporations - $500M or More in Assets

- Number of returns
- Total receipts
- Net income (less deficit)
- Total income tax after credits

$500 or more
All others
What is going on in the corporate statistics?

- The largest corporations ($500 million or more in assets) account for:
  - 0.1% of corporate returns
  - 60% of total receipts
  - 80% of net income
  - 84% of corporate income tax

- Implication: Largest corporations dominate statistics and measures of economic activity in the corporate sector
So what gets picked up in the individual tax statistics?

- Individual salary/wage income
- Individual self-employment income
- Individual share of business income executed in the flow-through form
- Individual receipts of investment income

Implication – Individual sector reflects substantial “business” income
Federal Individual Income Tax Burden in 2003
(Shares of Personal Income Tax Payments by Percentile Groups – Income – Positive AGI and Tax – Individual Income Tax)

Source: Joint Economic Committee Study, 2006 using data from SOI
### Individual Income Tax - 2005

<table>
<thead>
<tr>
<th></th>
<th>Pretax Household Income (%)</th>
<th>Individual Income Tax (%)</th>
<th>After tax Household Income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest Quintile</td>
<td>4.0</td>
<td>-2.9</td>
<td>4.8</td>
</tr>
<tr>
<td>Second Quintile</td>
<td>8.5</td>
<td>-0.9</td>
<td>9.6</td>
</tr>
<tr>
<td>Middle Quintile</td>
<td>13.3</td>
<td>4.4</td>
<td>14.4</td>
</tr>
<tr>
<td>Fourth Quintile</td>
<td>19.8</td>
<td>13.1</td>
<td>20.6</td>
</tr>
<tr>
<td>Highest Quintile</td>
<td>55.1</td>
<td>86.3</td>
<td>51.6</td>
</tr>
<tr>
<td>All</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Top 10%</td>
<td>40.9</td>
<td>72.7</td>
<td>37.4</td>
</tr>
<tr>
<td>Top 5%</td>
<td>31.1</td>
<td>60.7</td>
<td>27.8</td>
</tr>
<tr>
<td>Top 1%</td>
<td>18.1</td>
<td>38.8</td>
<td>15.6</td>
</tr>
</tbody>
</table>

Source: All Households, CBO, 2008
Effective Individual Income Tax Rates for All Households by Quintile, 2005
## Individual Income Tax - 2005

<table>
<thead>
<tr>
<th>Quintile</th>
<th>Pretax Household Income (%)</th>
<th>Individual Income Tax (%)</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Lowest Quintile</td>
<td>5.0</td>
<td>-7.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Second Quintile</td>
<td>10.9</td>
<td>-3.7</td>
<td>12.3</td>
</tr>
<tr>
<td>Middle Quintile</td>
<td>15.7</td>
<td>4.6</td>
<td>16.7</td>
</tr>
<tr>
<td>Fourth Quintile</td>
<td>20.3</td>
<td>13.6</td>
<td>20.8</td>
</tr>
<tr>
<td>Highest Quintile</td>
<td>48.6</td>
<td>92.6</td>
<td>44.8</td>
</tr>
<tr>
<td>All</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Top 10%</td>
<td>35.9</td>
<td>78.7</td>
<td>32.4</td>
</tr>
<tr>
<td>Top 5%</td>
<td>27.9</td>
<td>66.9</td>
<td>24.6</td>
</tr>
<tr>
<td>Top 1%</td>
<td>16.3</td>
<td>41.7</td>
<td>13.9</td>
</tr>
</tbody>
</table>

Source: Households with children, CBO, 2008
Effective Individual Income Tax Rates for Households with Children by Quintile, 2005
Have you ever wondered . . .

- What is meant by “tax equity?”
- What are the complications in assessing this elusive concept?
- Is tax equity an achievable goal?
Tax Concepts

- Tax = f(tax base, tax rate)
- Tax Base?
  - Income is often used but – What is income?
  - Haig-Simons definition of income (variously stated)
    - Consumption + net accretions to wealth
    - Personal income + change in value of assets
    - NOTE: all changes are measured as accrued, not realized and are independent of source or use
Tax Concepts – Tax Rates

- **Marginal vs. effective**
  - Marginal – Rate on the next dollar
  - Effective – Average rate

- **Inclusive vs. exclusive**
  - $100 tax base with $30 tax
    - Inclusive – \( \frac{30}{100+30} = 23\% \)
      - Income Taxes
    - Exclusive – \( \frac{30}{100} = 30\% \)
      - Sales Taxes
Tax Concepts

• Benefit Principle (Individual Equity)
  • Tax = \( f(\text{benefits received}) \)
  • Difficulty
    - identifying benefits
    - inconsistent with redistribution

• Ability to Pay Principle
  • Capacity to pay a tax
  • What do we base ability on?
    - Income?
    - Consumption?
    - Wealth?
    - Utility?
Tax Concepts

- **Equity**
  - Horizontal Equity - Equals should pay equal taxes
  - Vertical equity - Unequals should pay unequal tax

*How do you measure “equal”???
Tax Concepts

- **Progressivity** (often used to achieve “vertical equity”)
  - **Progressive**
    - Taxes rise faster than income
  - **Proportional**
    - Taxes rise ratably with income
  - **Regressive**
    - Taxes rise slower than income
Tax Concepts

- Other tax policy goals
  - Efficiency
    - Minimize the economic cost per dollar raised
    - Neutral in its effect on the market
  - Simplicity
  - Administrative Ease
Complicating Factor: Tax Incidence

- Tax Incidence
  - Statutory versus Economic
  - The burden of the tax does not necessarily fall on the one who is taxed
- Who pays the corporate tax?? Social Security??
- What does the research tell us?
Complicating Factor: Taxpayer Behavioral Responses - Income Shifting

- Over time (Defer, defer, defer!)
  - Delay recognition
- Between entities
  - Corporation to partnership or individual
- Between jurisdictions
  - Domestic to foreign
- Between types
  - Ordinary income into capital gains
  - Interest into dividends (or dividends into interest)
  - Active versus passive
  - US versus foreign source
Complicating Factor: Other Taxpayer Behavioral Responses

- Working for pay or . . . not . . .
- Spending vs. saving
- Buying vs. renting
- And the list goes on. . . .
Complicating Factor – Behavioral Responses

- **Income Effect**
  - Increasing tax rate induces people to engage in more income-producing activity
  - Running faster to stay in the same place

- **Substitution Effect**
  - Increasing tax rate induces people to work less hours and substitute leisure activities
Not the Rolling Stones!

- Cancelled plans for four British concerts citing high tax rates.

- Mick Jagger: "I was tempted to bite the bullet...but there are over 200 people involved."
  - Income or substitution effect?

- Reporter notes – "One knows a rock band is getting old when it cancels a tour for tax reasons!"
Complications of Complexity

TAX PREPARATION

THE GOOD NEWS IS THAT UNDER THE NEW TAX PLAN YOU GET A $2,312.70 REFUND. THE BAD NEWS IS THAT IT WAS SO COMPLICATED, YOU OWE ME $2,310.60.
#1 Problem Facing US Taxpayers: Complexity

- Source: Nina Olson, the National Taxpayer Advocate, 2008 Report to Congress
- $193 billion per year spent by Americans on compliance costs – 14% of all income tax collected
- Tax-code changes have averaged 1 per day over the last 8 years – 500 changes in 2008 alone
Complicating Factor: Tax Complexity - Tax Expenditures

Definition: tax reductions due to exclusions, deductions, exemptions, and credits

Examples:
- Pension contributions
- Employer contributions for medical ins and care
- Mortgage interest on owner-occupied homes
- Non-business state and local taxes
- Capital gains
- Accelerated depreciation, etc. etc.
# Revenue vs. Outlay Equivalent Cost for Eight Tax Expenditures in 2004

<table>
<thead>
<tr>
<th>Provision</th>
<th>Revenue Loss</th>
<th>Outlay Equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Net exclusion of pension contributions and earnings (All plans)</td>
<td>$151,906</td>
<td>$180,890</td>
</tr>
<tr>
<td>2. Employer exclusion for medical premiums and care</td>
<td>123,850</td>
<td>160,520</td>
</tr>
<tr>
<td>3. Charitable contribution deduction (All types)</td>
<td>42,120</td>
<td>59,790</td>
</tr>
<tr>
<td>4. Child credit</td>
<td>21,310</td>
<td>28,410</td>
</tr>
<tr>
<td>5. Medical expenses deduction</td>
<td>6,340</td>
<td>6,910</td>
</tr>
<tr>
<td>6. Workers' compensation benefits</td>
<td>6,190</td>
<td>7,710</td>
</tr>
<tr>
<td>7. Hope and lifetime learning tax credits</td>
<td>5,860</td>
<td>7,510</td>
</tr>
<tr>
<td>8. Earned income tax credit</td>
<td>5,090</td>
<td>5,660</td>
</tr>
</tbody>
</table>

Source: Tax Policy Center
Tax Expenditure Budget, 2006

- Commerce and Housing: 39.6%
- Health: 16.7%
- Income Security: 14.5%
- Education, Training, Employment, and Social Services: 11.5%
- General Purpose Fiscal Assistance: 7.8%
- Social Security: 3.1%
- International Affairs: 2.7%
- General Science, Space, and Technology: 1.2%
- Other: 2.9%
Implications of Complexity

It's confusing and complicated. Layers of new tax cuts, credits, rates, exemptions...

Taxpayers will call it a nightmare when they try to decipher it!

I call it job security!
Be careful what you build. . .

Alternative Minimum Tax: Are You The Next Target? - *Business Week, December 13, 2004*

Coping with the Alternative Minimum Tax
*Business Week, January 12, 2006*

IRS.gov Offers Online Alternative Minimum Tax Assistance – *AP Newswire, January 27, 2007*
Projected Number of AMT Taxpayers with and without Effect of the 2001–2006 Tax Cuts

Millions of taxpayers

Ten states with highest % of tax filers with positive tax liability subject to AMT

Source: Tax Foundation, 2005
History of the Personal Exemption, 1948-2006

Comparison of the Actual to Hypothetical Exemptions that Keep Pace With Per Capita Income Growth and Inflation

Source: Tax Policy Center
In the great circle of life...
And it just keeps getting bigger . . . .
Solution: Simplify?
But how????

Frank and Ernest

IRS
PAY TAXES HERE

I DON'T WANT TO PAY MY FAIR SHARE OF TAXES. I WANT TO PAY SOMEONE ELSE'S FAIR SHARE.

THAVES 11-2

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Danger: Unintended Consequences

* That the power to tax involves the power to destroy ... [is] not to be denied.

~ U.S. Supreme Court Justice John Marshall in McCulloch v. Maryland, March 6, 1819.
Sum it all up!

- Challenges in tax reform
  - Economic Incidence ≠ Tax Incidence
  - Taxpayers respond to incentives
  - Differential treatment encourages behavioral responses
  - Tax is a silent partner in economic transactions
  - Simplicity vs. complexity

- Beware of unintended consequences

- We live in interesting times!
Read More About It!

- Useful websites:
  - Tax Foundation: www.taxfoundation.org
  - Tax Policy Center: http://taxpolicycenter.org

- . . . . And all of your favorite newspapers and periodicals!