FAIRNESS ISSUES

Testimony before the President's Advisory Panel on Federal Tax Reform

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March 23, 2005

Fairness Issues

I will look primarily at three issues

- Measuring the distributional effects of tax proposals
- Other aspects of fairness: do tax proposals treat future generations and other levels of government equitably?
- The role of the Earned Income Tax Credit in improving tax fairness

Measuring the Distributional Effects of Tax Proposals

- Many economists and tax analysts have concluded that the best way to measure the distributional effects of a tax proposal is to examine the percentage change in after-tax income that would result.

- A 1999 Treasury analysis that reviewed various ways to assess the distributional effects of tax proposals concluded that the percentage change in after-tax income is "the best measure of the change in a family's well-being."[1]

- The percentage change in after-tax income is particularly important because after-tax income represents the income that households have to spend or save.

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[1] Julie-Anne Cronin, Office of Tax Analysis, *U.S. Treasury Distributional Analysis methodology,* OTA Paper 85, September 1999.

After-Tax Income Gaps Have Widened

Adding to the importance of considering the effects of tax policy changes on the distribution of after-tax income is the fact that disparities in the distribution of after-tax income have widened fairly dramatically over the past quarter century. (Disparities in pre-tax income have widened substantially as well.) Changes in the tax code preferably should lean against this trend and, at a minimum, should not accelerate it.

The best data on changes in after-tax income come from the Congressional Budget Office. CBO uses Census data and IRS *Statistics of Income* data to produce what analysts widely regard as the most authoritative and reliable data series on the matter. The CBO data cover the years 1979-2002.

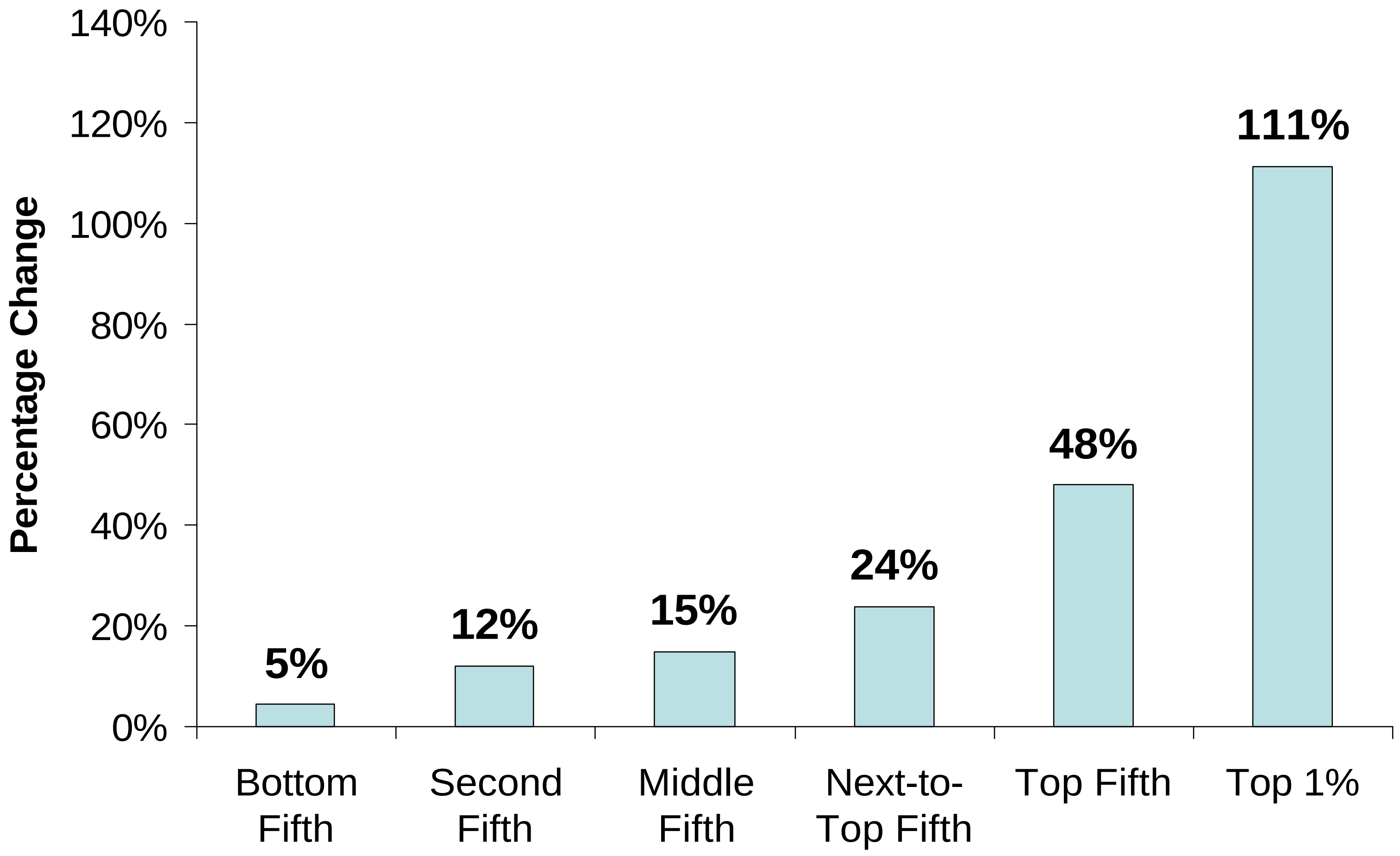
Changes in Average After-Tax Income by Income Group, 1979-2002

(in 2002 dollars)

Income Category	1979	2002	Percent Change 1979-2002	Dollar Change 1979-2002
Lowest fifth	$13,200	$13,800	4.5%	$600
Second fifth	$26,700	$29,900	12.0%	$3,200
Middle fifth	$38,000	$43,700	15.0%	$5,700
Fourth fifth	$49,800	$61,700	23.9%	$11,900
Top fifth	$87,700	$130,000	48.2%	$42,300
Top 1 Percent	$298,900	$631,700	111.3%	$332,800

Source: Congressional Budget Office, *Effective Federal Tax Rates: 1979-2002*, March 2005

Change in Average After-Tax Income: 1979-2002



Source: Congressional Budget Office

Developing Distributional Tables

- The most informative, ideologically neutral distributional tables are those issued by the Urban Institute-Brookings Institution Tax Policy Center. These tables provide extensive information that enables one to assess a tax proposal from a variety of distributional perspectives. The TPC tables include the measure that many economists and analysts regard as the most valuable single measure, the percentage change in after-tax income, along with other useful distributional information.

- The approach reflected in the distributional tables issued by the Treasury Department can change with the administration.

- Distribution tables issued by the Treasury today are of limited value. They generally omit seven of the eight columns of information included in the TPC tables.

Example of a Tax Policy Center Distribution Table

April 8, 2004 **Preliminary Results** http://www.taxpolicycenter.org

"Middle-Class Provisions" in EGTRRA and JGTRRA:

Distribution of Individual Income Tax Change by Cash Income Class, 2004[1]

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Income Tax Cut				Pre-EGTRRA	Proposal
Less than 10	20,428	14.2	5.8	0.1	0.1	-4	3.6	3.5
10-20	26,467	18.4	52.5	1.1	4.4	-155	6.6	5.6
20-30	20,379	14.2	78.7	2.0	9.6	-439	12.8	11.1
30-40	15,377	10.7	84.7	1.9	9.3	-566	16.6	15.0
40-50	11,446	8.0	92.9	1.9	8.8	-722	18.7	17.1
50-75	20,054	14.0	97.8	1.9	19.9	-930	20.6	19.1
75-100	11,395	7.9	98.0	2.3	18.6	-1,528	22.7	20.9
100-200	13,281	9.3	95.0	1.7	24.0	-1,690	25.1	23.8
200-500	3,339	2.3	75.0	0.5	4.1	-1,155	27.6	27.2
500-1,000	527	0.4	82.2	0.3	0.8	-1,404	29.7	29.5
More than 1,000	257	0.2	84.2	0.1	0.4	-1,439	33.8	33.8
All	143,509	100.0	70.6	1.5	100.0	-652	22.6	21.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2).
Notes: See table in the appendix, with notes included.

“Wage Tax” Would Pose Equity Problems

Recent tax law changes have begun moving the income tax toward a wage tax (which, unlike a consumption tax, doesn’t tax consumption made with existing assets). This increases regressivity without capturing potential economic advantages of a consumption tax.

Moving further in this direction would pose serious equity concerns. Under some proposals, affluent investors would be able to borrow substantial amounts and deduct the interest, while having the earnings on investments financed with the borrowed funds largely or entirely exempt from tax.

- This increases incentives and opportunities for tax sheltering
- By enabling affluent individuals to shelter substantial income from taxation, it shifts tax burdens to the less affluent

Why a Wage Tax is Regressive

An analysis by economists William Gale and Peter Orszag, both senior fellows at Brookings and co-directors of the Urban Institute-Brookings Tax Policy Center, explains why a wage tax would be regressive. Gale and Orszag write:

> “... the middle 20 percent of the population derives 80 percent of its total income from wages and salaries; the top 1 percent, by contrast, obtains only 50 percent of its total income from wages and salaries. Similarly, the top 1 percent of the population is projected to earn 12 percent of total taxable wage and salary income in 2004, but 46 percent of total taxable capital income.
>
> “These patterns mean that the shift toward exempting capital income from tax and placing the full burden on wages is hugely regressive. It moves the tax burden down the income distribution, toward families that derive most of their income from work.” (Gale and Orszag, “The Wage Tax,” *Yale Politic*, March 2004.)

Equity and Retirement Savings

Retirement saving will become more important in future decades, especially if Social Security and Medicare ultimately are pared back. But tax incentives for retirement saving in the current system are upside-down.

- About two-thirds of the tax benefits from preferences for 401(k)s and IRAs go to the top 20% of households
- This is partly because the tax incentives to put money in retirement accounts are greater for those in higher tax brackets
- This is neither an efficient nor an equitable way to increase saving: to increase saving, one must generate *additional* contributions, not induce asset shifts. Studies suggest that upper-income households are more likely than less-affluent households to shift existing savings in response to tax incentives, rather than to save more.
- Well-designed measures to reform tax preferences for retirement saving could both improve equity and increase saving.

Other Aspects of Fairness: Generational Equity

Tax reform should not saddle future generations with more debt

- Reform proposals should not result in revenues beyond the 10-year period being lower than they would be in the absence of reform. (10-year revenue neutrality measures aren’t sufficient to ensure this; tax changes can be designed so they are revenue-neutral for 10 years but lose large amounts of revenue after that.)
- Reformers should be wary of “backloaded” proposals whose full costs do not show up until after the 10-year point, such as proposals for Retirement Saving Accounts and Lifetime Savings Accounts.

Other Measures of Fairness: Intergovernmental Equity

States are struggling to finance their obligations, and they will face more difficulties as the population ages (especially since Medicare does not cover long-term care costs, which results in states bearing rising costs for long-term care through Medicaid).

Most states with an income tax conform to the federal definition of taxable income. Thus, when federal policymakers narrow the tax base, states lose revenue (unless they “decouple” from the federal tax code, which adds to complexity).

Federal tax reforms should be designed in a way that protects state revenue bases, and avoids causing states to lose significant revenue.

The Critical Role of the Earned Income Tax Credit in Equity Considerations

EITC makes tax code more progressive.

EITC expansions were used in 1986 Tax Reform Act to maintain distributional equity for package as a whole.

EITC expansions used in 1980s, 1990, and 1993 to offset regressive effects of increases in payroll taxes and in gasoline, alcohol, and tobacco excise taxes.

EITC: Other Attributes

- Studies find EITC substantially increases work effort and reduces welfare receipt among single parents. EITC has been integral to welfare reform.*
- Census data show the EITC reduces poverty among children by more than any other program or category of program.
- EITC has much lower administrative costs than other means-tested programs.
- EITC has enjoyed bipartisan support: created by Russell Long, championed by Ronald Reagan, lauded by leading conservatives and liberal economists alike, including Gary Becker and Robert Barro.

* See Grogger (2003), Meyer and Rosenbaum (2001), Dickert, Houser, and Scholz (1995), Eissa and Liebman (1996).

But EITC Needs Improvement to Make it Less Prone to Error, Less Burdensome and Fairer

Error rate primarily reflects credit’s complexity

- EITC instructions have more pages than AMT

Possible remedies:

- EITC simplification proposals made by the Administration last year to simplify the EITC “abandoned spouse rule” and eliminated the complex EITC investment income test.
- Consolidation of the EITC, Child Tax Credit, and personal exemption for children.

EITC also has a marriage penalty that was reduced by 2001 Act but could be reduced more.

EITC and Equity in Tax Code: A Hole that Should be Filled

A key goal of President Reagan and the 1986 Tax Reform Act: workers below the poverty line should *not* be subject to income tax and taxed deeper into poverty.

The goal was missed in one area: single workers begin owing income tax several hundred dollars *below* the poverty line. This is in addition to payroll taxes.

- A single worker at the poverty line ($10,062) pays $827 in federal income and payroll tax when the employee (but not the employer) share of the payroll tax is counted. This is the tax the worker owes *net* of the EITC.

- Counting the employer share, the worker pays $1,600 in taxes.

Finishing the Job: Ensuring that Workers Below the Poverty Line Are Not Subject to Income Tax

Enlarge the small EITC for adult workers not raising children.

The current EITC for these workers equals only 7.65% of their first several thousand dollars in wages.

This “credit rate” could be raised to 15.3%.

This also may induce more low-skilled individuals to enter the labor force.

Final Fairness Issue: Noncompliance and Enforcement Affect Both Horizontal and Vertical Equity

Noncompliance reduces horizontal equity. One individual can pay more than a comparable individual because the comparable individual is noncompliant.

Compliance measures can affect vertical equity if, for example, noncompliance is scrutinized intensively in the EITC but similar scrutiny is *not* applied to higher-income filers or businesses, especially in places (such as small business income) where noncompliance rates appear higher than for the EITC.

IRS enforcement (especially *outside* the EITC) has been weakened too much in recent years.

Conclusions

1. Distributional concerns should rank high in designing tax reform proposals. The single best distributional measure is the change in after-tax income.

2. A “wage tax” would raise serious equity problems and could expand opportunities for tax sheltering; it could carry the downside of a consumption tax (increased regressivity) without the economic advantages of such a tax.

3. Current incentives for retirement saving are neither efficient in increasing saving nor equitable and could be significantly improved.

4. Tax reform should not saddle future generations with more debt, and hence should not result in revenues beyond the 10-year window being lower than they would be in the absence of reform.

Conclusions (continued)

5. Tax reform should avoid narrowing state revenue bases and causing states to lose revenue.
6. The Earned Income Tax Credit has been successful in promoting work and reducing poverty, and has been used to improve the distributional effects of tax packages.
7. The EITC could be improved by making it simpler, reducing its marriage penalty, and expanding the very small EITC for workers without children.
8. Stronger compliance measures could strengthen tax fairness.

A model for reform: The 1986 Tax Reform Act admirably met these equity standards while also improving economic efficiency.