

# Taxing Choices: The Economics of Tax Policy



School of Management

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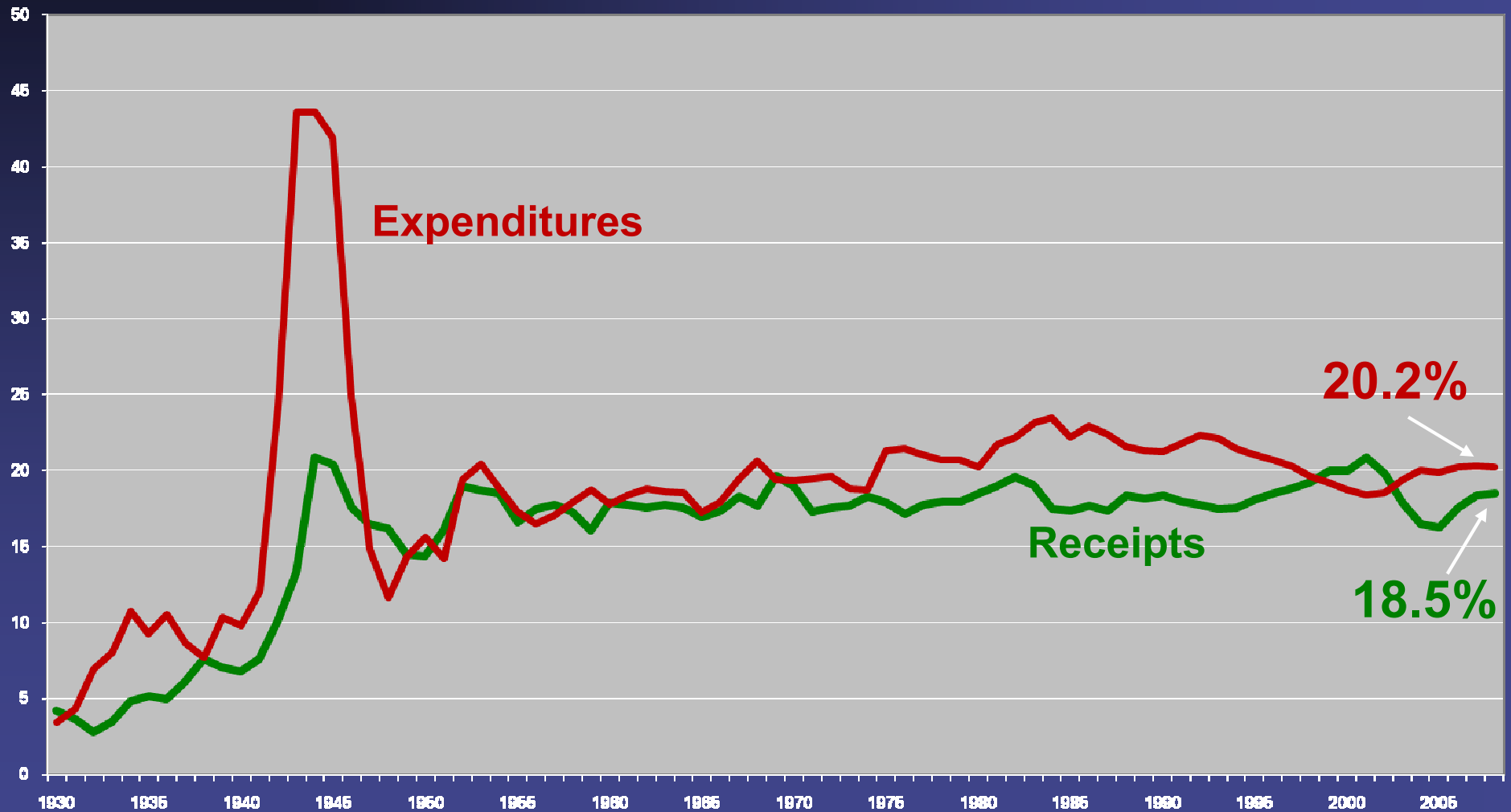


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# In this session

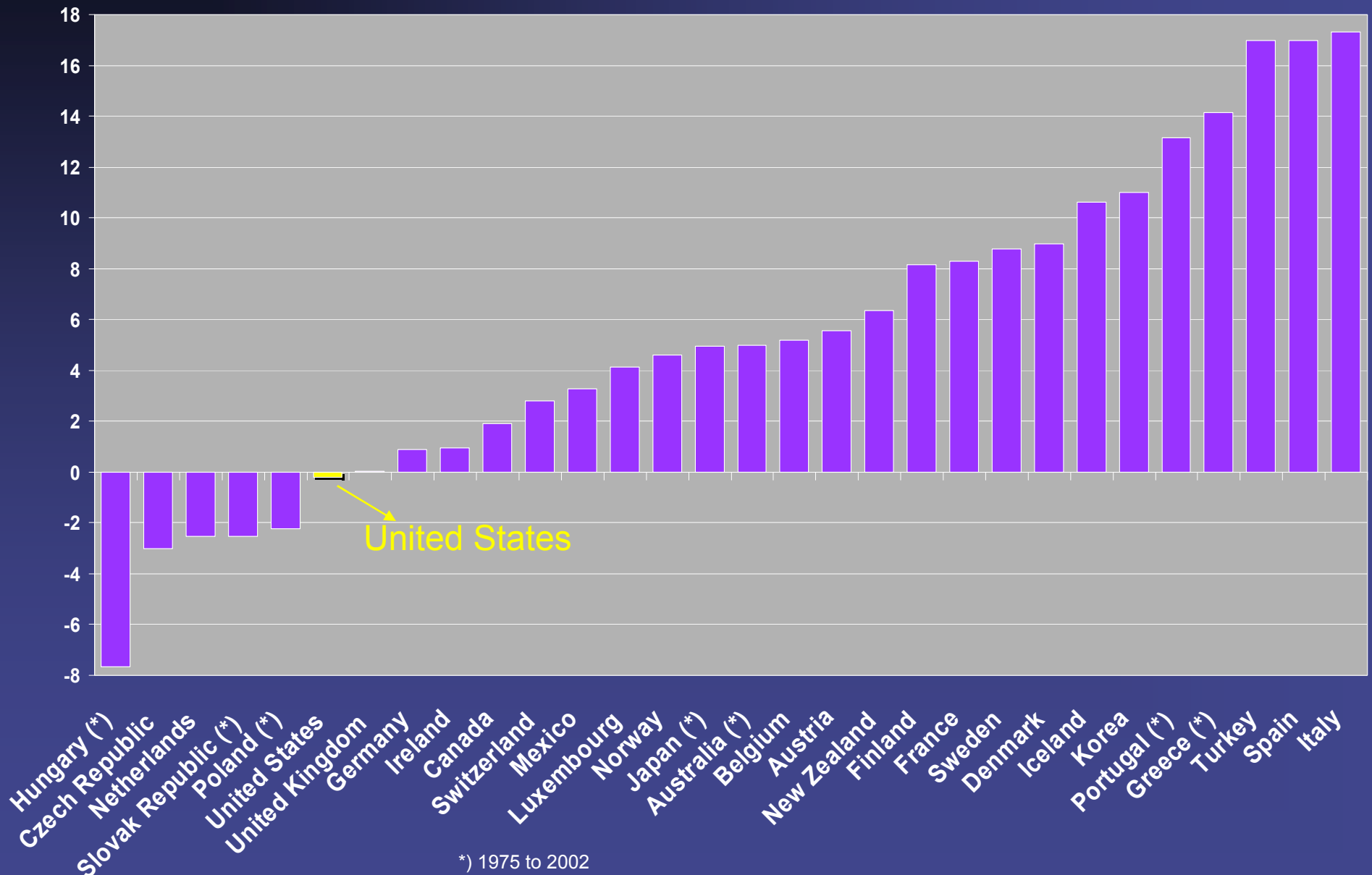
- ✱ The economics of taxation
- ✱ Complications to achieving tax fairness
- ✱ Solutions?
- ✱ Sum it up!

# Federal Receipts and Outlays as a Percentage of GDP – 1930-2008

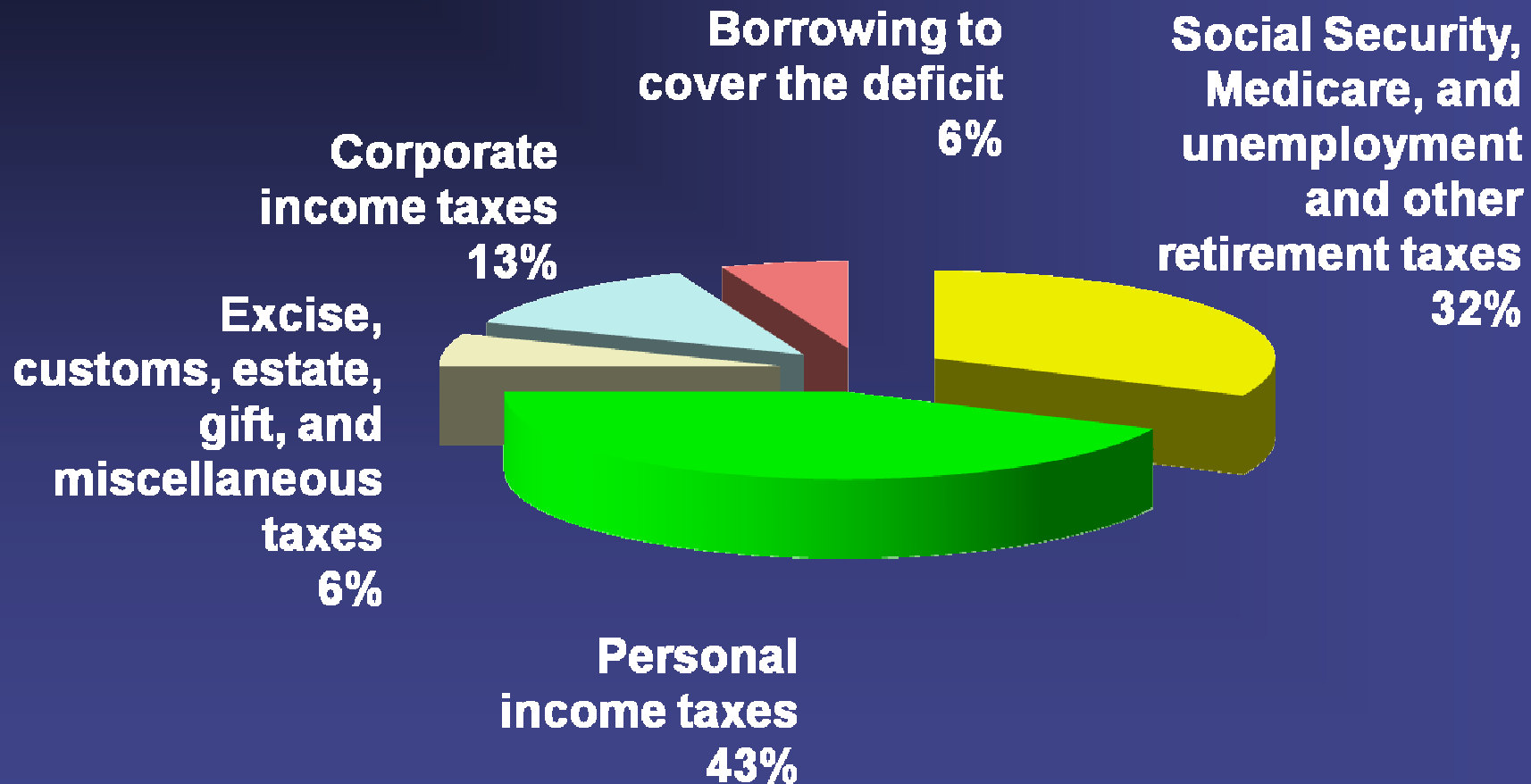


Source: OMB

# A Global Perspective: Change in tax to GDP ratios 1975 to 2003 – OECD data

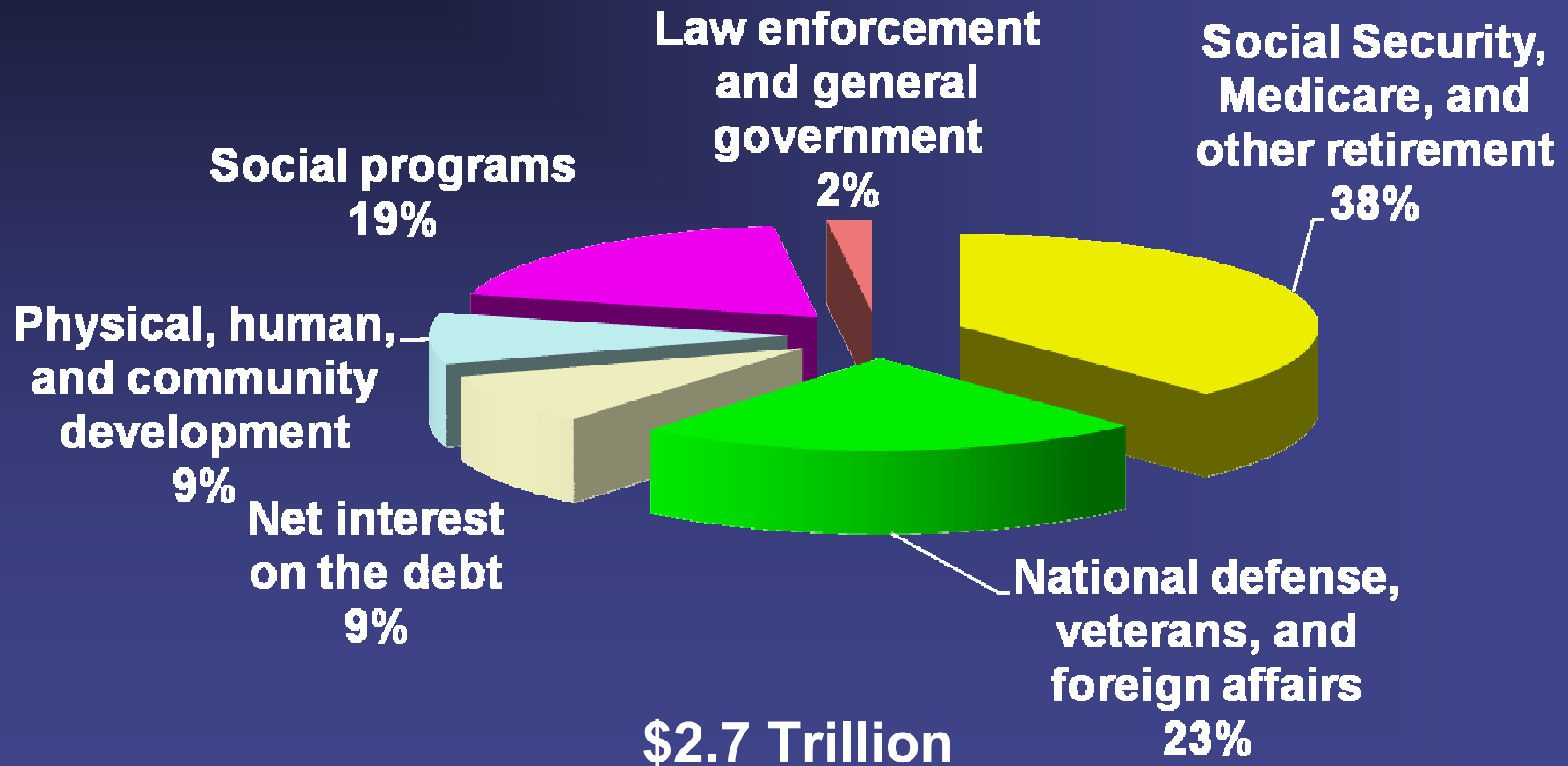


# Federal Receipts – FY 2005



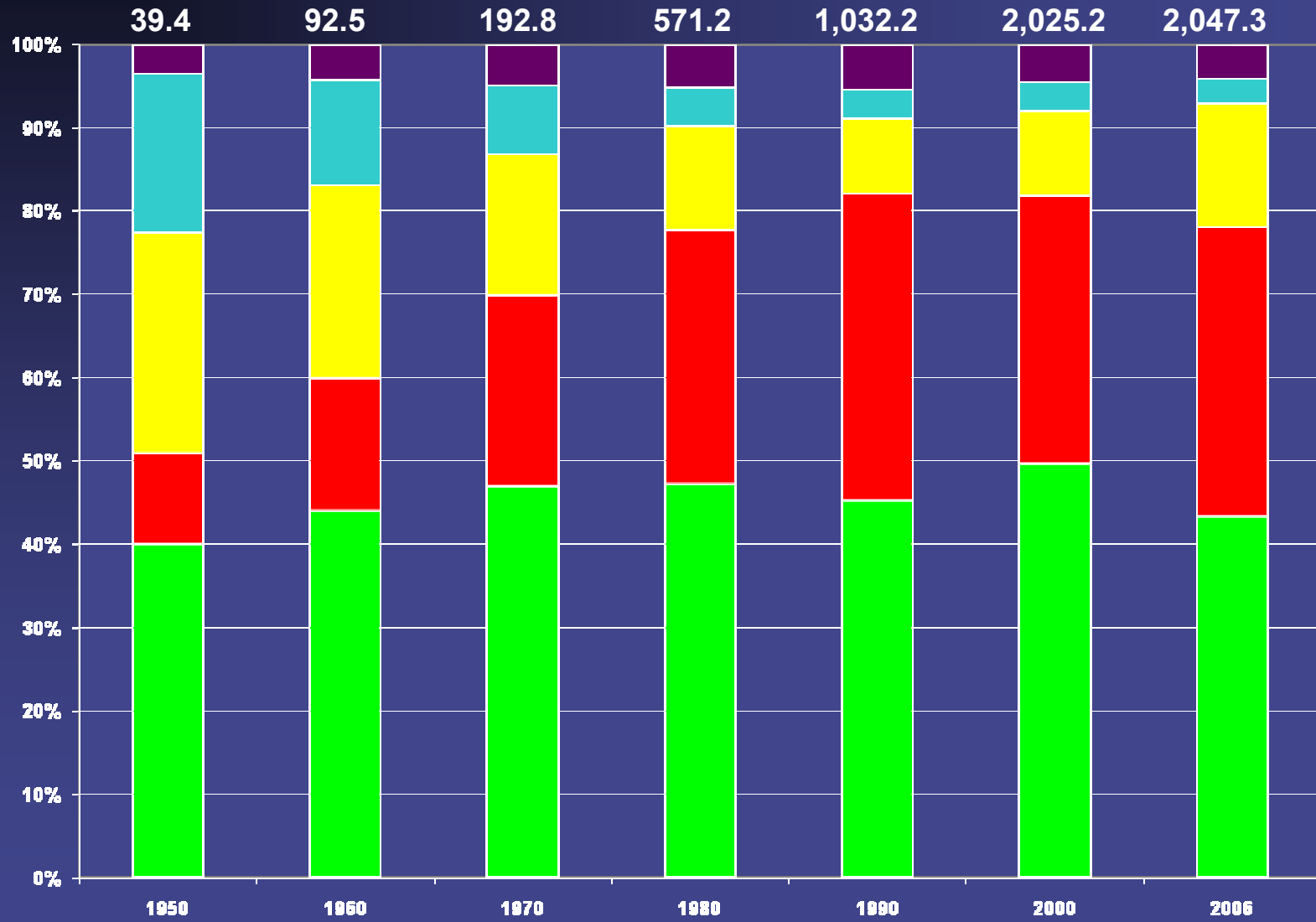
**\$2.6 Trillion**

# Federal Outlays – FY 2005



# Federal Receipts Over Time

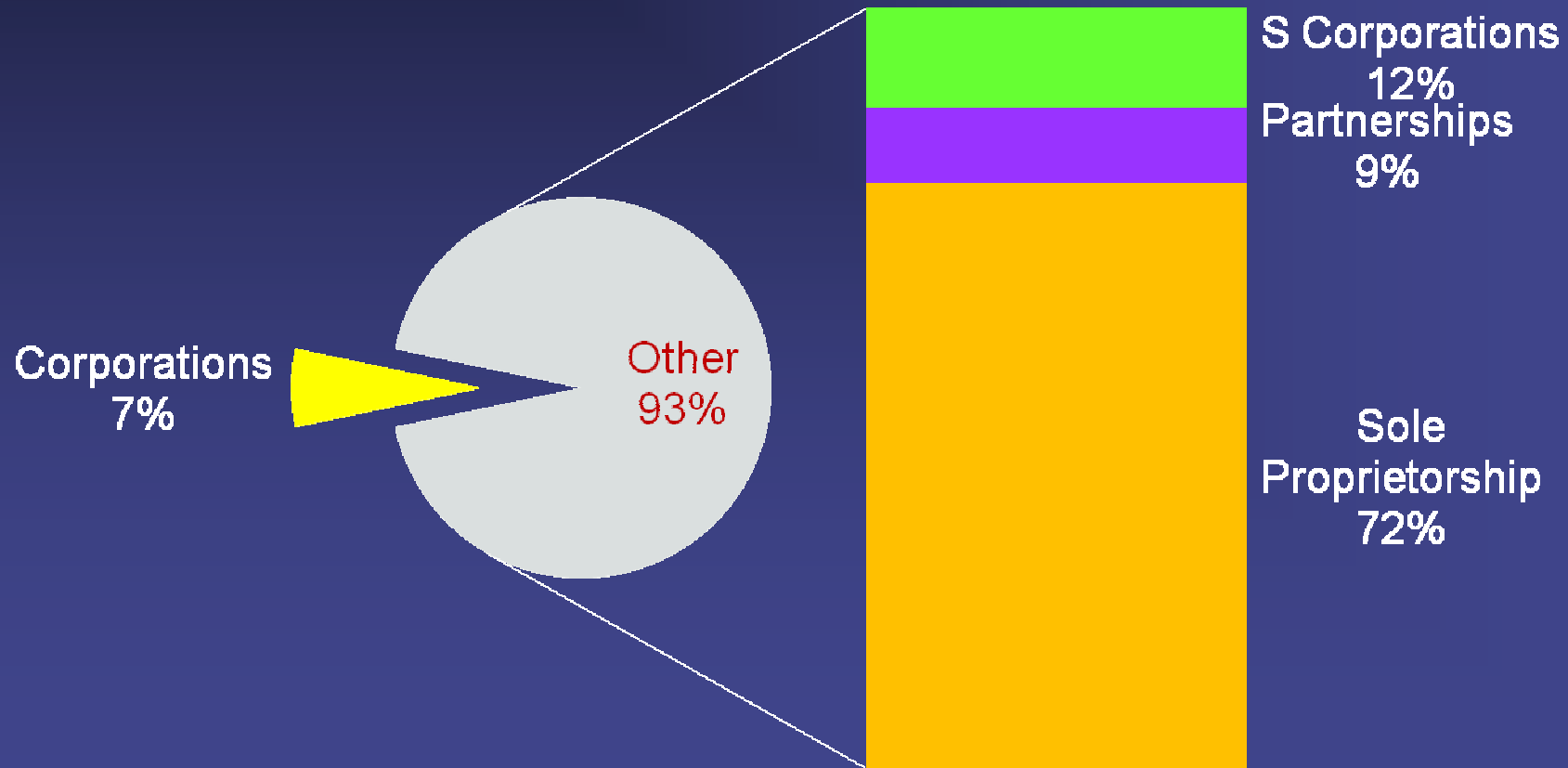
(in billions)



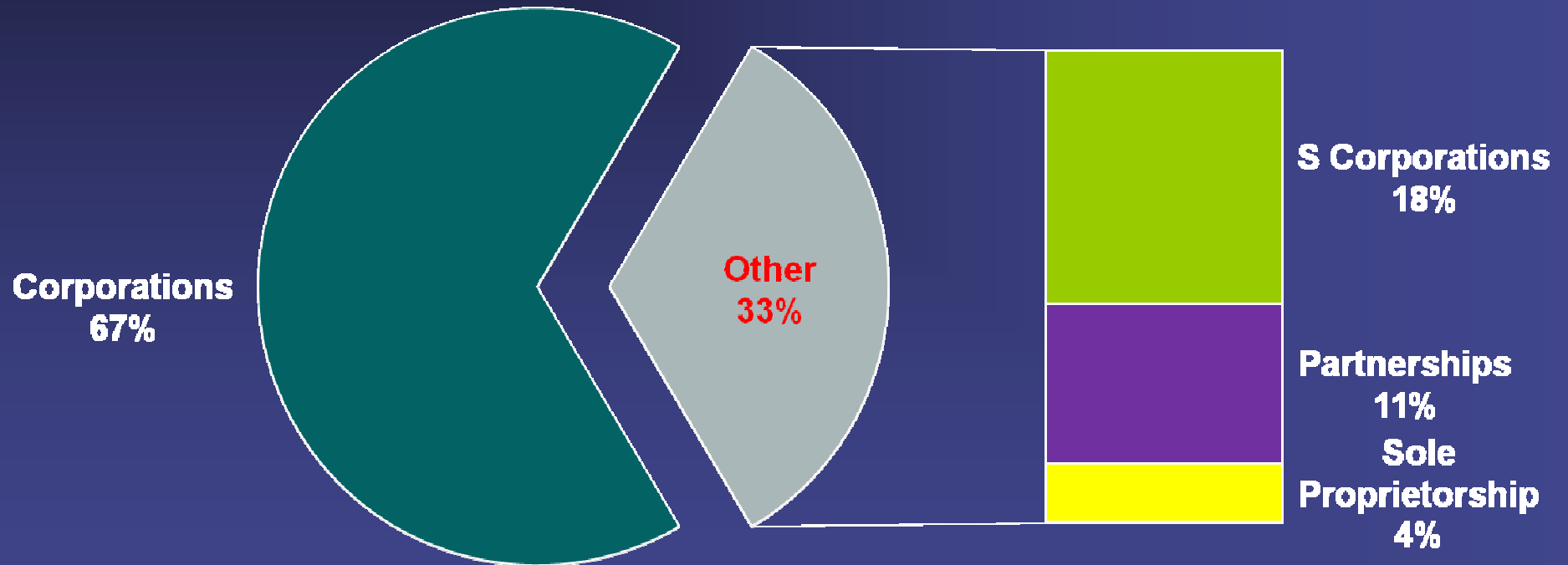
Other Excise Taxes Corporation Income Taxes Social Insurance and Retirement Individual Income Taxes



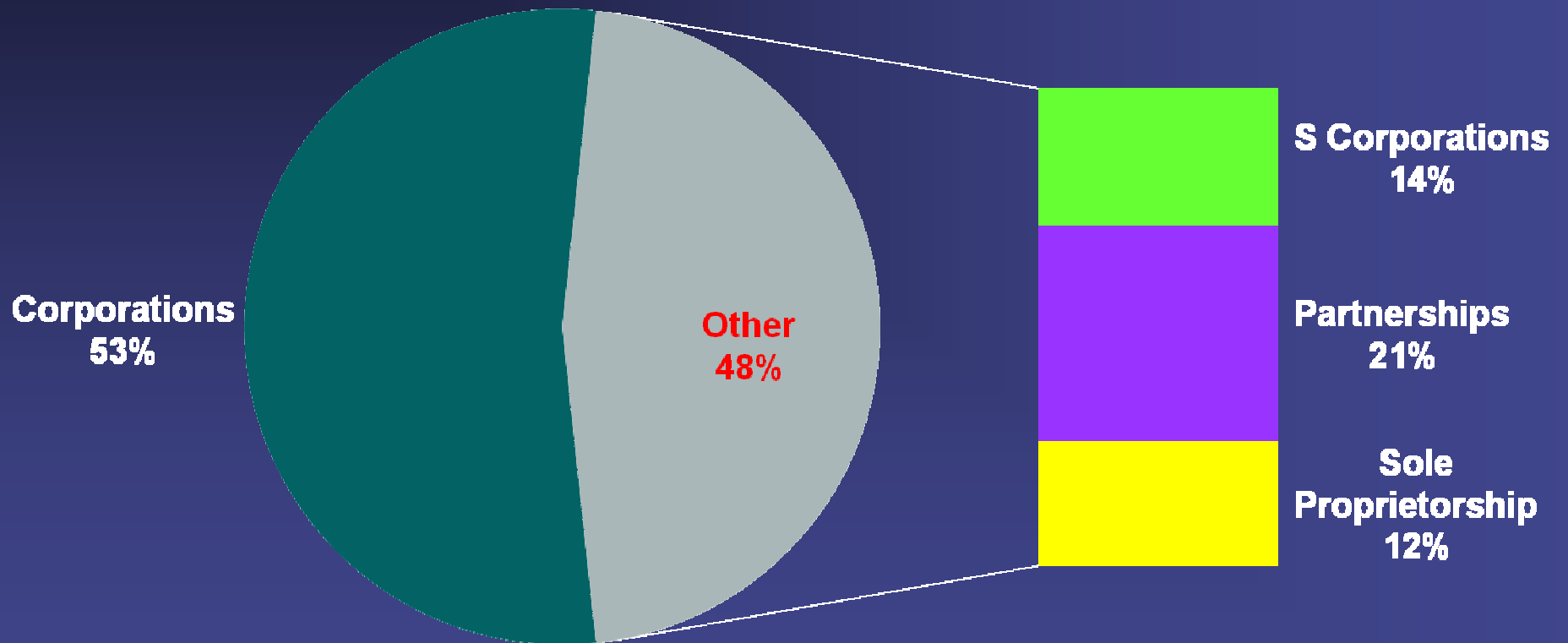
# Corporations vs. Flowthroughs – 30 Million Returns - 2005



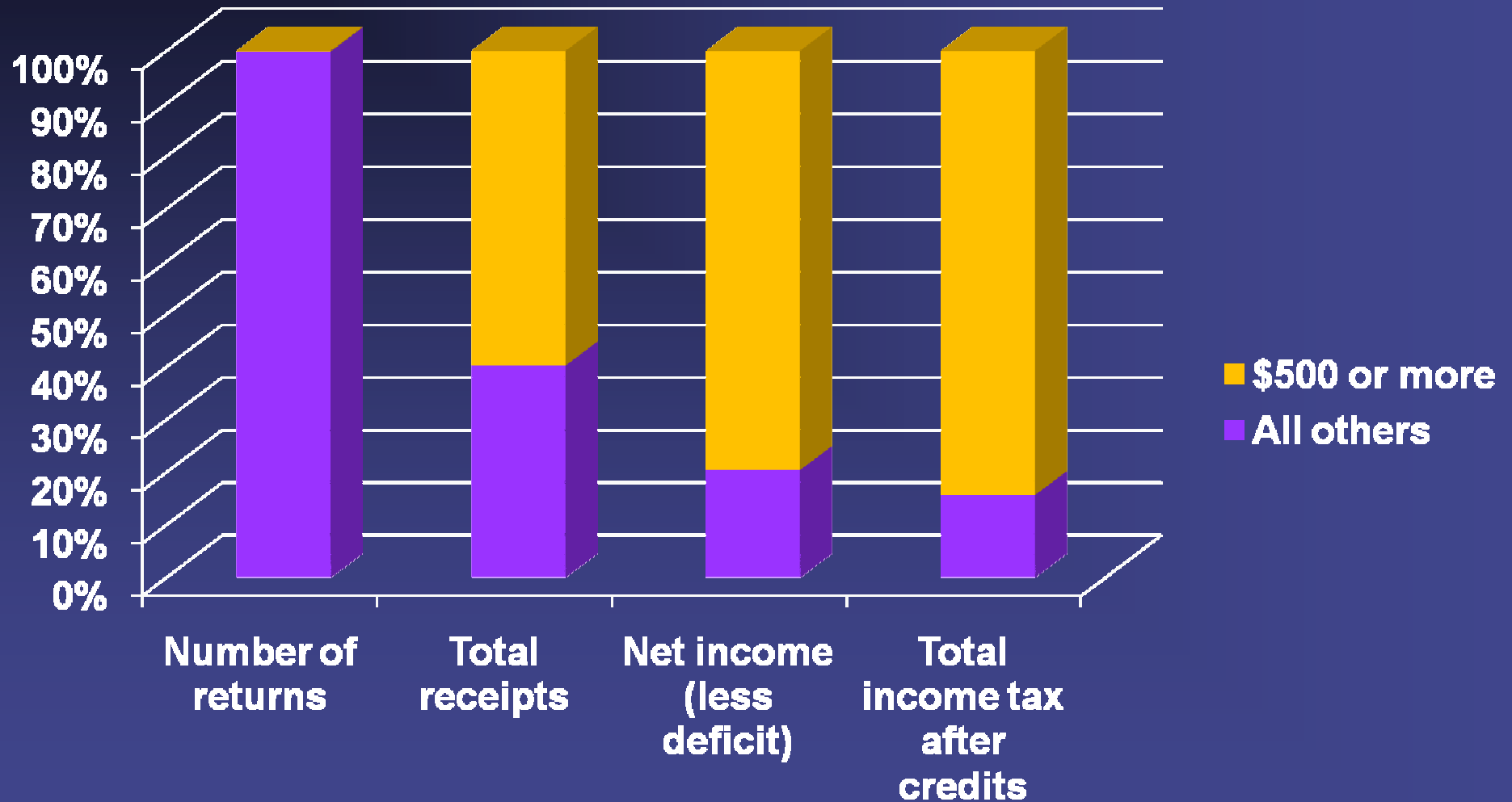
# Corporations vs. Flowthroughs – \$29.6 Trillion Total Receipts - 2005



# Corporations vs. Flowthroughs – \$2.6 Trillion - Net Income - 2005



# C Corporations - \$500M or More in Assets



# What is going on in the corporate statistics?

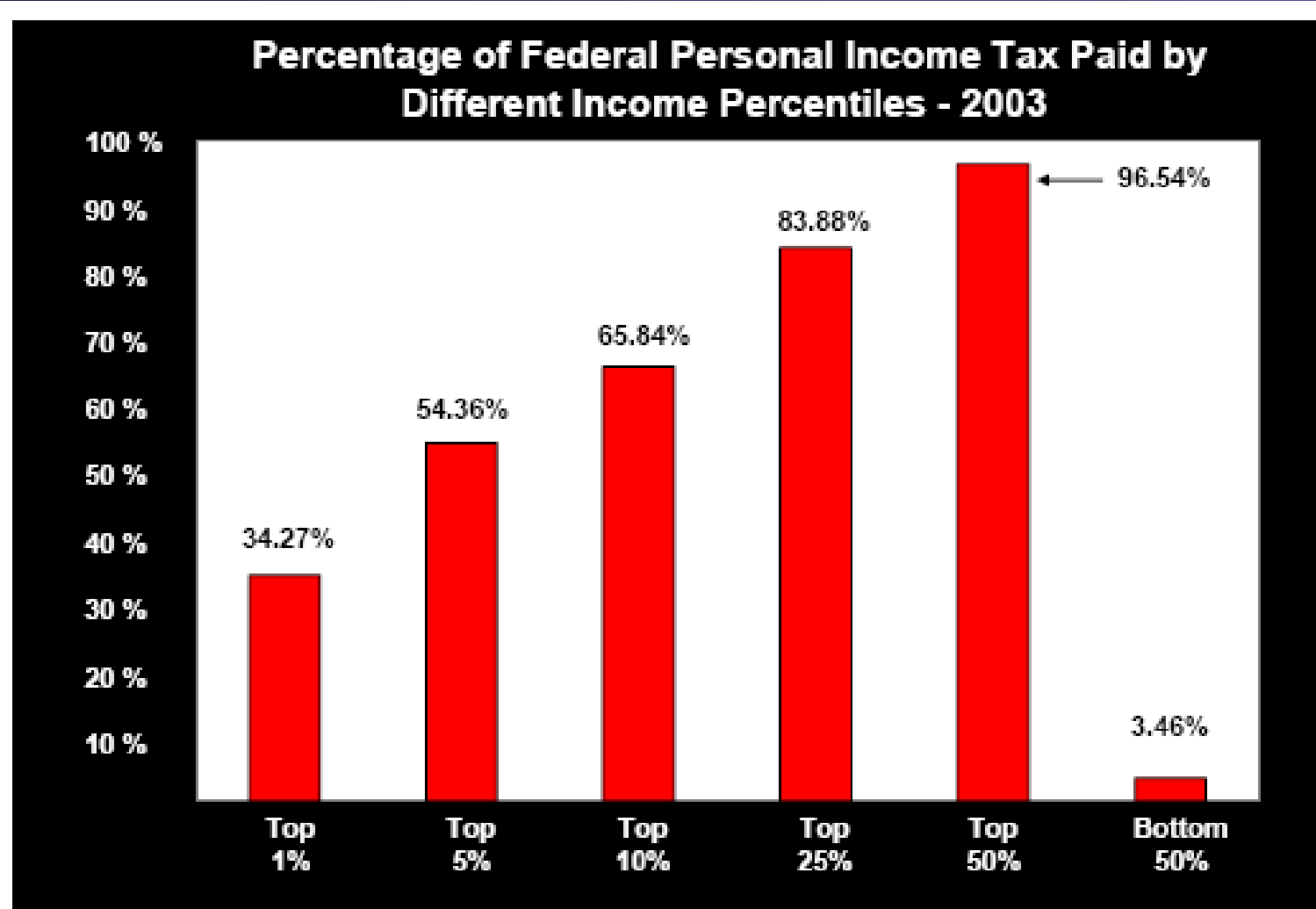
- ✿ The largest corporations (\$500 million or more in assets) account for:
  - ✿ 0.1% of corporate returns
  - ✿ 60% of total receipts
  - ✿ 80% of net income
  - ✿ 84% of corporate income tax
- ✿ Implication: Largest corporations dominate statistics and measures of economic activity in the corporate 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

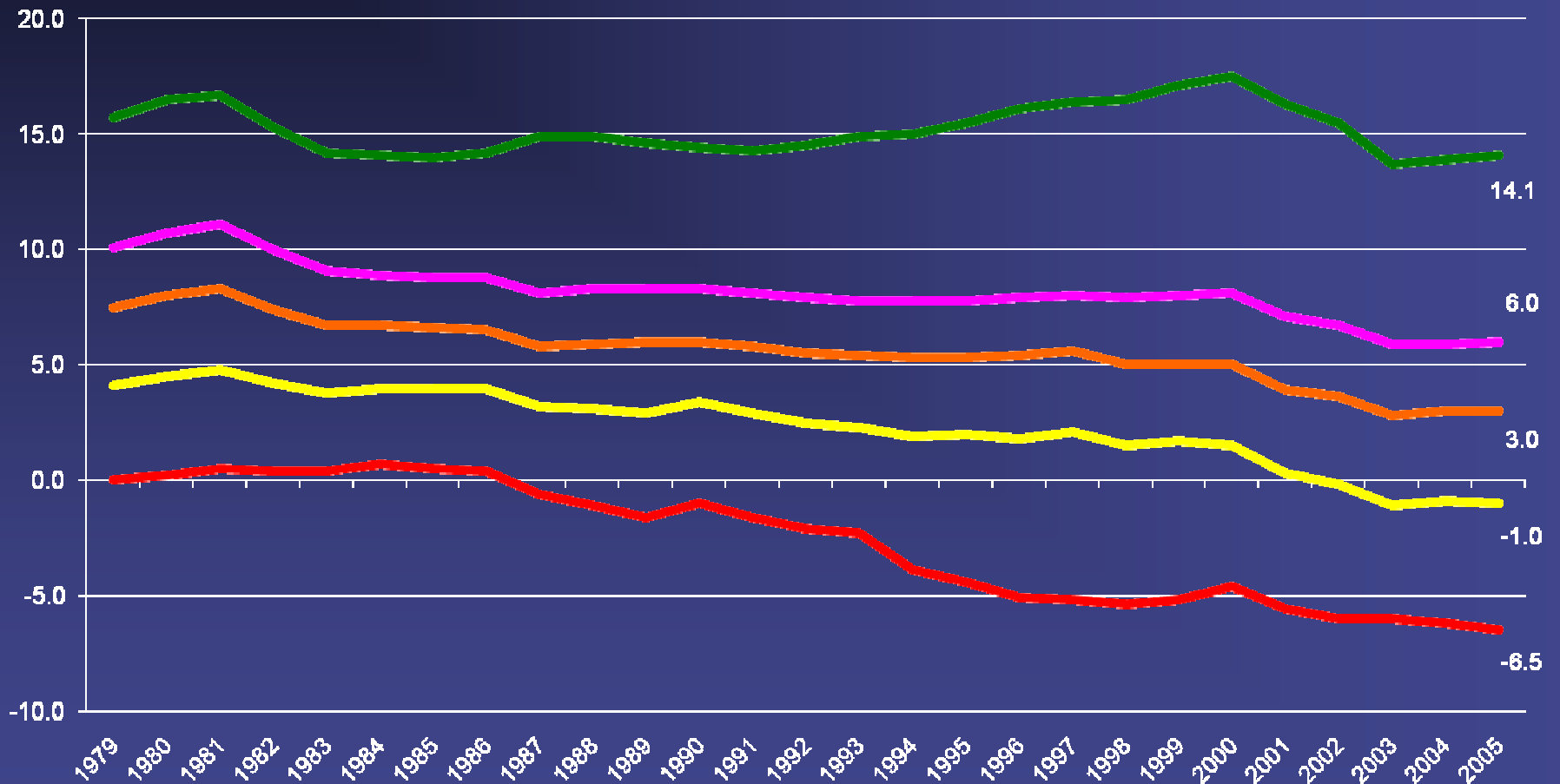
# Individual Income Tax - 2005

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

Source: All Households, CBO, 2008



# Effective Individual Income Tax Rates for All Households by Quintile, 2005

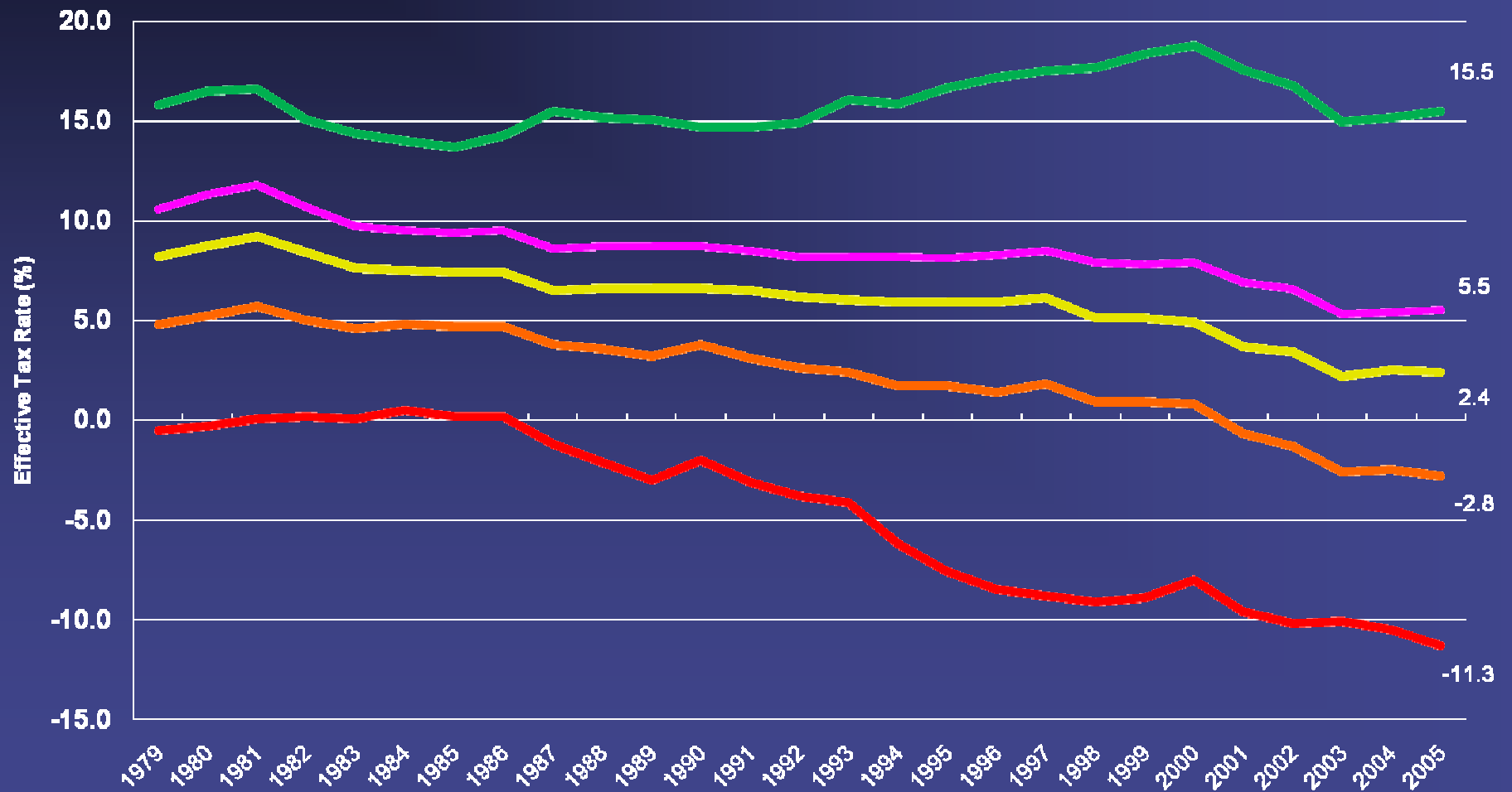


# Individual Income Tax - 2005

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

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 =  $f(\text{tax base, tax rate})$
- ✿ 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 –  $30/(100+30) = 23\%$ 
      - Income Taxes
    - Exclusive –  $30/100 = 30\%$ 
      - 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





# #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

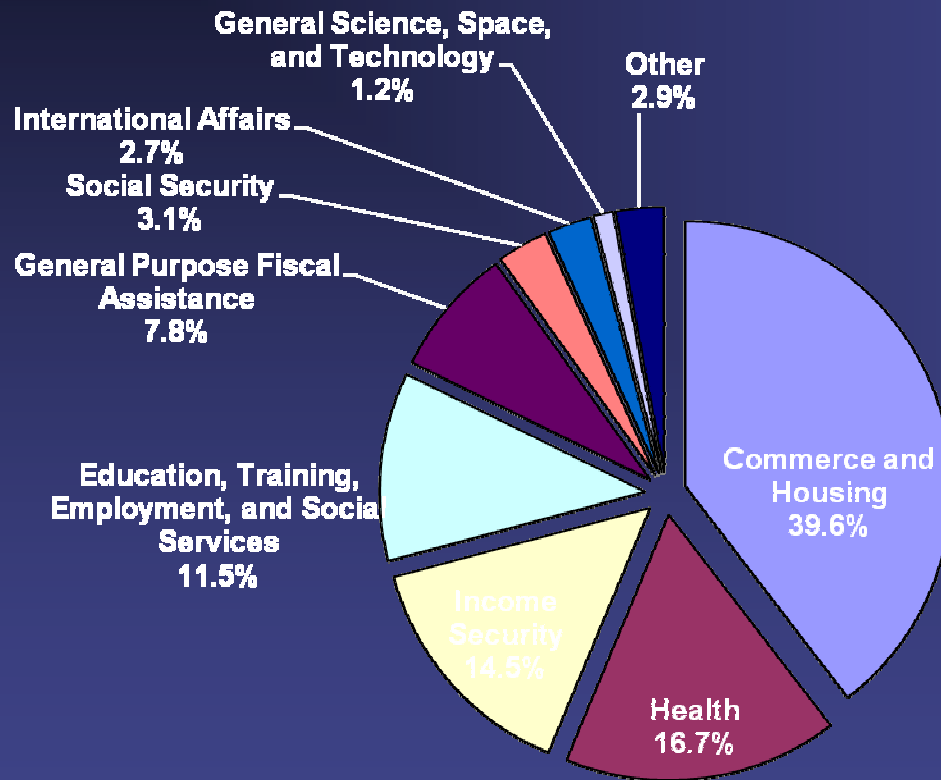
- ☀ Definition: tax reductions due to exclusions, deductions, exemptions, and credits
- ☀ Examples:
  - ✧ Pension contributions
  - ✧ Employer contributions for medical ins and care
  - ✧ Mortgage interest on owner-occupied homes
  - ✧ Non-business state and local taxes
  - ✧ Capital gains
  - ✧ Accelerated depreciation, etc. etc.

# Revenue vs. Outlay Equivalent Cost for Eight Tax Expenditures in 2004

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

Source: Tax Policy Center

# Tax Expenditure Budget, 2006



# Implications of Complexity



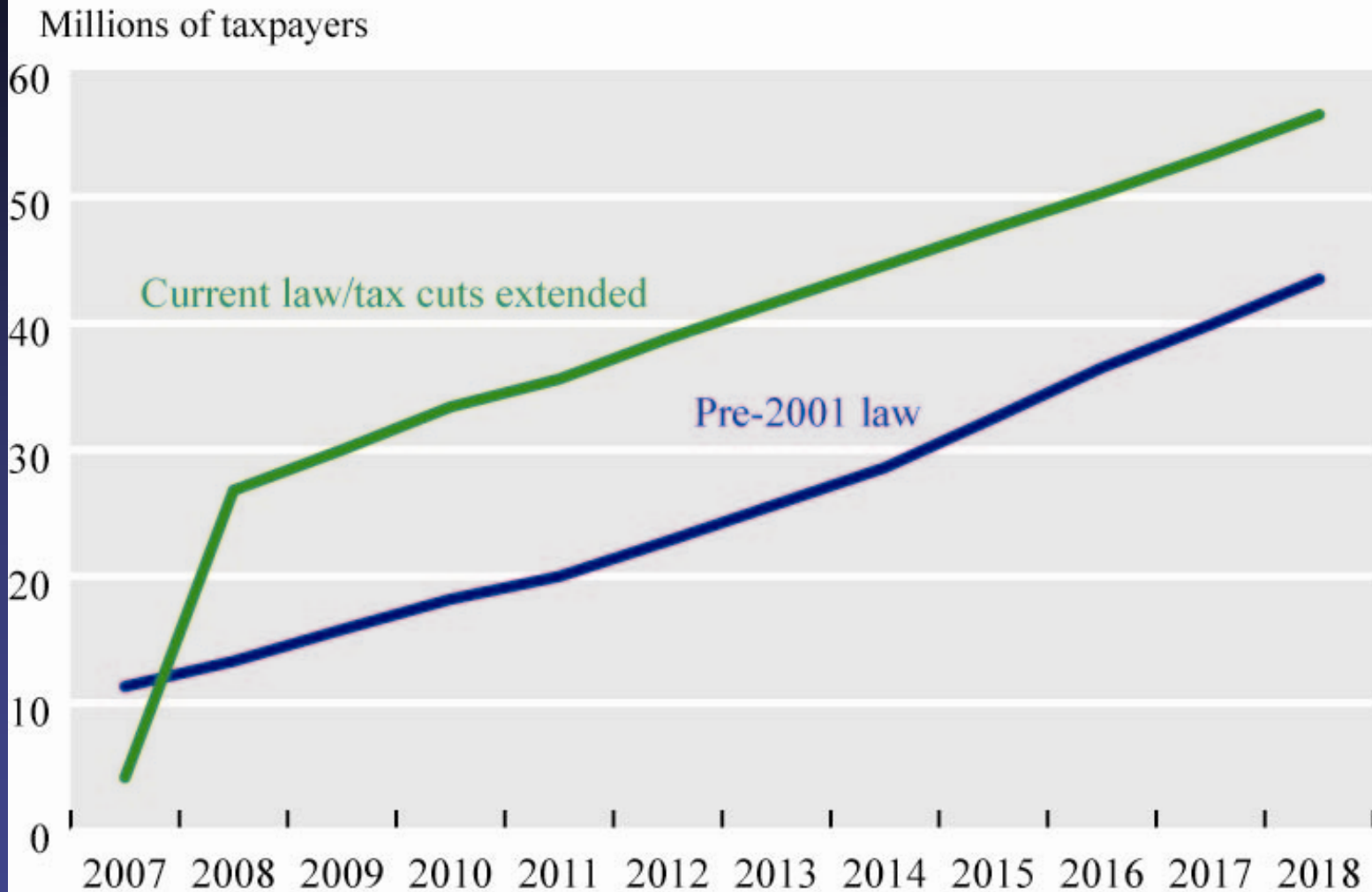
**Be careful what you build. . .**

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

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

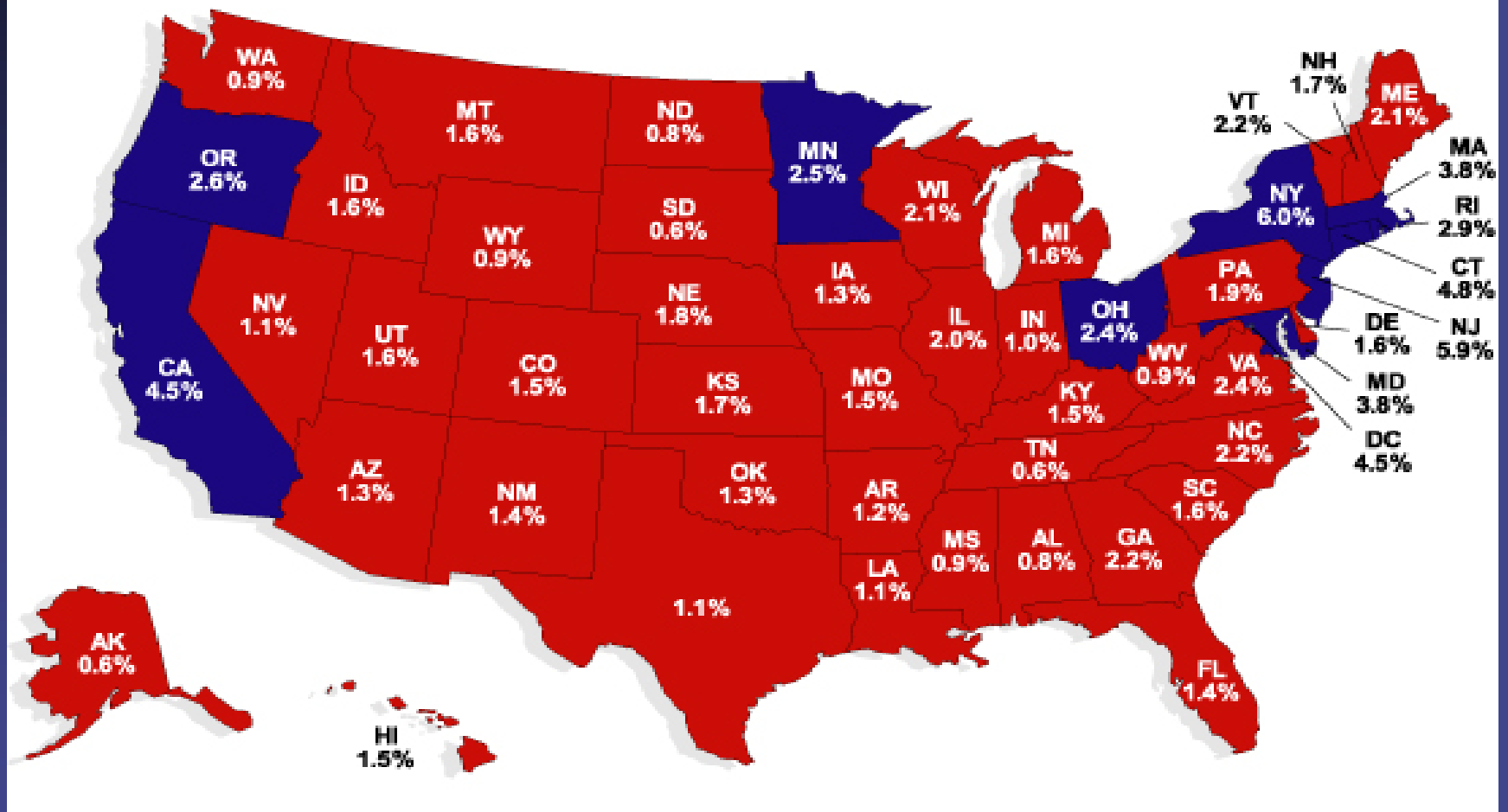
**IRS.gov Offers Online Alternative Minimum Tax Assistance** – *AP Newswire, January 27, 2007*

## Projected Number of AMT Taxpayers with and without Effect of the 2001–2006 Tax Cuts



Source: Tax Policy Center table T08-0094,  
<http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=1809>

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

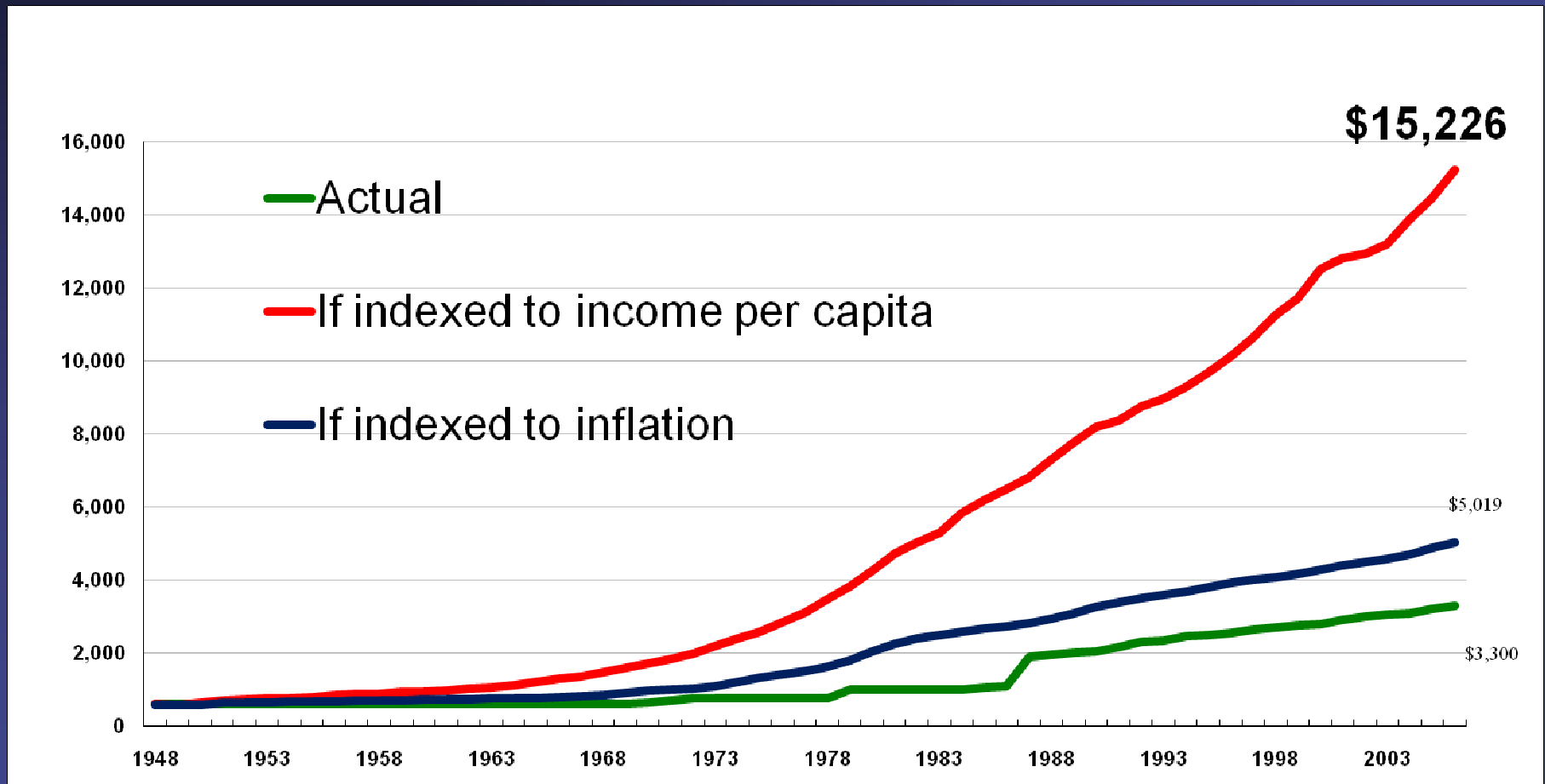


Source: Tax Foundation, 2005



# History of the Personal Exemption, 1948-2006

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

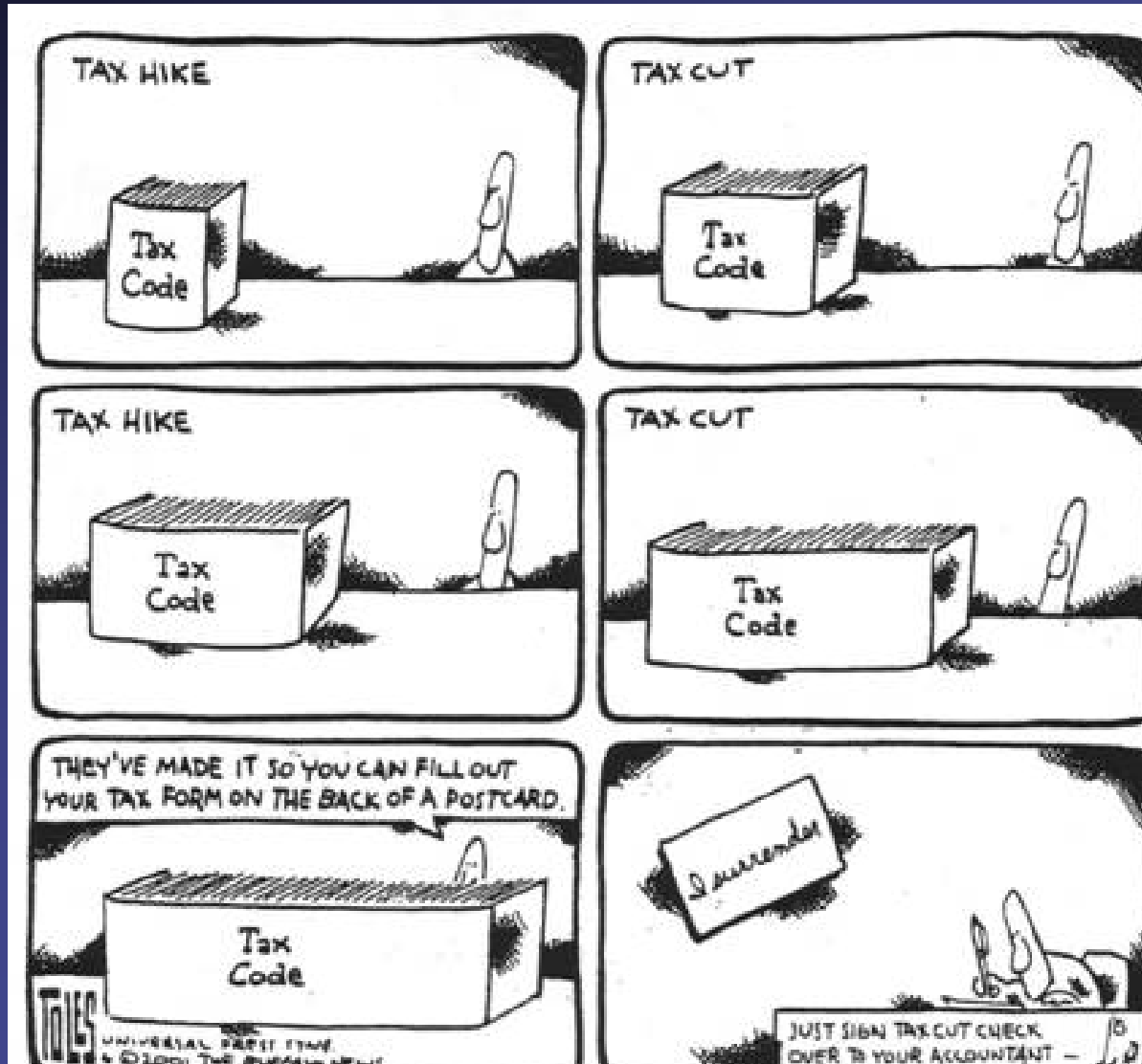


Source: Tax Policy Center

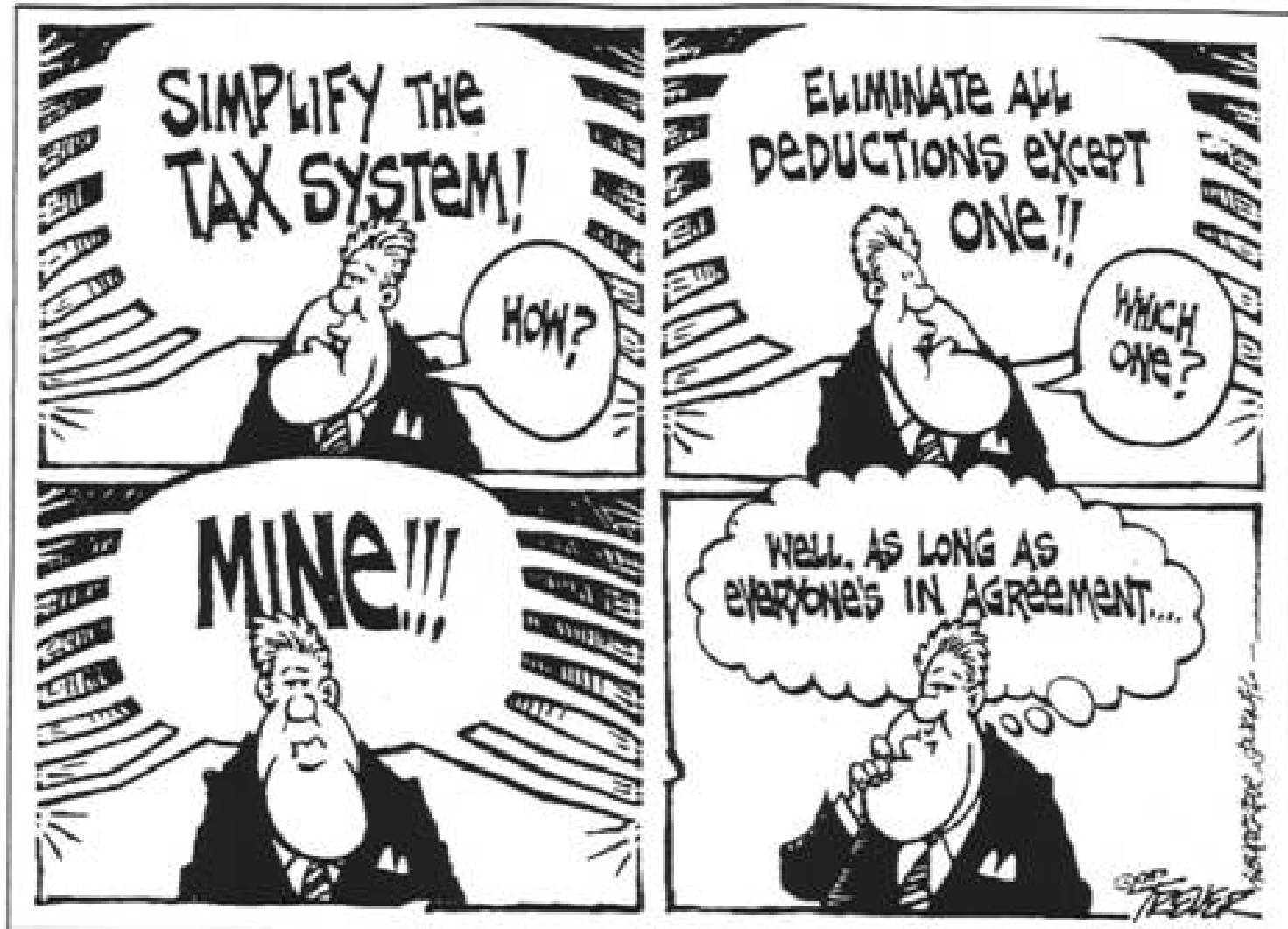
In the great circle of life. . . .



And it just keeps getting bigger . . . .

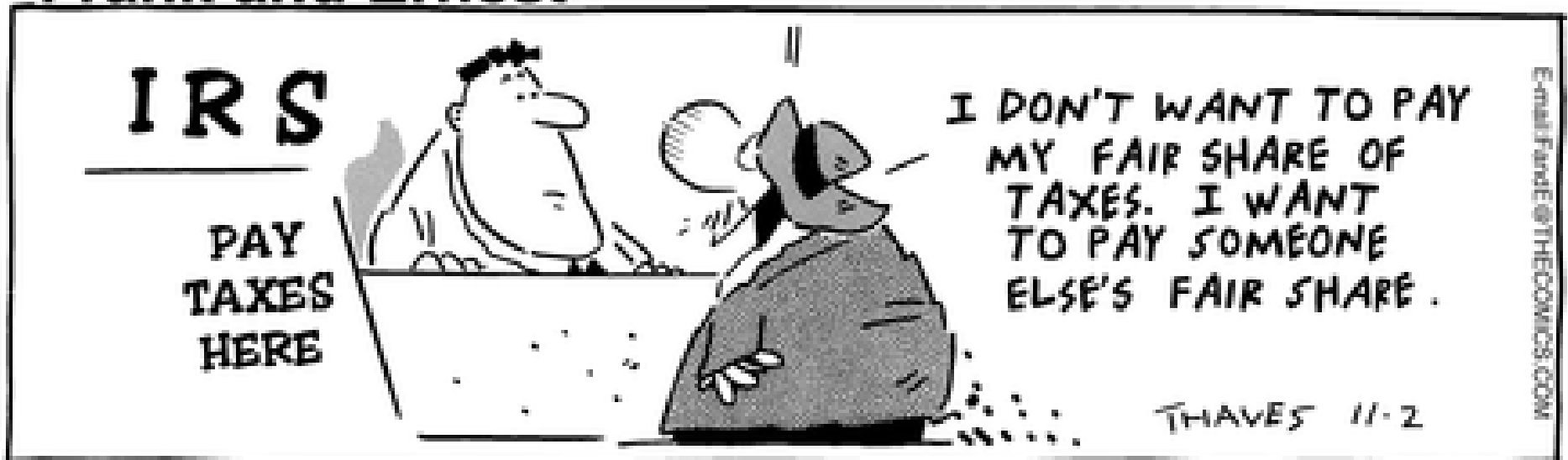


# Solution: Simplify?



# But how????

## Frank and Ernest



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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  $\neq$  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!

- ✿ Steurle, Eugene C., *Contemporary U.S. Tax Policy*, Urban Institute Press, 2004.
- ✿ A history of taxation in the U.S. -<http://www.tax.org/museum>.
- ✿ Scholes, Wolfson, Erickson, Maydew, and Shevlin, *Taxes and Business Strategy: A Planning Approach, 2<sup>nd</sup> Edition*, (Prentice-Hall, 2002).
- ✿ Useful websites:
  - ✿ Tax Foundation: [www.taxfoundation.org](http://www.taxfoundation.org)
  - ✿ Tax Policy Center: <http://taxpolicycenter.org>
  - ✿ Statistics of Income: <http://www.irs.gov/taxstats/index.html>
- ✿ . . . . And all of your favorite newspapers and periodicals!