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Statement of

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Fairness in Tax Policy

March 5, 2007

Chairman Serrano, Ranking Member Regula, Members of the Committee: Thank you for inviting me to share my views on fairness in tax policy.

As you are well aware, the issue of tax fairness is highly contentious and, unfortunately, economics provides little guidance. One person's idea of a fair tax system—for example, a flat tax on wages—epitomizes unfairness to those who believe in tax progressivity.

Defining fairness is tricky. Economists are mostly agreed on one notion of fairness—so-called horizontal equity—the idea that the tax system should treat similar people in a similar way. That means, for example, that the tax system shouldn't discriminate between owners and renters, people with health insurance and people without, or those who choose to drive a hybrid car and those who drive an old clunker. Of course, the tax system does discriminate in each of those cases, always with the rationale that a higher policy goal is being advanced: building community (mortgage interest deduction), encouraging health insurance coverage (health insurance exclusion), and improving the environment and reducing reliance on foreign oil (hybrid vehicle tax credit). Thus, even when we have an objectively supportable standard, other goals may trump it and often do. The consequence is that neighbors with identical incomes might often pay very different amounts of tax.

[1] Views expressed are mine alone and do not necessarily reflect the views of any organization with which I am affiliated.

The more controversial notion is that of vertical equity—the idea that higher-income people should pay a larger share of their income in tax than those less able to pay. This concept underlies our progressive federal income tax, but all of the loopholes and deductions in the tax system can undermine progressivity. Also, an income tax violates horizontal equity in the sense that it taxes people who choose to save more than otherwise similar people who prefer to spend all of their incomes.

I believe that there is a compelling argument for a progressive tax system for several reasons. First, people vary widely in their abilities to earn income. If you did not know whether you were going to be a lucky person with high ability to earn income or an unlucky one with low ability and earning capacity, you'd want a progressive tax system as a kind of insurance. You'd share a large portion of your income when things work out well in exchange for a higher after-tax income when you fall on bad luck.

Second, inequality has been growing in the United States and the tax system has developed into the prime instrument available to mitigate that trend. Inequality in the United States has not arisen from a reduction in work effort among the middle class. In fact, they appear to be working more hours than ever. Inequality appears to arise from various factors including technology, international trade, and a winner-take-all society in which top performers earn much, much more than everybody else. Those trends show no signs of abating, so the tax system might be the best instrument available to diminish after-tax inequality, even as pre-tax inequality is growing.

Third, even those who believe that it is fine for a small number of people to control more and more of society's resources might have an interest in using the tax system to diminish inequality. Growing inequality can lead to a populist revolt against factors thought to be implicated, such as free trade and relatively unfettered markets. Increasing trade barriers and increased regulation could diminish the incomes of those at the top by much more than a modestly progressive tax system (and might not help those at the bottom either). The progressive income tax might be viewed as a mechanism to buy the support of ordinary working people for a system that disproportionately benefits a few high earners.

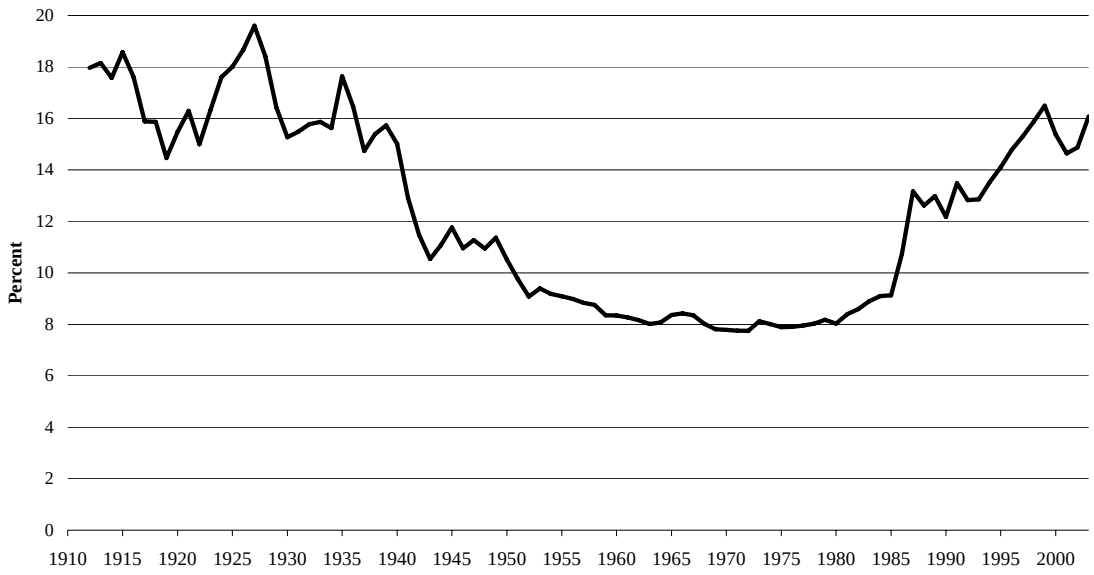
Unfortunately, recent tax changes have significantly undermined the progressivity of the tax system. What is more, since they were paid for with borrowed money, we won't know their full impact until the deficits are closed at some time in the future. Depending on how the tax cuts are financed, they could end up being even less progressive than current distributional tables imply, or they could turn out to be very progressive.

My testimony will summarize the trends in inequality and discuss some of the factors at play, examine the role the federal tax system has played in mitigating inequality, and discuss the effect of the tax cuts enacted since 2001. I finish with some concluding observations.

Trends in inequality

If people all had equal abilities to earn income, a simple flat tax would be fairest, but that has never been the case. Although there are significant differences in choices people make to work, save, pursue higher education, and in the kinds of jobs they're willing to take, there are huge differences in terms of intelligence, inheritance, and luck. Those differences manifest themselves in a highly skewed distribution of income, and the skew in favor of the rich seems to be growing over time. As economists Thomas Picketty and Emmanuel Saez (2003) have shown, the 1 percent of households with the highest incomes now earn about 16 percent of all income (excluding volatile capital gains)—a level last seen just before the great depression, and twice the share in the 1960s and 1970s (figure 1).

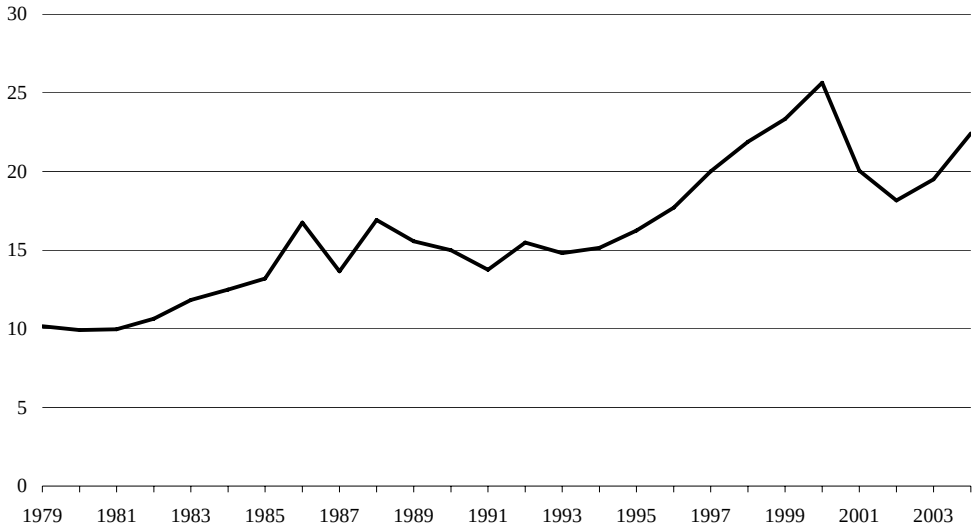
Figure 1. Income Share of Top 1 Percent (excluding capital gains), 1913-2004



Source: Picketty and Saez (2003) and updated data from http://elsa.berkeley.edu/~saez/TabFig2004.xls.

The average household in the top 1 percent receives 22 times as much as the average household in the middle 20 percent according to data reported by the Congressional Budget Office (CBO) (figure 2). By comparison, through the 1980s, that ratio never exceeded 17.

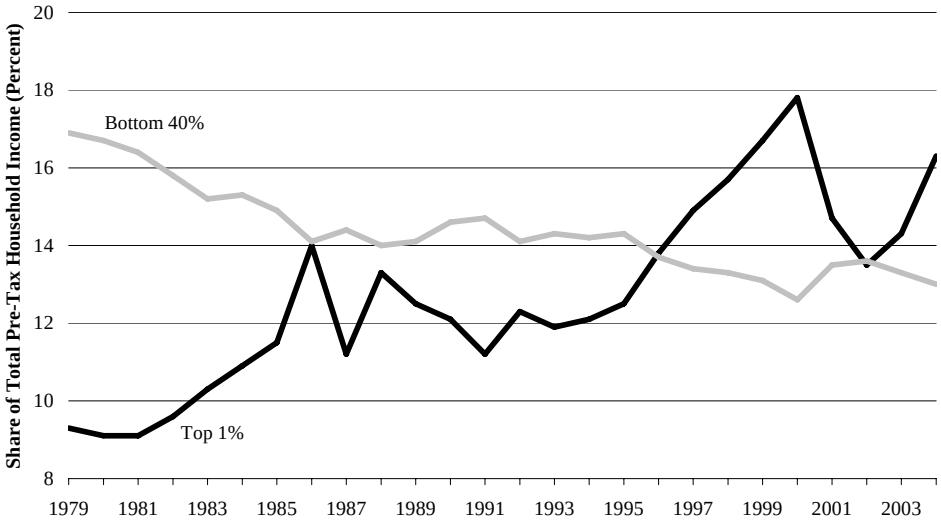
Figure 2. Ratio of Income in Top One Percent to Middle 20 Percent, 1979-2004



Source: Congressional Budget Office and Tax Policy Center.

Looked at another way, the CBO data show that the top 1 percent of households received about 9 percent of income in 1979, compared with about 16 percent in 2004 (figure 3). The bottom 40 percent received about 17 percent of income in 1979, but their share dropped below that of the top 1 percent in the late 1990s; they received about 13 percent of pre-tax income in 2004.

Figure 3. Share of Pre-Tax Income Earned by the Top 1% and Bottom 40%, 1979-2004

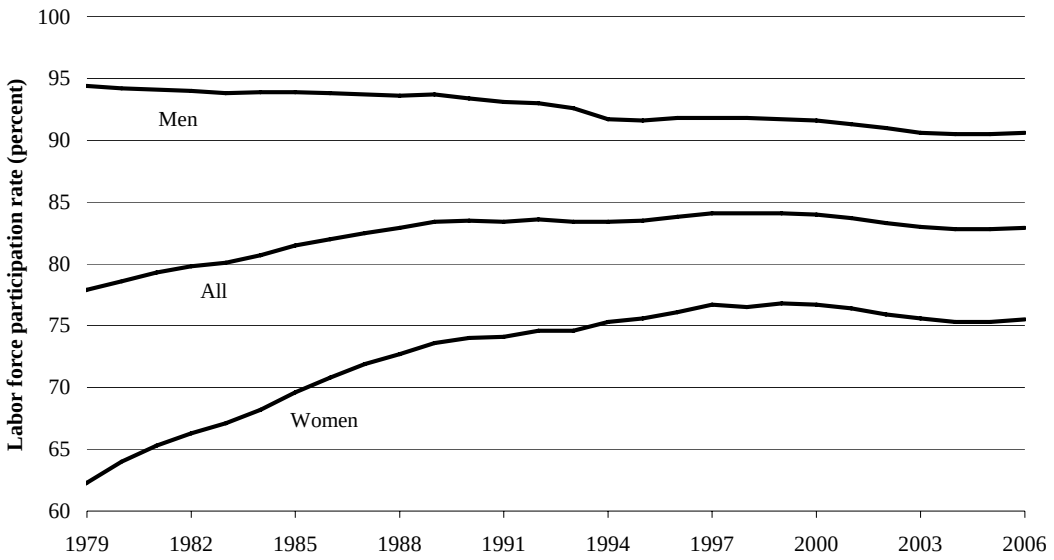


Source: Congressional Budget Office.

Income inequality is clearly worsening, and the trend appears likely to continue. Explanations for rising inequality include the decline in the power of labor unions, increased immigration, and the effects of international trade and the growth in information technology (Goldin and Margo 1992). Despite remarkable gains in labor productivity, the benefits of those gains have mostly accrued to the highest-income 10 percent. All other income classes have seen their wages grow more slowly than productivity. Economists Ian Dew-Becker and Robert Gordon (2005) attribute the increasing skew in earnings to "the economics of superstars," which richly rewards the top performers relative to others who are nearly as productive.

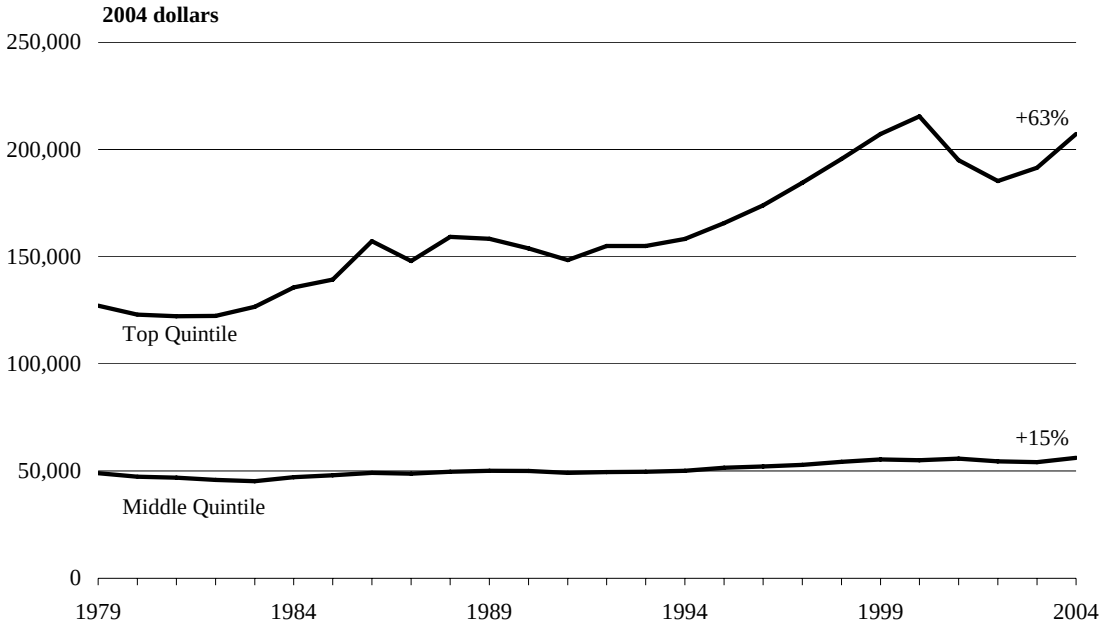
Increased inequality has *not* arisen because the middle class has become a bunch of slackers. Indeed, the opposite seems to be the case. Women between the ages of 25 and 54 are 20 percent more likely to be working now as they were in 1979, and there has been only a slight decrease in labor force participation among men of the same age (figure 4). Sociologists Michael Hout and Caroline Hanley (2003) found that married women with children increased their average time at paid work by nearly half between 1979 and 2001, and married women without children worked over 25 percent more hours each week in 2001 than in 1979. Together, married parents increased their hours worked by more than 10 percent, whether they had children or not. The average American family is working harder than ever but, except at the top of the income scale, its income does not reflect the extra effort. Between 1979 and 2004, average income for households in the middle quintile rose less than 1 percent a year, climbing just 15 percent after adjusting for inflation (figure 5). In contrast, households in the top quintile saw their average income soar 63 percent, more than four times as fast.

Figure 4. Civilian Labor Force Participation Rate, Age 25 to 54, 1979-2006



Source: Bureau of Labor Statistics.

Figure 5. Average Pre-Tax Household Income
Middle and Top Income Quintiles, 1979-2004



Source: Congressional Budget Office.

The tax system and inequality

The federal tax system reduces economic inequality because, overall, it is progressive. That means that it reduces the after-tax incomes of high-income people by proportionately more than the incomes of lower-income people. Figure 6 illustrates how the tax system has diminished income disparities historically. In 1979, the bottom four quintiles (80 percent) of the income distribution earned 55 percent of pre-tax income and the top quintile earned the other 45 percent. Over time, the higher-income households earned an ever larger share of pre-tax income. In the late 1980s and first half of the 1990s, the two groups approximately split total income in half; in 1996, the top 20 percent pulled ahead and the gap widened after that.

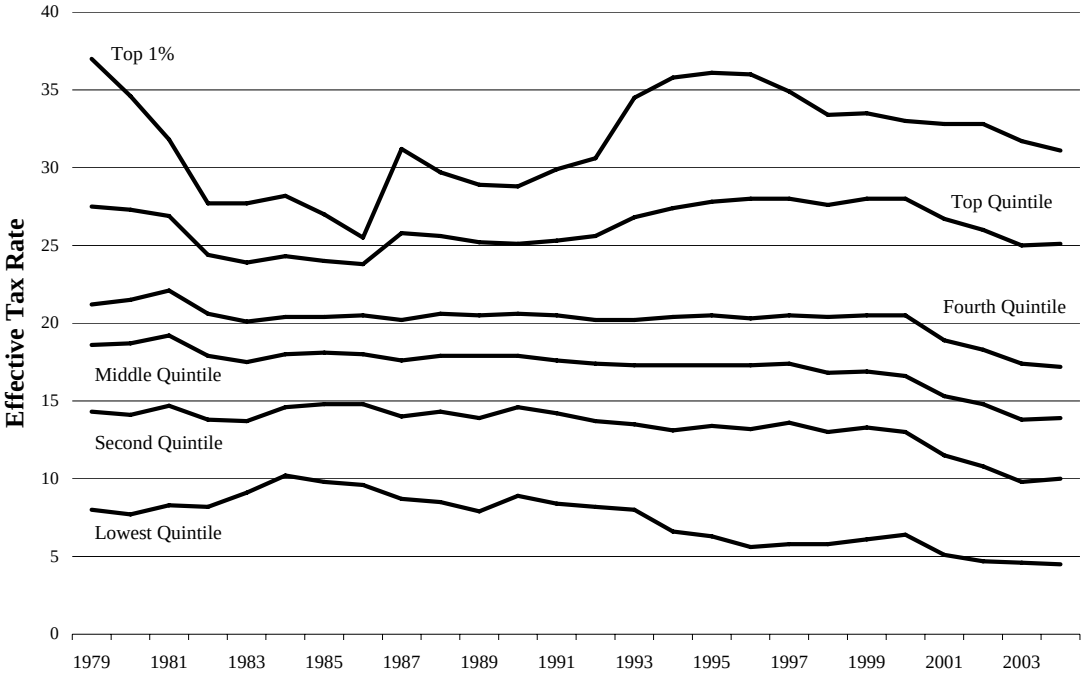
The right-hand panel in figure 6 shows how taxes change that comparison. Except for one year, 2000, which was fueled by unusually large stock options and capital gains, the bottom 80 percent always received a larger share of after-tax income than the top 20 percent. In 1979, the difference in shares of after-tax income was 16 percentage points, compared with a 10 percentage point difference in the share of pre-tax income. In 2004, taxes shifted the division from a 6 percentage point advantage in pre-tax income for the top quintile to a narrow edge in after-tax income for the bottom 80 percent. Clearly, the progressive tax system leads to a more even distribution of after-tax income.

Figure 6. Pre- and After-Tax Shares of Household Income for the Top 20 and Bottom 80 Percent, 1979 to 2004

Source: Tax Policy Center calculations based on Congressional Budget Office data.

The CBO data also show how the progressivity of the tax system has changed over time. In 1979, the richest 1 percent of tax units paid about 37 percent of their incomes in taxes to the federal government, compared with 19 percent for the middle quintile and 8 percent for the lowest income quintile (figure 7). The Reagan tax cuts in the early 1980s reduced taxes dramatically for the highest income earners and by lesser amounts for other income groups. The exception was people in the bottom 20 percent, who actually paid more because of the payroll tax increases enacted to extend solvency of the Social Security system. Tax changes enacted by President Clinton and the first President Bush restored the federal tax system to the level of progressivity achieved in the early 1980s, although a cut in taxes on capital gains, enacted in 1997, reversed that pattern for very high income families. Expansions in refundable tax credits (the earned income tax credit, and in this decade, the child tax credit) have reduced the tax burdens on low- and middle-income households since the mid-1980s. The dramatic increase in incomes of higher income workers in the late 1990s contributed to an increase in effective tax rates for the top two quintiles, since a progressive tax system collects larger and larger shares of income in taxes when income growth exceeds inflation. Symmetrically, the drop in income in 2001 reduced average tax bills, but the tax cuts enacted since 2001 had a far larger impact.

Figure 7. Effective Federal Tax Rates by Quintile and Top 1%, 1979-2004

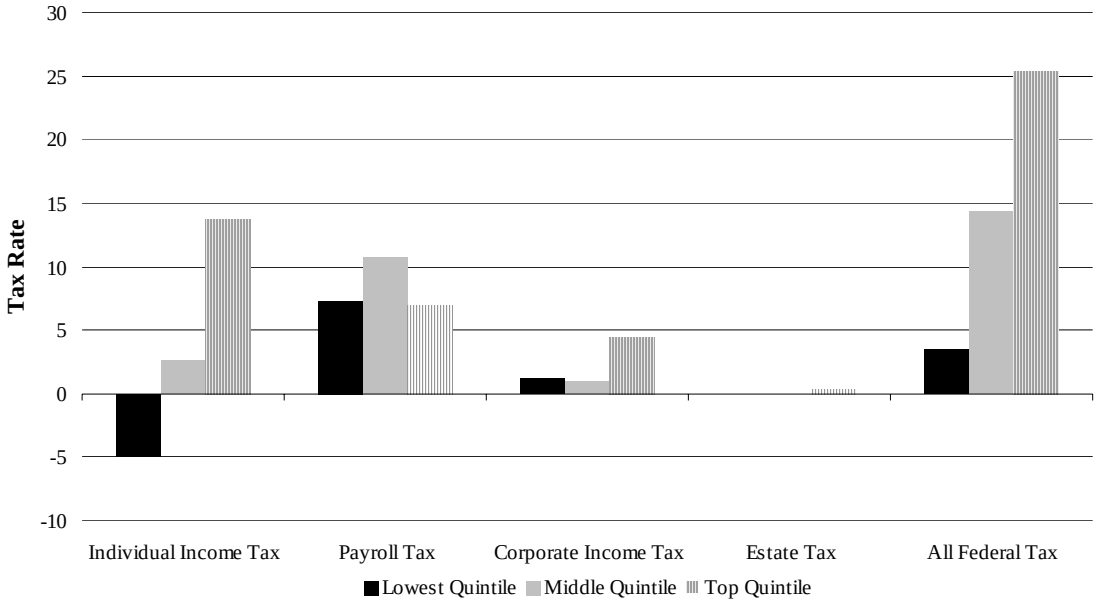


Source: Congressional Budget Office.

The federal tax system is an amalgam of progressive and regressive taxes. The individual and corporate income taxes and the estate tax are highly progressive (figure 8). Because of the refundable tax credits, individual income tax burdens are actually negative for the lowest-income households, meaning that they get a refund in excess of taxes paid. The middle quintile paid only about 3 percent of income in income taxes while the top quintile paid an average of 14 percent. Corporate income taxes are a much smaller source of revenue, but most of them are also borne by high-income households (under the assumption that the tax falls on owners of capital). And the estate tax—the smallest source of revenue shown in the figure—is entirely borne by very high income tax units.

Payroll taxes and excise taxes (not shown) are regressive, however. The payroll tax is regressive for two reasons. First, only wages are subject to the tax and wages are almost all of income for low- and middle-income households, but only a fraction for very high-income families. Second, the Social Security tax, which is more than 80 percent of payroll taxes for most people, only applies to earnings up to an annual cap. Above that level, no additional Social Security tax is due. Thus, the tax declines as a fraction of wages for high-income earners. In consequence, payroll taxes are a smaller share of income for the top 20 percent than they are for the bottom 80 percent. Excise taxes (which TPC does not currently model) are also regressive because the goods subject to the taxes (alcoholic beverages, cigarettes, gasoline, tires, etc.) make up a larger share of consumption from income for lower-income people than for those with higher incomes.

Figure 8. Average Tax Rates by Cash Income Quintile and Tax, 2006

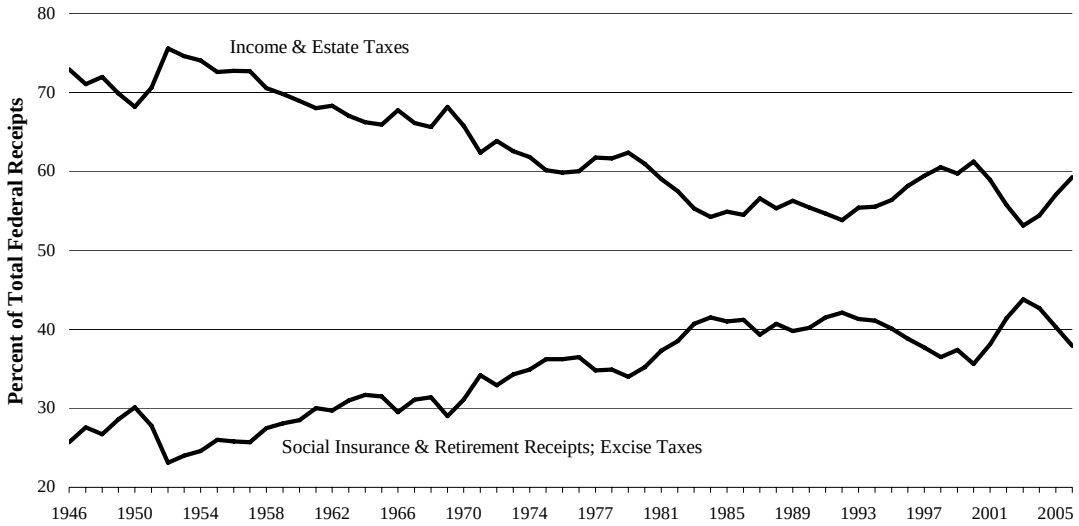


Source: Tax Policy Center Table T06-0304, http://www.taxpolicycenter.org/estimates/T06-0304.

Nonetheless, despite these regressive components, the overall federal tax system remained progressive in 2006. The top quintile paid 25 percent of income in tax, compared with less than 15 percent for the middle quintile and less than 4 percent for the lowest-income 20 percent.

The tax rates shown in figure 7 understate the longer-run shifts in the composition of taxes. As noted, the increase in payroll tax rates enacted in the early 1980s raised tax burdens disproportionately on lower-income households. Over a longer period, the change in composition of taxes has been even more dramatic. After World War II, progressive income and estate taxes composed more than 70 percent of federal receipts, while regressive payroll and excise taxes accounted for only about 26 percent of receipts (figure 9). (The two components do not add up to 100 percent because customs duties, fees, and other miscellaneous receipts are excluded.) By 2006, the regressive taxes made up almost 40 percent of receipts while progressive taxes accounted for less than 60 percent.

Figure 9. Composition of Federal Receipts by Source, 1946-2006



Source: Office of Management and Budget.

Finally, it should be noted that a complete assessment of tax burdens must include state and local taxes, which constituted about one-third of total taxes in 2006. State and local governments rely much more heavily on regressive taxes, such as sales taxes, than does the federal government, and state income taxes often assess tax liability on households near, or even below, the poverty line. Robert McIntyre and colleagues (2003) at Citizens for Tax Justice have shown that when state and local taxes are included, the overall tax system is much less progressive.

Effect of the 2001–2006 tax cuts

Congress has enacted more than $2 trillion in tax cuts since 2001. The tax cuts have been disproportionately concentrated on the rich, and they have almost exclusively applied to the most progressive federal taxes—income and estate taxes. Overall, the tax cuts are highly regressive. Only 12 percent of tax units in the bottom quintile received any benefit at all and the average tax savings for that income group is about $20 in 2006 (table 1). Middle-income taxpayers received an average tax cut of $744, while the top quintile averaged $5,790 in income tax savings. Within the upper strata, the distribution of gains is even more startling. The top 1 percent—the same income group that has reaped most of the income gains in recent decades—got an average tax cut of over $44,000. The richest 0.1 percent—that is, 1 in 1,000 taxpayers—will average over $230,000 in tax savings on their 2006 income tax returns.

Table 1. Distribution of the 2001-2006 Tax Cuts in 2006

Cash Income Percentile	Percent of Tax Units With Tax Cut	Average Tax Change ($)	Change as Percent of After-Tax Income	Share of Total Federal Tax Change
Lowest Quintile	12.0	-20	0.3	0.3
Second Quintile	64.6	-349	2.0	4.3
Middle Quintile	87.2	-744	2.5	9.1
Fourth Quintile	97.9	-1,232	2.5	15.1
Top Quintile	99.4	-5,790	4.1	71.2
All	72.2	-1,628	3.3	100.0
Addendum				
Top 10 Percent	99.6	-8,985	4.4	55.2
Top 5 Percent	99.5	-14,039	4.6	43.1
Top 1 Percent	99.3	-44,212	5.4	27.2
Top 0.5 Percent	99.4	-74,249	5.8	22.8
Top 0.1 Percent	99.5	-230,136	6.2	14.1

Source: Tax Policy Center Table T06-0279, http://www.taxpolicycenter.org/estimates/T06-0279.

Of course, since income is highly skewed, one would expect income tax cuts to fall disproportionately on high-income taxpayers, but the recent tax cuts were much more skewed than income. For the bottom 20 percent, the tax cuts amounted to 0.3 percent of income. For the middle-income group, they were 2.5 percent, but the top 1 percent got tax cuts more than twice as large—5.4 percent of after-tax income. The top 0.1 percent saw their after-tax income increase by 6.2 percent

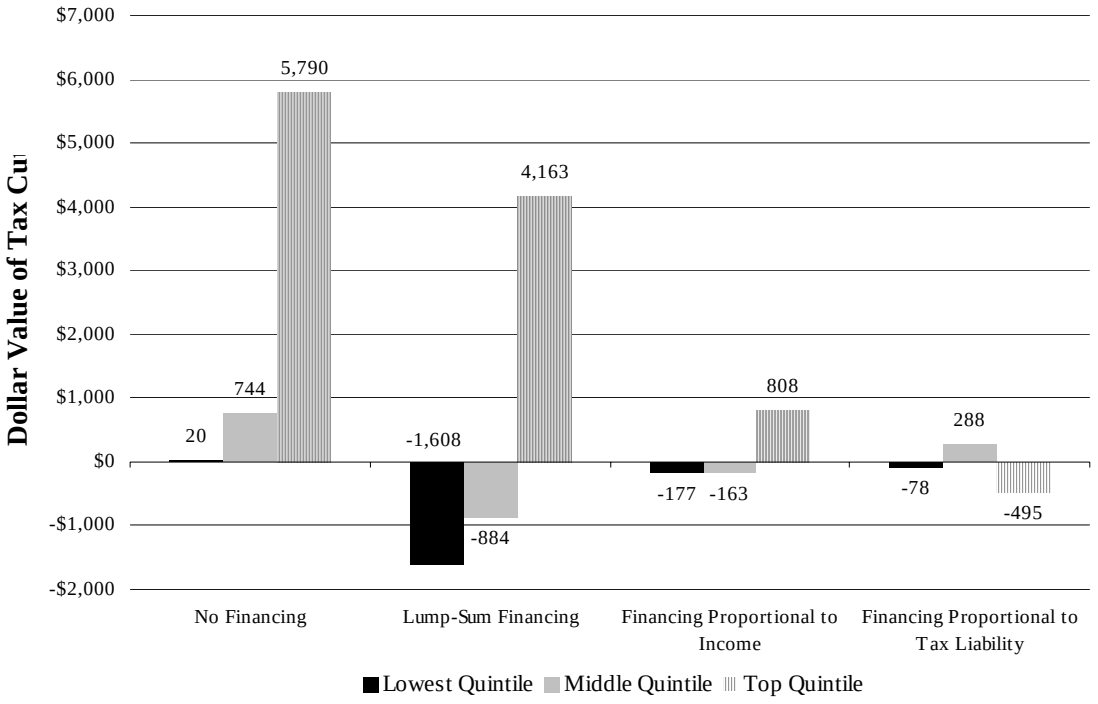
Supporters of the tax cuts enacted since 2001 sometimes imply that complaints about the rich receiving a disproportionate share amount to “class warfare” and a politics of envy because people in every income group paid lower taxes. There were only winners and no losers. Who could object to that? Following that logic, the best policy would have been to rescind all taxes, not just some of them. The problem with such a policy is that the country needs revenues to pay its bills. Eventually, the tax cuts will have to be paid back, and the way they are paid for will determine who the ultimate winners and losers are.

Assuming that the tax cuts do not pay for themselves—an assumption that would be accepted by virtually all mainstream economists, the Joint Committee on Taxation, the CBO, and the U.S. Treasury—the actual incidence will depend on how the deficits are financed. The president has justified the tax cuts by saying that the nation’s fiscal problem arises from too much spending rather than insufficient taxes. If that means that the tax cuts will eventually be offset by spending cuts, then low- and middle-income households could end up as big losers.

The Tax Policy Center has examined the implications of three different financing assumptions for the distribution of burdens. In the first, the cost of the tax cut is assumed

to be spread evenly among all tax units. This lump-sum financing option is analogous to across-the-board cuts in Social Security or Medicare or cuts in public works programs whose effects are widely felt. Under this scenario, the lowest-income household's $20 tax savings (ignoring financing) turns into a reduction in net benefits received from the public sector, that is benefit received less taxes paid, of $1,608 (figure 10). The middle-income household's $744 tax savings would turn into an $884 reduction in net benefits. But the highest income quintile would still receive on average a $4,163 net benefit, smaller than the tax cut appeared before financing, but still substantial. Very high income households receive even larger net benefits from the tax cuts (not shown).

Figure 10. Dollar Value of the Combined 2001-2006 Tax Cuts With and Without Financing, 2006



Source: Tax Policy Center Tables T06-0279, T07-0088, T07-0090, and T07-0092, http://www.taxpolicycenter.org/TaxModel.

There are, of course, many ways to finance the tax cuts. For example, everyone could add a fixed percentage of income to his income tax. Under that scenario, low- and middle-income households would still be worse off on net, but they would lose much less than under the lump-sum financing option. High-income households would continue to be net gainers, because they get a much larger tax cut measured as a proportion of their income than lower income groups do. A third alternative could offset the deficits with an income tax surtax set at a fixed percentage of income tax liability. That option would make both low-income and high-income households worse off, while the average middle-income household would benefit from a net tax cut.

These options do not come close to covering the range of possibilities. My main concern is that the tax cuts are exceptionally poorly timed, especially if they are extended beyond their 2010 sunset just as the baby boomers start to reach retirement age. The combination of a diminished tax base and exploding entitlement spending could lead to inflation or high interest rates or both. That is a particularly insidious form of tax. And, if that scenario plays out, there could be a backlash against the biggest short-term beneficiaries of the tax cuts—those with high incomes—which could result in top tax rates much higher than were in place before the 2001 tax cuts were enacted. In that case, high-income households could end up much worse off than they would have been without the tax cuts.

Conclusion

More than most developed nations, the United States relies on the federal tax system as an instrument of distributive justice. Other countries pursue "fairness" more through direct spending programs, such as free universal health insurance and generous welfare benefits, and through much more extensive regulation of markets. Arguably, the U.S. approach of relatively limited government and relatively unfettered markets is more conducive to economic growth, and growth rates in this country have been very impressive. The gains from economic growth, however, have increasingly accrued to those at the top of the income distribution, while middle-income households have been struggling to keep up. Aside from issues of fairness, this situation raises the possibility that the public will demand more limits on free markets, which could ultimately make everyone worse off.

The income tax system provides one mechanism of redistributing the gains of our dynamic free-market economy more equitably. Tax subsidies for low-income workers conveyed through the refundable earned income tax credit, for example, encourage work without interference in the market process of setting wages. However, the immediate benefits of the recent tax cuts have accrued disproportionately to those with very high incomes—the same people who have gained most from the economic expansion of the past few decades—and have undermined tax progressivity. And without knowing how they will be financed, it is impossible to determine how these tax cuts will ultimately affect the distribution of economic burdens in the United States.

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