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Is the Distribution of Tax Burdens and Tax Benefits Equitable?

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Chairman Baucus, Ranking Member Hatch, and members of the Finance Committee, thank you for the opportunity to appear before you today to discuss the distribution of tax burdens and the fairness of the tax system. My name is Aviva Aron-Dine. I am currently a Ph.D. candidate in the economics department at the Massachusetts Institute of Technology, focusing on public finance and labor economics. Previously, I was a policy analyst at the Center on Budget and Policy Priorities, where I worked on federal tax issues, with a particular emphasis on income and estate taxes and the taxation of low- and moderate-income households.

The federal tax system contributes to creating a more equitable society in two important ways. First, federal taxes raise the revenue that is used to fund social insurance programs that protect the elderly and the disabled, safety net programs that alleviate hardship for the most vulnerable families, and public goods such as national defense and infrastructure. Second, the modestly progressive federal tax system levies somewhat higher rates on those with the greatest ability to pay, while imposing lower rates on those with lower incomes and supplementing earnings for the lowest-income working families with children.

Over the next few years, Congress – and especially this committee – will face critical decisions about how much revenue to raise and whom to raise it from; both of these decisions will affect the fairness of the overall fiscal system. In my testimony, I will provide some background on the economic and fiscal context for these decisions and then discuss two specific policy issues: income tax rates on top incomes and provisions of the tax system that support low- and moderate-income working families.

Context for Tax Reform

Over the past 30 to 40 years, the income distribution in the United States has pulled apart. Congressional Budget Office data show that, in 1979, the top 1 percent of households received 9 percent of total national income – or about the same share going to the bottom 25-30 percent of households. By 2007, these households received 19 percent of national income – about the share going to the bottom 50 percent of households.[1] Put another way, the average income of households in the top 1 percent is now more than 100 times the average income of households in the bottom fifth of the income distribution and about 30 times the average income of households in the middle fifth.

Rising income disparities would be less troubling if increased inequality had been accompanied by broadly shared prosperity. But in fact, at roughly the same time as income growth accelerated for the highest-income households, it slowed to a sputter for low- and even middle-income Americans. The average income of households in the top 1 percent of the distribution grew by a remarkable 241 percent between 1979 and 2007 (the latest year for which the CBO data are available), after adjusting for inflation. Meanwhile, average income for households in the bottom fifth of the income distribution grew by only 11 percent (less than half a percent per year), and average income for households in the middle fifth grew by only 19 percent (less than 1 percent per year). Median earnings for male workers – the earnings of the man in the exact middle of the earnings distribution – were about the same in 2009 as in the late 1960s.[2] Median earnings for women rose through the 1980s and 1990s, as a rising share of women started working full-time and as more women obtained college degrees, but in the most recent decade, women's earnings also stagnated (even before the recession).[3] In sum, after several decades following World War II during which the incomes of low-, middle-, and high-income households all rose steadily together, living standards started rising far more quickly for those at the top of the distribution and far more slowly for all other groups.

One might have hoped that the rise in inequality would have been offset by greater economic mobility: greater opportunity for low-income families to rise into the middle-class or to see their children do so. But in fact, increases in income inequality were not offset by any increase in economic mobility. Using Social Security earnings data, economists Wojciech Kopczuk, Emmanuel Saez, and Jae Song looked at individuals' earnings over long periods of time and found that, among male workers, mobility has if anything declined over the last several decades.[4] Meanwhile, intergenerational economic mobility remains quite low. Researchers from the Economic Mobility Project (a joint project of researchers from

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[1] Congressional Budget Office, Special Collection: Average Tax Rates by Income Group, June 2010, http://www.cbo.gov/publications/collections/collections.cfm?collect=13.

[2] Michael Greenstone and Adam Looney, "Have Earnings Actually Declined?" Hamilton Project, March 4, 2011, http://www.brookings.edu/opinions/2011/0304_jobs_greenstone_looney.aspx.

[3] Michael Greenstone and Adam Looney, "Women in the Workforce: Is Wage Stagnation Catching Up With Them Too?" Hamilton Project, April 26, 2011, http://www.brookings.edu/opinions/2011/0401_jobs_greenstone_looney.aspx.

[4] Wojciech Kopczuk, Emmanuel Saez, and Jae Song, "Earnings Inequality and Mobility in the United States: Evidence From Social Security Data Since 1937," *Quarterly Journal of Economics*, 2010, available at http://elsa.berkeley.edu/~saez/kopczuk-saez-songQJE10mobility.pdf.

the American Enterprise Institute, the Brookings Institution, the Heritage Foundation, the New America Foundation, and the Urban Institute) have found that, according to the most recent available data, a child born into a family in the bottom fifth of the income distribution has only about a 35 percent chance of making it into the middle income group or above, less than the 42 percent chance that he remains trapped in the bottom fifth. There are even some worrisome indicators that children's opportunities may be *more* constrained by their parents' incomes than in the past. For example, a recent analysis examined the likelihood that different students with the same standardized test scores but different family incomes would go to college. The researchers found that family income played a larger role in determining whether a student with a given test score would go to college in the early 2000s than it did in the early 1980s.[5]

Why inequality has risen so dramatically since the late 1970s is unclear. While policy (for instance, a decline in the real value of the minimum wage[6]) probably played a role, other factors, particularly a still-not-very-well-understood increase in the economic returns to education, were likely more important. In addition, the explosive growth of the financial sector and compensation for financial industry executives appears to have played an important role in the sharp rise in incomes at the very top of the distribution.[7]

But while policy was probably not a primary cause of rising pre-tax inequality and slowing income growth for low- and middle-income Americans, policy – in particular, tax policy – did less than it might have to lean against these trends; in some respects, it even leaned into them. The federal tax system has become *less* progressive over time, with total federal effective tax rates falling the most for the high-income households that saw the strongest growth in their before-tax incomes. The CBO data show that while *pre-tax* incomes for the top 1 percent of households grew by 241 percent between 1979 and 2007, *after-tax* incomes rose by an even larger percentage, 281 percent, because federal tax rates on high-income households fell over the same period in which their pre-tax incomes increased so dramatically. Put differently, if effective tax rates had remained the same over this period, average income within the top 1 percent would have risen by about $850,000 (in 2007 dollars). But in fact, average *after-tax income* rose by almost $1 million (to about $1.3 million), with reductions in federal effective tax rates

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[5] Philippe Belley and Lance Lochner, "The Changing Role of Family Income and Ability in Determining Educational Achievement," *Journal of Human Capital*, 2007.

[6] David S. Lee, "Wage Inequality in the United States During the 1980s: Rising Dispersion or Falling Minimum Wage?" *Quarterly Journal of Economics*, 1999, available at http://www.princeton.edu/~davidlee/wp/inequality.pdf.

[7] Steven N. Kaplan and Joshua Rauh, "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" Review of Financial Studies, 2010.

contributing the extra $150,000.[8] During this same period, CBO finds that average after-tax income for the bottom fifth of households rose by $2,400, and average after-tax income for the middle fifth of households rose by $11,200.

Today, the federal tax system, considered as a whole (including individual and corporate income, payroll, and excise taxes), is only modestly progressive, meaning that it does a modest amount to make the distribution of income less unequal. For example, CBO estimates that the top 1 percent of households have 19 percent of income before taxes and 17 percent after federal taxes, while the bottom 20 percent have 4 percent of income before taxes and 5 percent after taxes. State and local tax systems – most of which are regressive – likely undo some of that already limited progressivity.

I bring up all this background because I think it supplies two important pieces of context for tax policy and tax reform. First, the level and the share of national resources going to those with the highest incomes have increased dramatically in recent decades, and are far higher, for instance, than when Congress last considered major tax reform legislation. High-income households have also benefited substantially from the tax changes of recent decades. Second, the level of resources available to low- and middle-income households has increased only modestly, while their share of total national resources has fallen. While income trends are very difficult to predict, some economists expect technological change and globalization to interact in ways that make it more likely than not that these trends will continue in coming decades.[9]

There is, of course, another important piece of context for tax reform of which you are well aware. The federal budget is currently on an unsustainable course. At some point, deficits will have to be reduced to sustainable levels through some combination of spending cuts and tax increases.

As illustrated by recent efforts (such as the House-passed budget resolution), closing our large projected deficits entirely through spending cuts would inevitably require deep cuts in social insurance and safety net programs, thereby worsening poverty and hardship, especially among the low- and moderate-income elderly and other low-income households. Trying to close deficits entirely on the spending side would also likely require deep cuts in areas such as Head Start, K-12 education, Pell Grants and other student aid, and children's health and nutrition, programs that help create opportunities for children from low- and moderate-income families to succeed. Thus, a core requirement for "equitable"

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[8] While some of this reduction comes from a drop in corporate effective tax rates (and there is some controversy over how much of the corporate tax is borne by high-income households), the highest-income group saw a large reduction in its tax burden even if one focuses exclusively on individual income taxes – particularly in the most recent decade.

[9] See for example David Autor, "U.S. Labor Market Challenges Over the Long Term," October 5, 2010, available at http://econ-www.mit.edu/files/6341.

tax reform should be that it raises enough revenue to allow for a more balanced approach to deficit reduction. While there is widespread acceptance of the need for shared sacrifice and a widespread expectation that spending cuts will play an important role in deficit reduction, putting revenues on the table as well would make it possible to put the federal budget on a sustainable path without breaking basic commitments to the elderly, the disabled, low-income children, and other vulnerable Americans.

Options for Revenue-Raising Tax Reform

This committee has heard a great deal in recent weeks about opportunities to reform the tax code and raise revenue by eliminating or redesigning tax expenditures. I share the view articulated by many other witnesses that cleaning up the tax base should be a major component of tax reform and has the potential to contribute to deficit reduction while simultaneously improving the efficiency and fairness of the tax system.

I would like to focus my testimony, however, on the role that changes in high-income marginal tax rates can play in an equitable approach to tax reform and deficit reduction. No one is proposing to close the nation's projected budget gaps entirely, or even largely, by raising top income tax rates. However, many people reasonably believe that, in light of the dramatic and growing disparities in the resources available to high- versus lower-income families, high-income Americans can better afford a modest increase in their tax burdens than low- and middle-income Americans or the elderly can afford severe program cuts. For example, if top marginal income tax rates were restored to the levels of the 1990s, and the tax rates on capital gains and dividends were returned partway to their 1990s levels (as proposed in the President's budget), the top 1 percent of households would still enjoy after-tax incomes averaging well over $1.2 million, more than $900,000 higher than in 1979 and more than $650,000 higher than in 1990. But this change would raise about $80 billion per year, according to CBO/Joint Committee on Taxation estimates. It seems reasonable and equitable that any deficit reduction package that asks for sacrifices from middle-income families also make some demands on the most fortunate.

Some have suggested that raising income tax rates on high earners above their current levels just won't work, or would be counterproductive. The argument is that higher rates either will not raise much revenue or will so damage the economy that low- and middle-income Americans would actually be worse off than if they had borne the brunt of deficit reduction measures directly. If true, this would be very unfortunate, since it would leave policymakers with no option except to concentrate most or all of the burden of deficit reduction on low- and middle-income families. Fortunately, however, increasing tax rates on top earners would raise significant revenue (in line with what the Joint Committee on Taxation projects) and would have at most modest effects on the economy.

One way to see this is simply to consider the experience of the 1990s. If raising tax rates were as harmful to the economy and revenue growth as has sometimes been claimed, then one would expect to see some sign of this in the historical data. Instead, the data show that real federal income tax revenues grew by 6 percent per year during the 1990s business cycle (during which tax rates were increased), as compared to 2 percent per year during the 1980s and roughly 0 percent per year during the 2000s (decades in which top tax rates were cut).[10] Meanwhile, GDP growth over the 1990s business cycle was about the same as during the 1980s and somewhat stronger than in the 2000s. The real incomes of the top 1 percent also grew a bit faster (7 percent per year) during the 1990s as during the 1980s (5 percent per year) or the 2000s (3 percent per year). This is the opposite of what one would expect to see if tax increases on high-income households led to large drops in their pre-tax incomes.

The same basic conclusion about tax rates, revenues, and the economy emerges from economic research that estimates how much high-income taxpayers reduce their incomes in response to changes in income tax rates. The modern work in this area, which takes into account underlying trends in the income distribution, finds fairly modest responses to tax rates.[11] Moreover, the responses economists have measured *are generally in line with what the Joint Committee on Taxation assumes* about the responsiveness of income to tax rates. That is, the Joint Tax Committee's estimate that increasing top rates would raise substantial revenue is a best estimate *after* taking into account plausible estimates of the extent to which high-income taxpayers reduce their taxable incomes in response to tax increases.[12]

Economists have estimated not just how much high income taxpayers reduce their incomes in response to tax changes but also in what ways they do so. Typically, when people worry about the effect of upper-income tax rates on GDP and on lower-income households, they worry that higher tax rates will lead high-income people to work less. However, a large body of evidence finds that labor supply (the amount people work) – including the labor supply of high earners – is at most very modestly responsive to tax rates.[13] Instead, the main way that high-income taxpayers respond to taxes is by shifting their

[10] While some have suggested that strong revenue growth during the 1990s was due to the 1997 capital gains tax cut, individual income tax revenues also grew more rapidly between 1990 and 1997 than during the 1980s or 2000s.

[11] For a survey, see Emmanuel Saez, Joel Slemrod, and Seth Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," *Journal of Economic Literature*, forthcoming, available at http://elsa.berkeley.edu/~saez/saez-slemrod-giertzJEL10final.pdf.

[12] More technically, Joint Tax assumes an "elasticity of taxable income" (a term for the responsiveness of income to tax rates) of between 0.2 and 0.3. This is in the range of the consensus estimates from the economics literature, once one accounts for the fact that some of the income that disappears from the personal income tax base does not disappear from the tax base altogether. For example, some of it is sheltered in corporations and therefore taxed by the corporate tax, while some is shifted into deferred compensation and taxed in later years.

[13] Saez, Slemrod, and Giertz summarize: "With some notable exceptions, the profession has settled on a value for this elasticity [the labor supply response to tax rates] close to zero for prime-age males." For evidence on high earners specifically, see Jeffrey Liebman and Emmanuel Saez, "Earnings Responses to Increases in Payroll Taxes," 2006. In addition, Jon Gruber and Emmanuel Saez have found that that "broad income" – income before

income into forms that are taxed less heavily or not taxed at all. For example, they may decide to take more of their income in the form of deferred compensation (thus deferring taxes), shelter more income in corporations (if the top corporate rate is below the top individual rate), or claim more income tax deductions.

These non-labor supply responses are inefficient, and they reduce revenues, which is why they are taken into account in the Joint Committee on Taxation estimates. But the fact that most of the response of top incomes to tax rates comes from tax avoidance behaviors rather than reductions in labor supply is important, for two reasons.

First, it means that if the tax code were reformed to provide fewer opportunities for income shifting and tax avoidance, high incomes would become less responsive to tax rates, and raising tax rates would have lower efficiency costs while raising more revenue. (One study found that this is exactly what happened after the passage of the 1986 Tax Reform Act.[14])

Second, income shifting and tax avoidance generally *do not reduce GDP or economic growth*, and it is unlikely that they impose economic costs on anyone but the high-income taxpayers themselves. As noted above, the most common argument against raising tax rates at the top is that such increases *hurt other, non-high-income taxpayers*. While there are at least some theories under which a reduction in the labor supply of high earners could hurt middle- and lower-income people, it is much more difficult to come up with any theory for why high-income taxpayers shifting more of their earnings into lower-taxed forms would reduce earnings for middle- or lower-income individuals.

The bottom line is that raising taxes on high earners does raise significant revenue and imposes only modest efficiency costs. There is no plausible case to be made that middle- and low-income households would be better off bearing more of the costs of deficit reduction rather than sharing these costs with high-income households.

The Importance of the Earned Income Tax Credit and Refundable Child Tax Credit

Finally, I would like to discuss two provisions of the tax code that represent a success story in using the tax system to lean against the trend toward rising inequality and wage stagnation, reduce hardship among families with children, and promote and reward work. The Earned Income Tax Credit

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exemptions and deductions – is only modestly responsive to tax rates, even among high earners. The response of "broad income" should be closer to – but still larger than – the true labor supply elasticity. See Jon Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," *Journal of Public Economics*, 2002.

[14] Wojciech Kopczuk, "Tax Bases, Tax Rates, and the Elasticity of Reported Income," *Journal of Public Economics*, 2005.

(EITC) was created in 1975 and was subsequently expanded under presidents and Congresses of both parties. It increases the returns to work for low-wage workers with children by supplementing their earnings and offsetting their payroll tax burdens and the tax burdens imposed by typically regressive state and local tax systems. Since 2001, many low- and moderate-income families have also benefited from the Child Tax Credit, which provides a tax benefit of $1,000 per child to middle- and upper-middle-income households and which was made partially refundable so that low-income working parents could benefit from it as well. Reforms to the Child Tax Credit enacted in 2008 and 2009 addressed the problem that millions of children in low-income working families (including, for example, the child of a full-time minimum wage worker) were not eligible for the full credit, while maintaining the rule that only parents with meaningful work income can benefit. (In addition, recent improvements to the EITC reduced marriage penalties and provided some additional assistance to families with three or more children.)

As I believe you have heard from other witnesses in recent weeks, for many tax credits and deductions, we either have little evidence on whether they are achieving their goals, or we have evidence that they are ineffective or counterproductive. In contrast, study after study has found that the EITC raises the labor force participation rate of single mothers. Studies of the EITC expansions of the 1980s and 1990s, for example, find that these increases in the EITC raised the labor force participation rate of single mothers by 7 percentage points or more, or, equivalently, that they induced more than half a million people to enter the labor force.[15] In addition, a study by two economists at the Federal Reserve Bank of Chicago found that many families use their EITC payments to help with vehicle purchases or other transportation expenses that are necessary for them to maintain employment or get a better job.[16] The creation of the refundable CTC, which is also available only to families with earnings, has complimented and strengthened the EITC's pro-work effects.

The EITC and refundable CTC are also well-targeted and effective at achieving the goals of reducing child poverty and alleviating hardship for low-income families with children. Together, the EITC and the refundable Child Tax Credit now lift 7.2 million people out of poverty, including 4 million children.[17] The recent reforms to the CTC and EITC are themselves responsible for lifting 1.5 million

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[15] See for example Eissa and Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics*, 1996; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," 2006; and Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers," *Quarterly Journal of Economics*, 2001.

[16] Andrew Goodman-Bacon and Leslie McGranahan, "How Do EITC Recipients Spend Their Refunds?" Federal Reserve Bank of Chicago, 2008.

[17] Arloc Sherman, "Despite Deep Recession and High Unemployment, Government Efforts – Including the Recovery Act – Prevented Poverty From Rising in 2009, New Census Data Show," Center on Budget and Policy Priorities, January 5, 2011, http://www.cbpp.org/files/1-5-11pov.pdf.

people out of poverty. Moreover, surveys find that the EITC plays a crucial role in helping working families make ends meet and avoid hardship, allowing them to pay bills and cover basic expenses like rent, utilities, and food.[18] The EITC has also helped compensate for the declining real value of the minimum wage.

Recently, some have expressed concerns about the fact that the EITC and CTC eliminate income tax liability for many low- and moderate-income families with children. In particular, many have cited a Tax Policy Center estimate that 47 percent of Americans owed no income tax in 2009; perhaps 35-40 percent would owe no income taxes in a more typical, non-recession year (and without the now-expired Making Work Pay Credit and partial income tax exemption for unemployment insurance benefits).[19]

The "47 percent" figure is often cited as if it were self-evidently problematic, but this is not the case. What matters is the overall fairness of the fiscal system, not a headcount of how many people pay one particular federal tax. In the U.S. today, we have a broad-based payroll tax, regressive federal excise taxes, and individual and corporate income taxes that are quite progressive. When all federal taxes are taken into account, CBO finds that even the lowest-income fifth of households pay 4 percent of their incomes in federal taxes, while the second-lowest income group pays 11 percent of its income in federal taxes. In addition, state and local tax systems are typically regressive and often impose significant additional tax burdens on low- and moderate-income families. There is nothing obviously wrong with having *one* component of the overall tax system that is paid only by better-off households.

Some have suggested that the problem with people not owing income taxes is that they lack a "stake in the system," perhaps meaning that they lack a stake in making sure government operates efficiently and effectively. In thinking through this argument, it may be helpful to think about what types of people end up owing no income taxes and whether we really think any of these groups lack a "stake in the system" or should pay substantially more in taxes.

- Many of the people who owe no federal income taxes are either elderly, students, or individuals with incomes lower than the standard deduction and personal exemption ($9,500 for an individual). In other words, many of the people who owe no federal income taxes would owe no income taxes even *without* the EITC and CTC, and the only way to make them pay income taxes would be to either raise taxes on Social Security benefits or cut the standard deduction or personal exemption, the sum of which is already below the federal poverty line for an individual.

[18] Timothy M. Smeeding, Katherin Ross Phillips, and Michael O'Connor, "The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility," *National Tax Journal*, 2000.

[19] Roberton Williams, "Why Nearly Half of Americans Pay No Income Tax," *Tax Notes*, June 7, 2010, http://www.taxpolicycenter.org/UploadedPDF/412106_federal_income_tax.pdf.

- Another large group of people owing no income tax are low-income working families with children who benefit from the EITC and refundable Child Tax Credit. As noted above, for many families (including, for example, a parent of two working full-time at the minimum wage), the EITC and CTC make the difference between poverty and being able to provide necessities for their children, and they also boost the incentive to work for people with limited earning potential.

- The third major group of households not owing income taxes are moderate-income working families (families with incomes between 100 percent and a little over 200 percent of the poverty line) who are in the EITC "phaseout" range but for whom the EITC still defrays income taxes and provides some assistance. These households, many of which receive fairly small refundable credits, are somewhat better off but hardly comfortable, and many of these moderate-income households pay substantial state and local taxes, as well as payroll taxes. Moreover, if we wanted to raise the share of moderate-income families paying income taxes and target the EITC more narrowly to the very lowest-income families with children, we would have to phase out the EITC at higher rates. This would be equivalent to raising marginal tax rates substantially for workers just a little above the poverty line.

It is also worth noting that many people in all of these groups pay income taxes at other points in their lives, just not in a particular year. For example, the large increase in the share of households not paying income taxes in 2009 and 2010 was due in part to the recession and the fact that the income tax is designed to automatically cushion the blow in bad years. Similarly, even in more normal economic times, EITC recipients often receive the credit during a few hard years or when their children are young and then end up paying substantial positive income taxes at other points in their lives. For these workers, the income tax operates just like any other social insurance program (such as unemployment insurance), collecting premiums in good years and providing assistance in bad.

In light of the EITC and refundable CTC's successes, I would urge that tax reform not only preserve these credits - including the important reforms enacted in 2008 and 2009 - but strengthen them. In particular, amidst all the discussion of low-income workers who do not owe income taxes, it is easy to lose sight of a group of workers that, now that the Making Work Pay Credit has expired, will again begin owing positive income tax before their earnings even reach the poverty line. The maximum EITC for workers without dependent children is only $464; the childless workers' credit is not generous enough to eliminate income tax liability for workers at the poverty line, nor is it large enough to provide much of a work support or work incentive. Improving the childless workers' EITC could build on the success of the

EITC for families with children by enhancing work incentives for low-wage workers without children, especially for less-educated men (a group whose labor force participation rates have declined in recent decades). It would also help reduce hardship among this very low-income group.