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IS THE DISTRIBUTION OF TAX BURDENS AND TAX BENEFITS EQUITABLE?

HEARING

BEFORE THE

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IS THE DISTRIBUTION OF TAX BURDENS AND TAX BENEFITS EQUITABLE?

TUESDAY, MAY 3, 2011

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:11 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Nelson, Menendez, Carper, Hatch, Grassley, Snowe, Kyl, and Roberts.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Jeff VanderWolk, International Tax Counsel; Tiffany Smith, Tax Counsel; Tom Reeder, Senior Benefits Counsel; and Matt McFeeley, Intern. Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Nick Wyatt, Tax and Nomination Professional Staff Member; Theresa Pattara, Tax Counsel; Curt Beaulieu, Tax Counsel; Antonia Ferrier, Communication Director; Aaron Taylor, Professional Staff Member; and Maureen McLaughlin, Detailee.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Anne-Robert-Jacques Turgot, the noted 18th-century French economist, said, "The more a man enjoys the advantages of society, the more he ought to hold himself honored in contributing to those expenses."

Turgot laid out a key measure for evaluating a tax system: determining whether the country's citizens are paying their fair share. Americans want to see a fairer and more equitable tax system.

In a recent independent poll, most taxpayers said they believe the taxes they currently pay are fair. But an article by the *Associated Press* detailing this new study also revealed a perception among average Americans that the wealthy do not pay their fair share.

The perception is that the tax loopholes and benefits that exist do not benefit average Americans, and Americans do not know a lot about them.

The wealthy folks can hire attorneys and accountants to find every credit and deduction, while average Americans cannot afford that time and that expertise.

One fact behind this perception may be the way changes to the code have affected people differently. Since 1986, Congress has made over 15,000 changes to the code. In most cases, these changes have not benefitted all taxpayers.

According to IRS data, the 400 taxpayers with the highest adjusted gross incomes had an effective tax rate of just below 17 percent for the 2007 tax year. The average income for those taxpayers was $345 million per household. But the effective tax rate of folks earning between $1 million and $1.5 million was much higher at 24 percent.

How is that possible? The U.S. has a fairly progressive income tax system. The tax brackets rise with income. But we also must consider the tax incentives that affect a person's tax liability and bring down tax rates.

Two prime examples of this inequality are deductions and exclusions. Many of these incentives only benefit people who earn higher incomes, and the size of the benefit they receive is also dependent on income.

Look, for example, at the charitable deduction. Only families who itemize their tax returns are able to take advantage of this deduction, and only one-third of taxpayers itemize their returns. That leaves two-thirds of all Americans unable to receive a tax benefit for charitable deductions.

Among those who do receive the deduction, there is also a disparity. A taxpayer with a 35-percent tax rate saves 35 cents in taxes for every dollar given to a charity, while a taxpayer with a 10-percent rate only saves 10 cents of every dollar.

Take, for example, two taxpayers making $1,000 donations to the Alabama tornado relief efforts. This donation could cost a taxpayer with $35,000 in income $1,000 after taxes, because they almost certainly would not itemize. But the same donation would cost the taxpayer with $435,000 of income much less; that is, $650 after the benefit.

We should also consider that the Tax Policy Center estimates that 47 percent of Americans did not pay income taxes in 2009. But that does not mean they did not pay any taxes at all. Many of these same folks paid payroll taxes, and they paid excise taxes. A large share of them are seniors, and many are families living in poverty.

The general perception of inequity in the tax code may also stem from the fact that economic prosperity is not shared as widely as it once was. Over the last 30 years, households with incomes in the highest 1 percent have seen their before-tax income grow by 280 percent. But over the same period, 90 percent of Americans have seen essentially no increase at all. This disparity is also apparent in after-tax income. These past 30 years have been very different from the 30 years before, when the economic growth was widely shared.

As we focus on tax reform, we must ask whether our tax code has contributed to this disparity in income growth. We should consider whether our tax system should take these disparities into account in some way, and we must question whether our tax code can better promote economic mobility and opportunity.

So let us remember that the taxpayers are more likely to willingly pay taxes that they perceive as fair. Let us make our tax system work for all Americans, not just for those who can afford to pay high-priced attorneys and accountants.

[The prepared statement of Chairman Baucus appears in the appendix.]

Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman.

The debate that we will have here today on the distribution of tax burdens has a long and distinguished pedigree. From my perspective, I have not heard anyone get the better of the former Prime Minister Margaret Thatcher, who addressed this issue in her last speech before the House of Commons on November 22, 1990.

This is how she responded to a liberal colleague who made the mistake of thinking that he could get one by her: "The honorable gentleman is saying that he would rather that the poor were poorer, provided that the rich were less rich. That way, one will never create the wealth for better social services, as we have. What a policy. Yes, he would rather have the poor poorer, provided that the rich were less rich. That is the liberal policy."

Now, this quote, more than 20 years old, is uncannily applicable to the subject of today's hearing.

Our examination of the burdens and benefits of the tax code is taking place in the shadow of a debate as to whether a group of people described as "the rich" are paying what others call their "fair share."

The canned answer for those asking this question is that the rich are never paying their fair share and must pay more for the good of the whole. A certain percentage of the population obsesses over this issue, making sure that the so-called "rich" do not exceed their allotted share of the fruits of their own labor.

How Washington politicians hope to determine this fair share in an even-handed way that does no harm to our economy and job creators remains a mystery to me.

As we head into this debate, there are a few basic facts we need to acknowledge. According to the Urban-Brookings Tax Policy Center, in 2009 the top quintile of the population in terms of income distribution earned 53.4 percent of income, but paid 67.2 percent of all taxes.

When we look at only Federal income taxes, the numbers show that the so-called "wealthy" are paying an even greater share relative to everyone else. According to the Tax Foundation, for calendar year 2008, the most recent year for which actual tax data is available, the top 1 percent of the population in terms of income paid 38 percent of all Federal individual income taxes. The top 5 percent paid approximately 58.7 percent of all income taxes, while everyone else, the bottom 95 percent, paid 41.3 percent of Federal income taxes.

I do not have to have a Ph.D. in math to understand that—I am pretty sure that 41.3 is less than 58.7 percent.

Meanwhile, the Tax Policy Center estimated that, for tax year 2010, approximately 45 percent of households, or about 69 million households, ended up owing nothing in Federal income taxes for last year.

Now, I am no linguist, but I think that the proper term for that level of income tax liability is zilch.

Finally, the Joint Committee on Taxation estimates that approximately 51 percent of all households—this is an interesting figure to me, because just a couple of years ago, I think it was around 40 percent. But the Joint Committee on Taxation estimates that approximately 51 percent of all households, which includes filers and non-filers, had either zero or a negative income tax liability for tax year 2009.

Now, just think about that. More than half of all tax units—more than half of them—either paid no income taxes or got money back.

There is a lot we can make of this information, and that is why we are having this hearing. I think many taxpayers are skeptical that the answer to our current fiscal problems is for them to sacrifice more when almost half of all households are not paying any income taxes.

The other side argues that those 69 million households pay other taxes, like employment taxes, but that point avoids the larger issue.

Those who promote higher income tax rates in the name of equality and deficit reduction need to come clean about what this entails. With the income tax base so narrow, meaningful reductions in our deficits would require far more than taxes on the rich.

Those tax increases would hit squarely in the middle class, which the President proposes is off limits.

As I said earlier, it is estimated that the top quintile of the population, in terms of income, pays more than 67 percent of all taxes to the Federal Government.

Margaret Thatcher understood that, by artificially forcing equal outcomes through confiscatory taxation, we undermine the vibrant and dynamic economy that encourages productivity and the creation of resources and wealth; and, by doing so, we actually diminish the revenues that could otherwise be available or that would otherwise be available to the government to perform its limited constitutional functions.

In short, the quest for social equality through government tinkering actually results in fewer resources and worse outcomes for the Nation as a whole and the poor in particular.

There are some who have become so fixated on what other people have that they see the tax code as a sort of utopian sociological experiment and are willing to kill the goose that is laying the golden eggs. When we talk about raising income taxes, we need to be clear about what we are doing. We are not taxing wealth. We are taxing income and, by doing so, we are discouraging productivity, entrepreneurship, and risk-taking.

The millionaire Thurston Howell III already has his money, and he is taking an extended vacation on Gilligan's Island. Trust me, Thurston and Lovey do not care if you raise the income tax. The people who would care if income tax rates were jacked up in the name of social and economic equality are the people who are not

rich now, but might be in the future. It is the entrepreneurs and small business owners who would get hurt.

In the name of socking it to Thurston and Lovey, it is the Skipper and Gilligan who really get whacked. Why would anyone take risks and work harder if they knew in advance they would not be allowed to enjoy the fruits of their own labors?

What this hearing is fundamentally about is whether the tax code is a means of funding the basic and essential functions of a constitutional republic or whether it is a means for a small elite to create their vision of a utopia.

I think the answers to these questions about the equitability of tax burdens and tax benefits will become apparent once we actually determine the purpose of the Federal tax code.

I hope that in the end we can agree that it is a good thing for all people, rich and poor, to do better.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. I would now like to introduce our witnesses. First is Mr. Daniel Shaviro. Mr. Shaviro is the Wayne Perry professor of taxation at New York University's School of Law. Mr. Shaviro worked extensively on the Tax Reform Act of 1986, while serving on the Joint Committee on Taxation.

The second witness is Mr. Scott Hodge, president of the Tax Foundation.

After Mr. Hodge, we have Ms. Aviva Aron-Dine, with the Massachusetts Institute of Technology's Department of Economics.

Finally, we have Mr. Alan Reynolds, a senior fellow at the Cato Institute.

Thank you all for coming.

As is our regular practice, we will have your statements all included in the record, and I ask each of you to speak for about 5 minutes.

Mr. Shaviro?

STATEMENT OF DANIEL SHAVIRO, WAYNE PERRY PROFESSOR OF TAXATION, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Mr. SHAVIRO. Mr. Chairman, Ranking Member Hatch, and members of the committee, thank you for the opportunity to appear today to discuss tax equity issues.

My written testimony addresses three specific topics: the changes in U.S. income distribution since 1986, how tax expenditures affect the distribution of tax burdens, and the implications for tax rate design of curtailing tax expenditures.

The Tax Reform Act of 1986, which I was very proud to work on, was designed to be distributionally neutral relative to prior law through the tradeoff between reducing tax rates and broadening the base.

In assessing high-end distributional neutrality, the Treasury and Congress looked at only two high-income groups, those earning from $100,000 to $200,000 and those earning $200,000 or more.

In 2011, by contrast, the President's Fiscal Commission examined how its proposal would affect each of the following groups: the 80th and 90th percentiles, the 90th to 95th, the 95th to 99th, the top 1 percent, and the top 0.1 percent.

A similar change in focus emerged during the 2010 debate concerning extending the Bush tax cuts for people at the top of the income distribution. Many on both sides of the debate argued that people at the very top were importantly different from those earning only, say, $250,000.

This change reflects widespread public awareness of rising high-end income concentration, a trend in which there is substantial academic consensus that does not depend on people's policy preferences.

Rising high-end income concentration has also been widely noticed in our society and has strongly influenced broader social and political attitudes, and I think it is, therefore, something that Congress, when evaluating tax reform and, more particularly, tax rates, is very likely going to want to think about.

My second point pertains to the distributional effects of the big tax expenditures for middle- and upper-income taxpayers; for example, the home mortgage interest deduction, the exclusion for employer-provided health insurance, and the charitable deduction.

Two things are clear. First, financial benefit from these items rises faster than income as you go from the bottom of the income distribution to the 99th percentile; but second, at the very top, the benefit shrinks as a percentage of income.

This means that a 1986-style trade of lower rates or base-broadening would likely create winners at the very top, at least absent repealing items, such as the 15-percent dividend rate, that arguably are not tax expenditures.

Congress could, if it chose, address those items' distributional effects without entirely repealing them. For example, it could create or reduce dollar caps on items such as home mortgage loan principal and/or it could convert various deductions and exclusions into uniform rate percentage credits. These would very likely improve efficiency and revenue, while also addressing distribution.

My third point concerns the relationship between repealing tax expenditures and deciding whether to reduce marginal tax rates. Often the two changes are grouped together 1986-style on the view that base-broadening alone would excessively increase tax revenues.

But to view repealing tax expenditures as a tax increase requires forgetting the very point that often motivates calls for their repeal, which is that they are "spending through the tax code," as the Fiscal Commission said. And, if you look at the House of Representatives' fiscal year 2012 budget resolution, it is very much the same analysis of tax expenditures as really spending.

The late economist David Bradford offered a powerful illustration of the point that tax expenditures are actually disguised spending. He described a pretended secret plan to reduce the budget deficit by formally cutting spending rather than taxes. In step one he said, suppose that we eliminate $50 billion of defense spending on needed weapons; and, step two, to make up for the loss of the weapons, we enact a new $50-billion weapons supplier tax credit.

What happens in the end is the Pentagon gets the very same weapons from the very same suppliers, effectively at the very same prices, but, by official measures, both spending and revenues have declined by $50 billion.

Bradford's pretended last step was that you then increase tax rates sufficiently to raise $50 billion of new tax revenues. When the dust has settled, the only thing that really changed is that tax rates are higher, but in terms of official measures, you have cut spending by $50 billion while tax revenues remained the same.

Now, for any tax expenditure that similarly is disguised spending, although the label does not always fit items on official lists, repealing it as an economic substance is a spending cut, not a tax increase.

Thus, while stand-alone tax expenditure repeal would increase officially measured tax revenues, it would not actually make the government larger in any meaningful economic sense, and that is presumably what people have in mind when they debate tax and spending levels in the Federal budget.

Given how tax expenditures are officially misclassified, officially measured revenue neutrality, as distinct from budget neutrality, is really semantical and not related to the actual policies that are taking place.

So tax rates should be cut as a part of tax reform if and only if that is Congress's independent policy preference, not because base-broadening made it necessary. And Congress should also keep in mind that base-broadening generally reduces the efficiency loss from high tax rates given that it makes the taxes harder to avoid.

Two final points I will just mention very quickly. First is that there really is no serious chance that rate cuts from where we stand today will raise revenue rather than lose it.

And the second is that it is possible to have an economic growth dividend from cutting rates, but it depends on how it is done, and it is likely to be quite modest.

Thank you.

[The prepared statement of Mr. Shaviro appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Shaviro.

Mr. Hodge?

STATEMENT OF SCOTT HODGE, PRESIDENT, TAX FOUNDATION, WASHINGTON, DC

Mr. HODGE. Thank you, Mr. Chairman, members of the committee.

Since 1937, Mr. Chairman, the Tax Foundation's mission has been to promote economically sound tax policy at all levels of government. We are guided by the immutable principles of economically sound tax policy.

Taxes should be neutral to economic decision-making. They should be simple, transparent, and they should promote economic growth. An ideal tax system should only do one thing, and that is raise sufficient amount of revenues to fund government programs with the least amount of harm to the economy.

I think by all accounts, the U.S. tax system is far from that ideal.

Over the past 2 decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, save more for retirement, purchase health care, buy a home, replace the home's windows, adopt children, then put them in daycare, take care of grandma, purchase school supplies, go to college, and the list goes on.

I would think that if we were starting from scratch to build a tax system, these are not the things that we would want a tax system to do.

So the question before the committee is: Is the distribution of tax burdens and tax benefits equitable? I would say no, but not in the way that many of you might think.

First, while it is well understood, as Mr. Shaviro mentioned, the major tax preferences largely benefit upper-income taxpayers, the real issue is the fact that these tax expenditures have harmful effects on the economy and the people whom they are intended to benefit.

The biggest crises facing working families and the economy today are health care, housing, and State and local government finances. Yet, these are the very areas in which the government and the tax code are already the most involved.

The cure for what ails these industries is not more subsidies, but to be weaned off the tax system.

Secondly, as a consequence of trying to use the tax code to help the middle class, we have knocked nearly half—now, more than half—of all households off the tax rolls. We have turned the IRS into an extension of the welfare state, and we have created a growing class of Americans who are disconnected from the basic cost of government.

As we get closer and now over the tipping point in which we have more non-payers than payers, we need to have a national discussion on whether it is fair or equitable to have millions of people enjoy the benefits of government and pay nothing to the costs.

Good citizenship requires that we contribute at least something to the basic costs of government if we are going to enjoy the benefits of it.

Finally, while some people would like to make the tax code more progressive, the fact is, according to the OECD, the U.S. has already the most progressive income tax system of any industrialized country. The top 1 percent of taxpayers pays a greater share of the tax burden than the bottom 90 percent combined.

And Tax Foundation research shows that the majority of Americans now get more back in government spending than they pay in taxes, and that we are redistributing more than $826 billion annually from the top 40 percent of Americans to the bottom 60 percent.

So we need an honest discussion over how much redistribution should be considered fair and equitable. And, whatever inequality we have in America today is being driven by demographic factors that are beyond the control of the tax code, such as the rise of dual-earner couples, the rise of entrepreneurship, educational attainment, and the aging of America.

And those taxpayers who are now shouldering the lion's share of the tax burden in America today are what I call the successful mid-

dle class. These are educated, dual-income families who are at the heart of the Nation's successful entrepreneurial class. And we have to stop obsessing about the distributional tables that are static and do not take into account the mobility in America.

Our research has found that nearly 60 percent of households in the bottom income quintile move up to higher quintiles over at least a 9-year period of time, and those at the top often move down to the bottom or lower within a short period of time.

Even the IRS, in their Fortunate 400 rankings, found only 15 percent of those in the Fortunate 400 were on that list for the entire 15-year period of time. There is a lot of churning at the top.

Let me close by suggesting that we need to develop a new way of thinking about equity in the tax code. We need to strive to build a consensus around some basic simple concepts.

First, an equitable tax system should be free of most of the credits and deductions and not try to micromanage individual or business behavior.

Second, every citizen should pay at least something toward the basic cost of government. And an equitable tax code should be simple and have the lowest rates possible. Finally, we need a tax code that is conducive to long-term economic growth, because that is the key to fixing the long-term fiscal health of this Nation.

Thank you, Mr. Chairman. I appreciate the opportunity, and would welcome any questions.

[The prepared statement of Mr. Hodge appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Hodge.

Ms. Aron-Dine?

STATEMENT OF AVIVA ARON-DINE, Ph.D. CANDIDATE, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Ms. ARON-DINE. Thank you, Mr. Chairman. Thank you, Ranking Member Hatch and members of the Finance Committee, for having me here today.

As Professor Shaviro talked about and as Chairman Baucus also discussed, over the past 30 years, the income distribution in the United States has become increasingly skewed. While the incomes of the top 1 percent more than tripled over this period, income growth for low- and middle-income Americans slowed to a sputter.

The lesson I draw from these facts is that, as we are making decisions about our tax system, we should work to promote economic opportunity, especially for those who have struggled the most with the economic changes of recent decades. We should certainly avoid policy steps that would worsen inequality and hardship.

That leads me to the two concrete policy recommendations I would like to offer. First, I would recommend that you preserve and strengthen the Earned Income Tax Credit and the refundable child credit. As I believe you have heard from other witnesses in recent weeks, there are many provisions in our tax system where we either do not know if they are working or we even have evidence that they are actively counterproductive.

By contrast, study after study has found that the EITC accomplishes its goal of getting low-income people, especially single mothers, to join the labor force. For instance, economists who studied

the EITC expansions of the 1980s and 1990s found that these improvements to the EITC induced well over half a million people to enter the workforce.

The EITC and the refundable child credit are also well-targeted and extremely effective at reducing poverty, especially for children. Together, these tax credits now lift 7.2 million people out of poverty, including 4 million kids.

Weakening either of these credits would increase inequality, poverty, and hardship, while strengthening them by simplifying the rules surrounding qualifying children and by improving the very small EITC available to workers without children would make the credits even more effective at encouraging and rewarding work.

Now, some have recently expressed concern about the fact that the EITC and the child credit eliminate income tax liability for many low- and moderate-income families. In particular, I know there is concern about this estimate that 51 percent of Americans owed no income tax in 2009.

Let me first note that the 51-percent figure was a temporary spike due to the recession, the now expired Making Work Pay Credit, and partial income tax exemption for unemployment benefits. In a more typical year, more like 35 to 40 percent of households would owe no income tax.

Basically, tax benefits did exactly what they were supposed to do during the recession. They expanded to help struggling families, and they will automatically contract as the economy improves.

But more importantly, the question is really just whether the tax treatment of low- and moderate-income Americans is fair or whether it would be better if this group paid substantially more in taxes. In thinking about this, it might be helpful to know some additional facts about these people.

First, according to the Tax Policy Center, 60 percent of those not owing income taxes are either elderly people or individuals whose incomes are so low that they are less than the sum of the standard deduction and personal exemption.

What that means is that 60 percent of those not owing income taxes would not owe taxes even without the EITC and or the child credit.

If, in your judgment, those people should owe income taxes, you would need to either pare back the tax exemption for Social Security benefits or reduce the standard deduction or personal exemption, the sum of which is already below the poverty line.

The other 40 percent of people not owing income taxes is mostly low-income workers with children who benefit from the EITC. These are working parents who play by the rules, but whose earnings leave them below twice the poverty line or, in many cases, in poverty.

I know that some people worry that because these families do not owe income taxes, they do not have enough skin in the game, enough of a stake in ensuring that government operates as cost-effectively as possible. But, in fact, the working families who benefit from the EITC have quite a bit of skin in the game, even in the narrow sense of paying Federal taxes.

CBO has found that the poorest 20 percent of households pay 4 percent of their incomes in Federal taxes, on average, while the

next income group pays 10 percent of its income in Federal taxes, and that is after netting out any benefits from refundable credits.

All of these families also pay a significant amount in State sales taxes and often State income taxes, too. And the fact that these households do pay significant taxes is probably not even the most important way in which they have skin in the game. As working adults raising children, low- and moderate-income working parents have a tremendous stake in the future of our society and in having government operate efficiently and effectively.

My second brief recommendation is that equitable tax reform needs to raise revenue, and it can and should do that in a progressive way.

We have seen from recent efforts that closing our large projected deficits through spending cuts alone would mean making deep cuts in social insurance and the safety net, and that would exacerbate inequality, poverty, and hardship.

But fortunately, there are policy options on the table that would raise enough revenue to let us avoid the most damaging of these budget cuts and take a more balanced approach to deficit reduction.

I agree with both Professor Shaviro and Mr. Hodge that there are ineffective tax expenditures that could be trimmed and that could raise revenue. I believe that increases in high-income marginal tax rates can also play a role in an equitable approach to tax reform and deficit reduction, particularly in light of the fact that CBO data show these households have seen the largest reductions in their tax rates over the last several decades.

Returning top tax rates just to their 1990s levels could raise more than $80 billion per year, and that is $80 billion that would not have to come out of programs for the elderly, low- and moderate-income families, or other valued public services.

Thank you again for allowing me to speak to you today, and I look forward to answering your questions.

[The prepared statement of Ms. Aron-Dine appears in the appendix.]

The CHAIRMAN. Thank you very much, Ms. Aron-Dine.

Mr. Reynolds?

STATEMENT OF ALAN REYNOLDS, SENIOR FELLOW, CATO INSTITUTE, WASHINGTON, DC

Mr. REYNOLDS. I am going to focus on facts, changes in average tax——

The CHAIRMAN. You might want to pull your microphone up a little closer, Mr. Reynolds. We want to hear you.

Mr. REYNOLDS. Does that work?

The CHAIRMAN. That works.

Mr. REYNOLDS. I am going to focus on changes over time in average tax rates, top marginal tax rates, and revenues as a share of GDP.

This is referred to in three tables at the back of my prepared testimony, and those tables are designed to explain why revenues from the individual income tax have remained near 8 percent of GDP for decades, even though the average income tax rates were cut in half since 1979 for the middle and fourth quintiles, and even

though, since 2003, average income tax rates for the bottom two quintiles, the bottom 40 percent, have been negative.

From 1951 to 1963, for example, the lowest individual income tax rate we had was either 20 or 22 percent and the highest was 91 or 92 percent, and yet that system brought in only 7.8 percent of GDP.

From 1988 to 1990, the lowest income tax rate had been cut to 15 percent and the top tax rate to 28 percent, and that tax system brought in 8.4 percent of GDP.

So we, obviously, cannot just equate rates and revenues.

Since both individual and total revenues have long been a surprisingly constant share of GDP, aside from recessions and booms, the growth of real revenues over time mainly depends on growth of the tax base, GDP.

On the left side of my table 1 is average tax rates by quintile and the top 1 percent from 1979, 1989, 1999, and 2007. Those are all cyclical peak years. And what you see there is that, at the bottom quintile, the rate, of course, has been below zero because of the Earned Income Tax Credit and the child credit.

For the second quintile, the average tax rate since 1979 has fallen 110 percent, the middle quintile 56 percent, fourth quintile 39 percent, and, at the top 1 percent, yes, the average tax rate fell too, by 15 percent largely because of the inclusion of more dividends and capital gains, which are taxed at a lower rate.

I cite—in my prepared remarks—some studies which find that the amount of taxable income reported by the top 1 percent is extremely sensitive to changes in marginal tax rates, particularly capital gains and dividends, but also income in general. It is true that this is not true of the whole population, as Ms. Aron-Dine points out, but it is true of the top taxpayers.

So my second and third tables focus on some obvious effects of tax rate changes on behavior, and the reason is to explain this paradox that revenues seem to have remained the same even though there have been huge cuts in average tax rates for the bottom 80 percent. Why is that? Behavioral responses tell us.

Table 2 focuses on capital gains, long-term capital gains, and it says that, from 1987 to 1996 when the capital gains tax was 28 percent, realized gains accounted for only 2.5 percent of GDP. When the tax rate was cut to 15 percent, it was 5 percent of GDP. You double the tax base and you are going to collect virtually the same amount of money.

Interestingly, the next column shows that, among the top 1 percent which we have heard so much about today, capital gains when the rate was high accounted for only 17.7 percent of their income, but 28 percent more recently when the tax rate was 15 percent. In other words, high-income people report more capital gains when the rate is low. If you are doing a trade from one stock to another stock, you think twice if that trade is going to cost you 28 percent before you even make the trade. So you do not make the trade, and you keep the stocks you own and only sell them if you have offsetting losses.

The third table deals with the top 1 percent in some detail, and what you see is—I have put figures in bold—whenever the capital gains tax rate went down, a lot of capital gains were reported.

When the individual income tax rate went up, i.e., 1993, salary income actually was fairly stagnant. It was unchanged from 1990 to 1994.

When the tax on interest income went up, the top 1 percent reported less interest income in 1993, 1994, and 1995, and so on and so on. But the main thing you want to watch is capital gains, because that dominates the CBO numbers. And capital gains have tripled—they doubled when the rate was cut to 20 percent, and the capital gains of the top 1 percent tripled after the tax was cut to 15 percent.

The same thing happened to dividends, and that can only be explained by a response to tax rates. There is no other explanation. They tripled, rising from an average of $30,000 in 2008 dollars to $83,000 by 2007.

My testimony closes with two factual points about tax expenditures. First of all, it is a common misconception that the 1986 tax reform was paid for by reducing deductions. That is not true. The deductions were shifted from itemized to standard, but the total deductions were the same 23 percent of AGI before and after the reform.

The second point is that, in tax expenditures discussions, including the Senate Budget Committee's compendium and the Deficit Commission recently, they make the mistake of thinking that the tax expenditure item for capital gains and dividends is a measure of the revenue that would be gained if capital gains or dividends were taxed at ordinary tax rates.

As JCT has explained to this committee, that is not true. That assumes no behavioral response, and the data I have shown show you have to take behavioral response into consideration.

If you double those tax rates, the top 1 percent would report less income, and they would pay less taxes, and they would look like they had less income in these data, but it is misleading.

[The prepared statement of Mr. Reynolds appears in the appendix.]

The CHAIRMAN. Thank you all very much.

I have a simple question to ask each of the four of you. And that is, in your judgment, to what degree has the code either contributed to or ameliorated maldistribution of income in the United States over the last 30 year?

Everybody agrees there is a growing gap. Everybody agrees the wealthier have more money, and the middle-income wage earners just have not earned very much.

But a question I have is, to what degree has the code contributed to that growth in maldistribution of income? The second question is, to what degree has the code diminished or ameliorated that maldistribution of income?

Whoever wants to go first can go first, but I am going to ask each of the four.

Mr. Reynolds, you raised your hand first.

Mr. REYNOLDS. Yes. My data talk to that point, because we show increasing progressivity, and that progressivity in the tax code was primarily through the Earned Income Tax Credit, through doubling of exemptions in 1986, through the child credit in 2003. So that is ameliorated.

The other point I want to make is that the numbers you are citing about the top 1 percent, those are the numbers in my data. They are pre-tax, pre-transfer income. So they tell us literally nothing about the distribution of after-tax disposable income. They do not include my Social Security as income, but it is income, and they do not tell you anything about how much taxes I pay—and I probably will not do that either—but it is a lot.

The CHAIRMAN. I am sorry, say again.

Mr. REYNOLDS. You cannot tell anyone's taxes from pre-tax data, and the——

The CHAIRMAN. No. But I am not——

Mr. REYNOLDS [continuing]. Numbers are pre-tax data.

The CHAIRMAN. I am just focusing on income tax right now.

Mr. REYNOLDS. Well, disposable income, if you take into account—there are measures of disposable income that take into account taxes and transfers, and I see no great change in inequality.

The CHAIRMAN. All right. My time is ticking away. Who wants to come next? Mr. Hodge? I will go down the line there.

Ms. Aron-Dine?

Ms. ARON-DINE. I agree with Mr. Reynolds both that the EITC has ameliorated wage stagnation and, also, that the tax code does not have that much of a role in pre-tax inequality. But the tax code and changes in the tax code have contributed to after-tax inequality, and the CBO data do speak——

The CHAIRMAN. After-tax inequality?

Ms. ARON-DINE. Income inequality, yes. And the CBO data do speak to that, because they give us growth in income, both before and after taxes.

So if we focus, for example, on the top 1 percent, their incomes grew by 241 percent before taxes, but they actually grew more than that, 280 percent, after taxes because their tax rate fell so much.

To put that in numbers, their incomes would have grown by $850,000, which is a lot, if the tax code had stayed the same, if their effective tax rate had stayed the same. But because their effective tax rate fell, their after-tax income actually grew by more like $1 million, with the tax code chipping in the extra $150,000.

The CHAIRMAN. So on a net basis, you think the code contributed to inequality.

Ms. ARON-DINE. Contributed to the concentration of income at the top and to after-tax inequality.

The CHAIRMAN. Mr. Hodge?

Mr. HODGE. I am a little dizzy with the numbers. I do not think that——

The CHAIRMAN. You will want to pull your microphone closer, please, Mr. Hodge, or turn it on.

Mr. HODGE. Turn it on. There we are. I believe that most of what is driving inequality today in America is beyond the reach of the tax code. Inequality is being driven by a couple of factors, including the rise of dual-earner couples.

People in the middle can launch themselves from the middle of the income scale to the top simply by saying "I do." They can also rise to the top by getting a college education. The rise of education in America and the returns to education are also contributing to inequality in a large way.

The rise of entrepreneurship—and this may be one area in which the tax code may have had a contributing factor, but in a positive way, and that is the creation of S corporations, LLCs and partnerships, and the explosion of entrepreneurship that we have seen over the past 20 years.

In 1980, there were only about 11 million tax returns that had some business income. Last year, there were close to 30 million, and that is because we have had an explosion of entrepreneurship in America today. And, as you know, those individuals or business owners file their business taxes on their individual tax return, not a corporate return. That has a contributing factor to the impressions or illusion of growing inequality, when really what you have is more than half of all business income in America today being taxed on the individual side of the tax code.

And then, lastly, we have the aging of America as the baby-boomers are now reaching their peak earnings potential before they move into retirement, and that pig-through-the-python, that bubble, I think, is also contributing to the impression or illusion of inequality.

I do not think that raising taxes will move us back to an equal position. It will not force people into getting a divorce, losing their education, et cetera.

The CHAIRMAN. I want to give Mr. Shaviro a chance.

Mr. SHAVIRO. Well, thank you. The tax code is not a main player in the story, which is a lot of the demographics, technology, things like that. The tax code has contributed, though, in the sense that, if there were higher rates that were effective—and that is, obviously, an important question—then it could have ameliorated after-tax inequality.

Mr. Hodge mentions entrepreneurs, and they are important, but I want to mention a lot of the story has to do with things like the financial sector, and CEO compensation going up, and things like that.

Salaries have really been the big driver of rising high-end income inequality.

The tax code can ameliorate that. That is all we are talking about, not eliminating it, but ameliorating it if there are slightly higher rates that are relatively effective.

And I would have to endorse, by the way, Mr. Reynolds's point that capital gains are unusually responsive to tax rates, but ordinary income tends to be considerably less responsive.

So the tax code can play a role, but it is not at the center of the drama.

The CHAIRMAN. Thank you very much.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Ms. Aron-Dine, in your written testimony, you state that "the Federal tax system, considered as a whole (including individual and corporate income, payroll, and excise taxes), is only modestly progressive."

However, as Mr. Reynolds notes in his written testimony, a 2008 study produced by the Organization of Economic Cooperation and Development, the OECD, found that, "Taxation is the most progressively distributed in the United States."

Given the high level of progressivity of the U.S. tax system versus the rest of the industrialized world, to what are you comparing our tax system when you say it is "modestly progressive?"

Ms. ARON-DINE. So let us focus just on international comparisons in that particular OECD study. What it found was that high-income people in the United States pay a very high share of income taxes, which they do, in large part, because they have a very high share of income, much higher than in most other developed countries.

But the study also continued to look at what the entire U.S. fiscal system, taxes and spending, does to ameliorate inequality as compared with the entire system, taxes and spending, in all of those other countries. And, when you look at those data and you look at the ranking of countries in terms of what they do to ameliorate inequality through their whole system, the U.S. is actually at the bottom.

In that sense, our system is actually among the least progressive. We do less than all but one or two other developed countries to ameliorate inequality through our tax system and our spending system considered as a whole, and that is from that same 2008 OECD report.

So, it is one of the senses in which I would say we have a system that, as a whole, is only modestly progressive compared to other countries.

Senator HATCH. Thank you.

Mr. Reynolds, you were——

Mr. REYNOLDS. Well, that study includes payroll taxes and other things. So it does get to the issue. And it is not just because we have a higher amount of income.

The ratio of the top 10 percent's income to the amount of taxes paid is 1.35. In other words, it is 35 percent more taxes paid than income. In Sweden, the top 10 percent get the same amount of income as they pay in taxes.

So, as far as you are talking about the tax system doing redistribution, the U.S. far outclasses anybody else. It is true that, on the spending side, it is another matter all together. But the big welfare states of Europe finance spending not with progressive taxes, but with flat rate value-added taxes, flat rate payroll taxes that are much higher than ours, and with relatively flat rate income taxes as well.

They have very high average tax rates and relatively high—and the ones with high marginal tax rates, such as France and Japan, get far less revenue from those steeply progressive rates than we do.

Senator HATCH. Mr. Hodge and Mr. Reynolds, the Joint Committee on Taxation recently informed us that 51 percent of all units, tax units, that is, did not have any income tax liability in 2009.

Now, do you think it is fair that more than half of all tax units did not pay any income taxes, while the remaining 49 percent of the tax units are stuck with the entire income tax tab?

Should not all tax units pay at least some income tax?

We will start with you, Mr. Hodge, and then Mr. Reynolds, and anybody else who would care to respond.

Mr. HODGE. Yes, Senator. I believe that everyone who enjoys the benefits of government should pay at least something, some modest amount to the cost of government. It is an essential part of citizenship to be invested in this Nation, and I think paying income taxes is one key to that.

Senator HATCH. Mr. Reynolds?

Mr. REYNOLDS. I was fortunate to be the research director for Jack Kemp's Tax Reform Commission, and I can report that every member of that commission—and they were a very interesting, distinguished group—was quite upset about the erosion of the tax base and the civics involved, and the civics are that it makes people think the government is free and, therefore, they demand too much of it, and that just does not make sense.

Senator HATCH. Mr. Shaviro?

Mr. SHAVIRO. I think it is a mistake to focus on one tax and one year in looking at this point, because people pay income taxes in other years, and they pay other taxes in that year.

And, also, I think the other point I want to make is that—are we saying that people who have too little income to have anything left after the standard deduction and personal exemption should pay some income tax, and I do not know. I mean, that is a judgment Congress will have to think about.

Senator HATCH. All right.

Ms. ARON-DINE. Just to put more of a point on that last point, it is easy to say everyone should pay something, but in terms of practical policy, what that would mean is either lowering the personal exemption or lowering the standard deduction. The sum of those is already below the poverty line.

So it would mean saying people in poverty should pay income taxes, should pay more taxes than they do today. It would mean raising taxes on elderly people, many of whom do not pay income taxes.

I think we want to think about the actual consequences that that would have for actual people.

Senator HATCH. What bothers me is that we have jumped from about 40 percent of tax units to now 51 percent.

Ms. ARON-DINE. And as I discussed, I think——

Senator HATCH. In just 2 years.

Ms. ARON-DINE. Right. And a lot of that is that we saw the worst recession in the post-war period during those 2 years, and Congress enacted measures, such as the Make Work Pay Credit and the partial income tax exemption for the UI benefit, that did deliberately pull some people out of the income tax, lowered their liability, because they were struggling in those years.

Now that those measures have expired and once the economy starts to recover, those tax benefits will naturally contract, and we will probably go back to something more like the levels we saw in earlier years.

Senator HATCH. My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Grassley?

Senator GRASSLEY. Mr. Chairman, before you start the clock, I would like to ask unanimous consent. In three instances, I would like to insert something into the record.

The CHAIRMAN. Without objection.

[The submissions appear in the appendix on p. 59.]

Senator GRASSLEY. And I would prefer to make a statement than to ask questions.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Whether the distribution of tax benefits and burdens is equitable is a very important topic. However, there is a more important question we should be debating. What is the purpose of the Federal income tax?

We cannot talk about whether taxpayers are paying their fair share if we do not know why we want them paying taxes in the first place.

We are in a situation where people are talking about increasing taxes on higher-income people, because supposedly they can afford it. And they probably can afford it. But I get sick and tired of the demagoguery that goes on in Washington about taxing higher-income people.

According to the Joint Committee on Taxation's latest analysis, 49 percent of the households are paying 100 percent of the taxes coming into the Federal Government, while 51 percent do not pay any income tax whatsoever.

How high do the taxes have to go to satisfy the appetite of people in this Congress to spend money; and, particularly, how high do marginal tax rates have to go to satisfy those clamoring for higher taxes from the wealthiest? How high to satisfy you? And you know who you are.

Investors Business Daily had an article. Even if the government confiscated all the income of people earning $250,000 a year, the money would fund the Federal Government today for just 140 days. Funding the government should be one, if not the primary goal of the income tax laws.

Note here that I am specifically focusing on income taxes. This is because payroll taxes are not supposed to be used to fund government. Social Security and Medicare taxes are, in fact, insurance premiums. Individuals who pay them expect a benefit when they get to a certain age.

It is clear that some people believe that the tax code should be used to reduce the growing income disparity between lowest and highest income quintiles. This assumes a key objective of the Federal Government through the Federal income tax laws should be to ensure that income is distributed equally throughout the citizenry. These folks actually believe that the Federal Government is the best judge of how income should be spent. That is not what our founding fathers had in mind.

In addition to considering the purpose of the tax revenue, we ought to have some principles of taxation that we abide by. I abide by the principle that 18 percent of the GDP of this country is good enough for the government to spend, because that is what it has been on a 50-year average. That leaves 82 percent in the pockets of the taxpayers for them to decide how to spend, because, if 535 of us decide how to divide up the resources of the country, we

would not have the economic growth that we have. We would be Europeanizing our economy, and that is bad.

In evaluating whether people are paying their fair share, experts frequently look at whether a proposal improves the progressivity of the tax system. Critics of lower tax rates continue to attempt to use distribution tables to show that tax relief proposals disproportionately benefit the upper income.

We keep hearing that the rich are getting richer while the poor are getting poorer. This is not an intellectually honest statement as it implies that those who are poor stay poor throughout their life and those who are rich stay rich throughout their life.

We have a 2007 report from the Department of Treasury on income mobility, 1996 to 2005. I quote: "Key findings: There was considerable income mobility of individuals in the U.S. economy during 1996 through 2005, as over half of the taxpayers moved to a different income quintile over this period. Roughly half of the taxpayers who began in the bottom income quintile, 1996, moved up to the higher income group, 2005.

"Among those with the very highest incomes in 1996, the top 1/100th of 1 percent, only 25 percent remained in that group in 2005. Moreover, the median real income of these taxpayers declined over this period.

"The degree of mobility among income groups is unchanged from the prior period, 1987 through 1996. Income growth resulted in rising incomes for most taxpayers over the period of 1996 to 2005. Median incomes of all taxpayers increased by 24 percent after adjusting for inflation. The real income of two-thirds of all taxpayers increased over this period.

"In addition, the median income of those initially in the lower income groups increased more than the median income groups in the higher incomes."

I will skip something, because I want to make one last statement here and then put the rest in the record.

I welcome this data on this very important matter for one simple reason. It sheds light on what America really is all about—vast opportunities and economic mobility.

I will put the rest of the statement in the record, Mr. Chairman.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

Senator Kyl, you are next.

Senator KYL. Thank you, Mr. Chairman.

I compliment Senator Grassley on what he just said. I note that the title of the hearing here is "Is the Distribution of Tax Burdens and Tax Benefits Equitable," and, of course, the answer to that question has to depend entirely on what we mean by equitable, what our definition is.

What measures or criteria do we use to answer that question? And I find it astonishing that some are inferring here that the purpose of the tax code is to ameliorate income inequality. I mean, that is an astounding proposition.

As Senator Grassley said, the key point is, what is the purpose of the tax code, and it should be simply to raise the revenue that the Federal Government needs.

To assume that somehow we in Washington have either the morality or the ability to judge how best people should spend their money is an astonishing proposition in and of itself. But then to go further and say that the purpose of the Federal law should be to ensure that income is distributed equally is incredibly foolish.

The factors that determine income inequality are—and I think most of the panelists agreed to this point. Mr. Shaviro said, "Well, I think the tax code can play a role, but it is not at the center of income disparity." I think that was an exact quotation there.

Education, marital status, work habits, other habits, personal decisions in life, individual preferences, and all of those things are what really determine the disparity in income in this country, and many, many, many other factors.

And at best, we can make a modest change in that, but I submit that, if the purpose here of the hearing is for us to figure out how to use the income tax code to somehow make everybody equal in this country in terms of income, it is a fool's errand, it is immoral, it is not what we should be about, and we ought to quit right now.

While I have a couple of minutes, let me ask a couple of questions here.

Mr. Reynolds, I was fascinated by the charts that you referred us to on the elasticity of taxable income studies indicating behavioral responses to changes in marginal tax rates.

You note that they are mostly concentrated at the top of the income scale; that when tax rates are high, these taxpayers engage in activities that produce less reportable income. I think everybody agreed with that proposition. When taxes are lower, there is more of an incentive to engage in activities that produce reportable income.

As you point out, this provides an explanation of why the top income earners' incomes rose when tax rates fell. More income was reported because the penalty for producing income was lower.

Now, first question. In the years immediately following the 2003 cut in individual dividends and capital gains tax rates, did Federal revenues increase or decline?

Mr. REYNOLDS. Well, remember, there is a lot going on. We are also expanding the Earned Income Tax Credit with that bill. We are adding a $1,000 child credit. We are adding a 10-percent tax rate. All of those plans were not revenue-positive, they lost revenue.

It is rather remarkable that in the last 2 years, in 2006–2007, that we are back to 8 percent, the normal 8 percent-plus share of GDP that I said tends to happen.

I did not actually predict that. In 2001, I wrote a *Wall Street Journal* article saying "a little bang for a lot of bucks." In other words, I thought the revenue losers would offset the revenue enhancers, which are the lower rates on capital gains and dividends, arguably, and the lower rate at the top in general. More income is reported when the penalty for doing so is reduced.

Senator KYL. The figures I have are, in 2005, revenues—Federal revenues—increased 14.6 percent, 11.7 percent in 2006, and 6.7 percent in 2007.

Mr. REYNOLDS. Sounds plausible.

Senator KYL. When capital gains tax rates were cut in 1997 and in 2003, did capital gains revenue rise or fall and how did the actual revenues compare to projections?

Mr. REYNOLDS. Excuse me. Are you talking about the latest capital gains rate reduction?

Senator KYL. No. In 1997, the first time, and in 2003.

Mr. REYNOLDS. Yes. Revenues, of course, soared from capital gains. Those numbers are in my table 2, although maybe not exactly. It shows that the capital gains as a share of individual revenues were 9 percent of GDP both in the post-1997 period and post-2003, whereas previously they were 7, 6.9 percent.

I am doing this only as a share of GDP. Doing it in real dollars would be even better. In a sense, every time we reduce the capital gains tax rate, there is such a revenue flood that, while the economy is doing well, that there is a temptation to do something like the child credit or something like that, and it has made the system extremely and precariously reliant on the stock market, among other things.

Senator KYL. But if I could. And I think both you and Mr. Hodge tried to make this point. A lot of what we are trying to accomplish here is to effect policy that is good for the country, not just that will produce revenue. And you can make mistakes doing that. You can also have a very positive effect, including promoting economic growth through lower tax rates.

Mr. Acting Chairman, thank you.

Senator HATCH [presiding]. Senator Menendez is not here.

Senator Roberts?

Senator ROBERTS. Thank you, Mr. Chairman or Ranking Member or co-chairman, your eminence. [Laughter.]

Senator HATCH. I like the last one most of all.

Senator ROBERTS. I am going to follow up and ask you all to respond to the question raised by Senator Kyl. What is the purpose of the tax code? Is it to raise revenue to support essential government functions, or do we see it as being a major mechanism for wealth redistribution? I do not mean that as pejorative.

If it is the latter, is that an appropriate role for the tax code? And I am going to confer an honorary doctorate of economics on all of you. So you are all doctors. That will be from the University of Kansas. And, if you want to go on with a Ph.D., we will add in income redistribution.

So you are all doctors now. Let us just start from Dr. Shaviro.

Mr. SHAVIRO. Well, I guess I am a doctor now. I am a jurist doctor, but then every lawyer could say so, too.

If all we want to do is raise revenue—we do not care at all about the distribution of wealth—the obvious thing to do would be to have a uniform head tax in which every American, be it Bill Gates or a homeless person, pays exactly the same amount.

No one agrees to that. So at this point, we are really talking in matters of degree, where really the question is—the phrase that is often used is the ability to pay, how well-off one individual is, how able to contribute to the cost of government, compared to another person.

And, as soon as you back off believing in a uniform head tax where everyone pays the same thing—which actually Margaret

Thatcher had an experience with that I recall—then we are really all in the same ballpark and not fundamentally disagreeing about what the enterprise is about.

Senator ROBERTS. Dr. Hodge?

Mr. HODGE. I do not believe the tax code should be used for social and economic engineering. I think the tax code has one purpose. As you mentioned, that is to raise a sufficient amount of money for the Federal Government.

But economic growth ought to be the key question here. Will we and do we or can we have a tax system that is conducive to long-term economic growth?

The OECD released a very important study 2 years ago showing that high corporate income taxes and high personal income taxes are the most harmful taxes to long-term economic growth.

Unfortunately, as we have talked about here, the United States has one of the most progressive personal income tax systems, and I think, as we all know, we have one of the highest corporate income tax rates among OECD nations. Both of those are contributing to our slow economic growth.

Senator ROBERTS. Dr. Aron-Dine?

Ms. ARON-DINE. I particularly appreciate it, since I like getting my Ph.D. a couple years early.

Senator ROBERTS. I know you are close, you are very close.

Ms. ARON-DINE. I am working on it.

I mostly agree with Mr. Shaviro that I think what we want is for our tax and spending systems together to accomplish a set of social goals.

I think we have agreed that those goals include helping families who are coping with situations of hardship, providing a safety net, and I think we have agreed that people at the top can afford to pay more for that.

You can call that redistribution or not, but it really does imply a progressive tax system.

Senator ROBERTS. So you are for both, right?

Ms. ARON-DINE. Yes.

Senator ROBERTS. I have to move on, because I am running out of time, and I have a couple of questions for Dr. Hodge, as well.

Please, Dr. Reynolds?

Mr. REYNOLDS. Taxes do not redistribute income. They just reduce it. The redistribution occurs through refundable tax credits, such as the EITC, which, interestingly enough, although it is $55 billion, is not counted in most of these studies of income inequality. It is like it does not exist. Neither are most transfer payments.

So it is not taxes that redistribute income. The redistribution occurs through spending programs, which are huge. Transfer payments are now over $2 trillion. Private wages and salaries are about $5 trillion. Again, we have to take that into account.

So taxes are not redistributive.

Senator ROBERTS. I appreciate it.

Dr. Hodge, again, this is a subject that my colleagues have said it is useless to bring up. I do not know how many times they have told me that, but I am going to do it again in the 35 seconds that I have left.

Actually, I will go over. I am sorry about that, Your Eminence.

In 2007, the Federal deficit stood at $161 billion and had declined from a high of $412 billion in 2004. That is quite a reduction. That does not play well into the bookshelf theory in concrete that we were—we, the editorial, we, the Congress—were spending money like drunken sailors and poor Marines or whomever.

But at any rate, the question that I have is that I thought that some of that was a result of the 2001–2003 tax relief. I do not say cuts, I say relief.

Mr. Hodge, can you expand on the idea that lowering tax rates does not necessarily result in a loss of revenue; the Federal Government can, instead, increase tax revenues?

Mr. HODGE. I think when you lower the most harmful taxes to the economy—and that is high marginal tax rates, as we did by lowering the top personal tax rates, as well as capital gains and dividends rates—the economy can grow and, to some extent, that will help replace some of the—or offset some of the revenue losses that might be expected in a static basis.

And I think, while there is a lot of debate on whether tax cuts sort of pay for themselves, I do think that lowering tax rates—lowering marginal tax rates—can increase economic growth, and that can have a positive impact on revenues over time, and I think we saw that during that period of time.

Senator ROBERTS. I appreciate that. My time has expired. Thank you.

Senator HATCH. Thank you.

I would like to note for the record that today is Senator Wyden's birthday. Happy birthday, Senator Wyden.

Senator WYDEN. Thank you, Senator Hatch. I just have been thinking about the comment my older daughter made the other day. She said that she had been studying the United States Senate, and she figured out that I am in the only profession on earth where I am actually one of the really young guys. [Laughter.]

Now, go figure the reports from the young generation. But I thank you and my colleagues for your thoughtfulness.

Senator HATCH. You are next.

Senator WYDEN. Thank you, Senator Hatch.

For our witnesses, I come to this by way of saying that a major part of tax reform is to establish new policies that are going to help grow a bigger economic pie in the United States.

That is something that I think would help bring us together. And towards that end, there is new Commerce Department data, it has been cited recently in the *Wall Street Journal* by David Wessel, but the new data shows that U.S. multinational corporations, which employ 20 percent of all U.S. workers, have been cutting workers in the United States while hiring them abroad.

In particular, the new data shows that over the last decade, U.S. multinationals have cut their U.S. workforce by 2.9 million jobs, while creating 2.4 million jobs overseas, and this is a dramatic turnaround from the 1990s, where significantly more jobs were added in the United States than overseas.

So let me kind of steer you clear of particular bills and the like. My own view is that, if you were to slash rates for doing business in the United States while keeping progressivity, you would ad-

dress that issue, and I have essentially proposed that with Senator Coats.

But just from a policy standpoint, let me ask you, Mr. Hodge, and you, Ms. Aron-Dine, this question. Should not any reform of the tax code, both from the standpoint of growth and putting us in a position where we can actually increase progressivity as well, eliminate or at least reduce the perverse incentives that encourage shipping jobs overseas?

We can steer clear of debates about territorial taxes and the like. My own view is that, if you slash rates dramatically for doing business in the United States, you eliminate some, not all, some of the debate about territorial taxes.

But just from a policy standpoint, for you, Mr. Hodge, and you, Ms. Aron-Dine, should not reform of the tax code eliminate some of those incentives for shipping jobs overseas?

Mr. HODGE. Well, Senator, I do not know of any incentives in the tax code that encourage U.S. companies to ship jobs overseas.

Senator WYDEN. How about deferral?

Mr. HODGE. I do not believe that that is an incentive to ship jobs overseas. I think that the drivers here are two things, only one of which the U.S. Government can do something about.

One is the dramatic decline in U.S. competitiveness on our corporate tax rate. As you know, we have one of the highest corporate tax rates in the world, and every other—in fact, 75 countries have cut their corporate tax rates in just the last 4 years alone, and most of those have also been turning toward a territorial tax system, the most recent being Great Britain and Japan, and they have both done it to encourage the repatriation of foreign profits from abroad.

So the sooner that we can cut our corporate tax rate dramatically, as you have suggested in your tax reform legislation, but also turn to a territorial system as our major trading partners have done, we will put not only the U.S., but U.S. companies, on an equal footing with our global competitors, and that, I think, will be the key to turning around this problem that you see and many people worry about.

Senator WYDEN. Ms. Aron-Dine?

Ms. ARON-DINE. Thank you. I think you may want to ask Mr. Shaviro, also, as this is, I think, his exact area of expertise.

But I will just make two comments. One is that I think the really striking example of how loophole-ridden and problematic our system of international taxation is is that Joint Tax says that we could raise revenue either by taxing income in real time—eliminating deferral—or by going to a fully territorial system. Either would raise more money than the loophole-ridden system we have now. And so I do think there is a lot of room for improvements.

I also think, in response to what Mr. Hodge said, that, in thinking about the problems caused by our corporate tax code, we want to think about effective tax rates rather than just the statutory tax rate, and that a lot of the inefficiency in the allocation of investment comes from the fact that different investments in different companies are subject to vastly different rates, again, because of all the special preferences in the code.

So I think there is absolutely room for growth-promoting corporate business tax reform, and that possibly could also raise revenue.

Senator WYDEN. My time is up. I just hope that—and you four are all specialists—that we can come together around policies that will increase the economic pie in the United States.

If you increase the economic pie, you lift a lot of boats, and I like to think—Mr. Hodge makes the point about territorial taxation. I am very open to talking about that. I could not figure out a way to do it and avoid some of the gaming problems with transfer pricing, but to me, if you can get those business rates down substantially here in the United States, they can come together around increasing the economic pie.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Carper?

Senator CARPER. Thanks, Mr. Chairman.

Lady, gentlemen, welcome. We are glad you are here. Thanks for helping us out.

I sort of look through these issues of changes in the tax code through a prism of—a little bit through four prisms. One is, is it fair, whatever we are considering; two, how does it affect budget deficits; three, how does it affect the economy in terms of providing a nurturing environment for job creation and job preservation; and, number four would probably be predictability, how does it affect predictability from year to year or how does it reduce uncertainty?

I am almost tempted to throw in a fifth one, which would be simplicity. Having just worked on our own family's taxes, that has a certain allure to me.

A month or two ago, we had another panel before us, some really bright folks as well, and one of them was a guy named Michael Graetz. I do not know if you all know him at all. And right now he is a professor of law at Columbia. He was a witness.

And he suggested that a properly designed value-added tax could be implemented in such a way to preserve the progressivity of the income tax system that we currently have in place, and he and others have proposed using the revenues raised from a VAT to reduce income taxes on earners below a certain level, as well as reducing taxes on corporations.

To be honest with you, I have not, in the past, thought a whole lot about a VAT, and I thought his assessment was interesting, and we had a really good discussion on what he was suggesting.

I would just ask you. Setting aside any positive economic effects from enacting a value-added tax, could each of you just give your thoughts on the desirability of a VAT in the context of ensuring that our tax system's burdens and benefits be equally distributed?

And what are your thoughts on a progressive consumption tax? And start at the end, take it away.

Mr. SHAVIRO. I have personally written about how I think replacing the income tax with a progressive consumption tax is, in principal, a good idea. I do not think it is an idea that is going anywhere, so I am not actually pursuing it these days in my work.

But it has the ability to combine redistribution with reducing a lot of these bad effects in economic growth that people are concerned about.

I think a VAT really is a necessary part of the long-run fiscal solution for the U.S. And people say it is a European thing. In fact, it is a universal thing, an OECD country thing, basically, countries around the world.

My feeling is, at least in my optimistic days, is that I feel that we will find a way——

Senator CARPER. Do you have those days often?

Mr. SHAVIRO. Not that often. [Laughter.]

Senator CARPER. Is this one of them?

Mr. SHAVIRO. When I think we are going to solve the budgetary problems we have—another thing I have written about a lot—I think a VAT has to be part of the solution, but obviously it has to be part of a solution when there is kind of a negotiated treaty, as it were, about what the new state of affairs will look like.

There is an old joke that the left hates the VAT because it is regressive, and the right hates the VAT because it is a money machine, but as soon as they exchange viewpoints, they will make a deal.

So I think there is really a deal to be made, and the VAT would likely be a part of it.

Senator CARPER. Thanks.

Mr. Hodge?

Mr. HODGE. I had a very senior British tax official tell me that, if you want a perfect tool for funding big government, a value-added tax is that tool. It is perfectly hidden from view, and you can dial up the rate at any time.

Interestingly enough, the British just dialed up their value-added tax rate this year to raise more revenue.

While I agree that consumption-based taxes are more economically efficient than income-based tax systems, I would not want to add one to the current system unless we could eliminate the corporate, individual income tax rates or income tax systems, pour lye on them so they do not return, and then we can have a value-added tax.

Senator CARPER. Thank you.

How do you pronounce your name?

Ms. ARON-DINE. Aviva Aron-Dine.

Senator CARPER. Thank you.

Ms. ARON-DINE. In response to your question about a VAT, a VAT, in itself, as you know, is very regressive. And so I think it really just depends, first, what it pays for and, second, whether you can find a way to shield the very poorest families from being too burdened by that.

In response to your question about a progressive consumption tax, the difference between a progressive consumption tax and the system we have is that it would not tax income from wealth at all.

I have a lot of concern about that, because wealth is extremely concentrated, even more so than income. One percent of American households has a third of all wealth. And so, if you get rid of taxes on that income, on income from wealth, somebody else is going to have to make up that revenue, and I just do not see how that could

possibly make sense in light of our deficit problems and in light of the increases in inequality.

Senator CARPER. Thanks.

Mr. Reynolds?

Mr. REYNOLDS. I am not an enthusiast for VAT for a lot of reasons. Look, we have a spending problem. Spending has gone from 19 percent of GDP to 24 or 25. There is no good way to finance that. That is a burden. That is a threat to taxpayers any way you look at it.

The VAT—all taxes fall on labor and capital, on individuals as suppliers of labor and capital. That is true of the VAT, too.

The VAT, in incidence, is rather similar to a payroll tax over a lifetime. Yes, it exempts savings. And, if we totally exempt capital, we will probably put a higher tax on labor. So like you, I am not for that.

High marginal tax rates are to be avoided. Devices that deliberately lose revenue are to be avoided. The elephant in the room is the 10-percent tax rate, which loses something like $700 billion over the next 10 years—no marginal impact whatsoever—and does not help poor people because poor people do not pay taxes in this country.

It just gives me $800, $900 more a year, thank you very much. Take it away from me.

Senator CARPER. Thank you. Thanks, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman.

Ms. Aron-Dine, let me ask you: we heard a lot recently—it seems like we have heard it here today, to some degree—about the share of Americans not owing any income taxes, and we have heard they have "no skin in the game;" that they are takers.

And listening to the rhetoric used makes it sound like a significant portion of Americans are simply sitting around doing nothing, waiting for the tax man to bring riches. It seems to me that the reality is far different.

I look at this, and I look at the single parent who works two jobs, probably more hours than anybody on this panel even or maybe sitting up here—although I know we spend a lot of hours here, as well—with no vacation, at the minimum wage. They barely make ends meet, despite spending almost every waking hour working.

Now, are these families takers? Or consider the Army sergeant with 6 years of experience, the backbone of our military—they have a salary scale of about $31,500. If they have a family, chances are they are below the threshold for owing Federal income taxes.

I think we can all appreciate how difficult it is to raise a family at $31,500, certainly in New Jersey. So, do you think this family does not have a stake in our society?

Ms. ARON-DINE. I think I agree with you that this family has a tremendous stake in our society. They pay other taxes besides income taxes. But more importantly, as you said, they have a stake in society as working people, as parents, and the EITC and the child credit, which are what eliminate their income tax liability, are tremendously successful as work supports, and I think we value the fact that they do that.

I also wanted to just draw a connection between your question and the previous question about Michael Graetz's plan. I know you heard from Michael Graetz recently and that he proposes phasing out income tax liability for something like 90 percent of people and replacing that with a VAT.

Now, that has pluses and minuses, but, if you were to do that, it would not then make sense for someone to say 90 percent of people are not paying income taxes, because that would have been the whole point of the change.

And so really we need to look at the whole system together, not focus on one isolated task, and I think we also need to think about, as you say, the other ways that these families contribute and the reasons why we provide them with some help through the tax code.

Senator MENENDEZ. I am sure the Army sergeant would like to be making a lot more, and would be happy to pay some taxes along the way.

Ms. ARON-DINE. Right.

Senator MENENDEZ. Let me ask Mr. Shaviro this. The Tax Policy Center estimates that the Republican budget's specific tax proposals, other than making the Bush era tax cuts permanent, would cost $2.9 trillion over the next 10 years, and that cost would be on top of the $3.8 trillion cost of making the Bush tax cuts permanent.

Roberton Williams of the Tax Policy Center has noted that, even if the $2.9 trillion was offset, the net result would be "very likely to make the tax code much more regressive than it is today."

Measures to lower the top rates to 25 percent and repeal the health reform law's payroll tax increase on people with incomes over $250,000 are tilted heavily toward the most affluent households. It is difficult to imagine a politically plausible series of tax expenditure reforms that would not only raise enough money to offset most of these new costs, but would also raise so much of that money from higher-income households that the overall result would not be regressive.

Do you think the proposal in the Republican budget plan to devote every dollar of revenue raised by curbing tax expenditures—many of which are utilized by middle-class families—to finance tax cuts for high-income households could suggest that the plan's framers regard a dramatic downward distribution of the tax burden as a higher national priority than stronger deficit reduction?

Mr. SHAVIRO. Well, I do not want to criticize their motives, certainly, sitting where I do, but I do think that the tax rate reductions they proposed were unwise, especially in view of the overall deficit posture.

And I note, in some ways, I have an easier job than the members of Congress; namely, I can say things that are unpopular, and I do not get into trouble for it.

I was pleased that the Ryan budget identified tax expenditures as a problem and said that they are really spending, but they certainly did not name any of them that they wanted to get rid of.

So that was kind of interesting, although, again, I could understand the motivation.

Senator MENENDEZ. Let me ask you this—let me name one. We have record profits—and I am happy for them to make profits, I believe in profits—but we have record profits in the oil industry. Do

we continue to give, over 10 years, about $30 billion in tax breaks? Is it something that is a good public policy?

Mr. SHAVIRO. I think those tax breaks are probably, for the industry, unwise. I actually remember when I was a Joint Committee on Taxation staffer, someone wanted, in a JCT pamphlet, to call some of these tax breaks "The Drain America First Energy Policy"—and they were not allowed to put those words in the pamphlet—the idea being we would rather kind of have the oil still there than use it up now due to tax breaks.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. And I appreciate this hearing and its focus, and I thank you all for making time to join us today.

Mr. Reynolds and Mr. Hodge, I would like to direct a question to you. There is this perception out there that the top tax brackets do not pay their fair share of income taxes due to the Bush era tax cuts in 2001 and 2003.

And yet, in fact, the share of Federal income taxes paid by top earners in this country has actually increased since these tax cuts went into effect.

How do you explain that?

Mr. HODGE. I think, Senator, first and foremost, we have used the tax system to try to relieve the tax burden on the lowest income people by expanding refundable tax credits to such an extent that we are now sending out more than $100 billion in refundable tax credits to people who owe no income taxes.

And, as we have seen in the recent estimates by the Joint Committee on Taxation, more than half of all Americans pay no income taxes. And so the only people left to pay income taxes are these high earners.

And so, even though rates have come down, their share has gone up, in large measure, because we are knocking so many people off the tax rolls.

Senator THUNE. Your testimonies talk about how taxpayers often respond to higher taxes by investing more income in tax-exempt activities or by avoiding income that is more heavily taxed.

If tax rates were to rise on upper-income taxpayers, do you suspect the Federal Government would collect as much as anticipated in revenue, or would it collect less?

Mr. REYNOLDS. My table 3 kind of addresses that point. As Scott said, the revenues have gone up even though rates have gone down. Revenues have gone up because rates have gone down.

Nobody has to realize a capital gain in a taxable account. You can keep it in an IRA or 401(k), or you can just not realize it and have an unrealized gain. Nobody has to hold dividend-paying stocks in a taxable account.

Nobody has to pay tax on interest instruments because they can always buy tax-exempt bonds.

So it is not really a matter of loopholes. It is just obvious behavioral responses to tax rates. And, when it comes to high incomes—on earned income, I am kind of a classic example. I have delib-

erately reduced my earned income by about 90 percent because my investment income puts me in the top tax bracket.

Senator THUNE. What would happen if rates were to go up on capital gains and dividends in terms of the effect on the amount of revenue raised?

Mr. REYNOLDS. It depends on how much. They are already going to go up a little, 3.8 percentage points, because of the health bill.

I think that will be a—it might be revenue-positive. I do not think the evidence is quite clear. If you get up around—if you were to go to, say, 23.8 percent, which has been proposed, on capital gains, I am pretty sure that would lose revenue over time.

We do not have enough evidence on dividends, but the fact that dividends tripled in the top 1 percent after the rate was cut is pretty astonishing.

Most of that money, at some rate, would just disappear, and then the top 1 percent would look poorer on paper because we do not count unrealized gains or we do not count the interest on tax-exempt bonds, and we do not count the dividends that are being collected in a Roth IRA.

Senator THUNE. The tipping point that you alluded to earlier where the Joint Tax Committee, with their report now, has come out and said that we have reached that point where 51 percent of Americans do not have income tax liability, which strikes me, at least in the time that I have been here, as maybe the first time that has happened.

That is a trend. We continue to see more and more people who do not have tax liability, fewer and fewer people in this country who are actually paying at least some Federal income taxes.

And in your testimony—it was you, Mr. Hodge, who referred to what some economists are calling the fiscal illusion, the idea that, when individuals perceive the cost of government to be less than what it really is because they are not bearing the burden of paying for it, they tend to demand more of it.

Do you believe that the expansion in the size and scope of government we have seen in recent years is directly related to the rapid rise in the percentage of Americans who owe no Federal income tax, or are these factors coincidental?

Mr. HODGE. I do think that, when Americans feel or perceive that government is cheap, they are going to demand more of it. And right now, they have been convinced that, if we only tax the rich, we can provide you more benefits.

And so with that kind of a bargain, we will all accept more government if someone else is going to pay for it. If an enterprising politician says "We are going to tax Canadians in order to provide you health care," everyone is going to be in favor of it.

And so right now, when you have half of all Americans with really no skin in the game, they are going to demand more government. And for those who say that they are paying other types of taxes, this is not exactly true.

Because of the generosity of refundable credits, the Joint Committee has found that 23 million people get more in refundable credits than their employee's share of the payroll tax, and 15.5 million get more in refundable credits than both shares of the payroll tax.

So these refundable credits are wiping out, not just their income taxes, but also their payroll taxes, too. That is only the tax side of the ledger. If we include spending, these people are getting considerably more back from government than they pay in taxes. That, I think, is inequitable.

Senator THUNE. I see my time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. If you have more questions, go ahead.

Senator THUNE. Let me just follow-up. You discussed the fact that what we call tax expenditures can distort economic activity; for example, causing more demand for things like housing and health care, where there is preferential tax treatment.

And I guess my question is, as you know, there is a major part of the administration's health reform law that consists of tax credits that will go into effect in the year 2014.

Do you expect that these credits are going to make the market for health-care related services more efficient or more distorted?

Mr. HODGE. I think it is going to be more distorted. I think we all understand that health care right now suffers from the third-party payer problem, and that is when someone else, whether it is an insurer, an employer, or the government, is paying the bills, we are all going to demand even more of it because it is cheap to us, and that distorts the marketplace.

And the marketplace—it is the competitive market where we are all consumers that gives us iPads for $499 and other cheap products that actually become cheaper over time while the quality goes up.

In health care, that does not happen, and it is all because of this third-party payer system. As we expand these credits, then we will, I think, see an erosion of costs, and the quality will go down.

Senator THUNE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Ms. Aron-Dine—well, strike that one.

A question I have, just generally, is, how do we increase American competitiveness and create more jobs in America with the code—and there are lots of efforts and lots of ways, clearly.

But unemployment is still too high. Global mobilization is fiercely upon us. A lot of companies are scrambling, in one respect, to maximize returns to their shareholders, but a lot of Americans—most Americans would like to have as many jobs as possible in the U.S., not overseas.

I know that is awfully simplistic, but the real basic question is, what can we do with the tax code, in your judgment, to help create, on the margin, generally, more jobs in the United States? Not getting into whether it is manufacturing jobs or financial service jobs or whatnot, whether moving eventually to a VAT with an income tax layered on top of it. I think that is what most European countries do. Would that help or not help?

Some suggest that at least a VAT allows exports, a center for exports under a VAT system, which we do not have in America. We had it before this Foreign Sales Corporation/Extraterritorial Income (FISC/ETI) was declared illegal in the WTO.

But just generally, irrespective of whether it could be passed this year or next year, in your general view, what does it take? What

do we do in the code? We have to have revenue, clearly, for government services, fair and moderate and balanced and all that.

But what could we do with the code to help promote more jobs on the margin?

Mr. SHAVIRO. Well, I think having a less distortionary income tax with less preferences in it. Also, having, I think, some shift from income to consumption, although it does raise distributional concerns.

Also, I think the case can be made for a lower domestic business rate, really a corporate rate, that would tend, over time, to bring more capital to the U.S. and increase earnings and/or wages and/or jobs. It would not, I think, have an immediate or dramatic response.

One effect that you get from that is that multinational companies, when deciding where to claim their revenue, where their income was earned, would be more likely to say the U.S. if the tax rate is lower.

If we do lower the business rate, I think for it to be credible in the long run, you really have to pay for it. And in addition, there is a real issue of how that interacts with the top individual rate.

We have not had the situation for decades where the corporate rate is much lower than the top individual rate, but I think we are headed to that world.

When you get there, what you basically have is owner-employees who pay themselves too little salary. So you kind of have to figure out how to make the tax code and individuals work if there is a lower corporate rate.

Having a corporation actually becomes a tax shelter, potentially, if you just want to avoid high individual rates when the two rates are different. There were mechanisms to deal with this in the law 30 years ago. It is something we might have to revisit if we go there again.

The CHAIRMAN. Maybe it is just the vogue today, but a lot of businessmen tell me, "Make my company's rates lower, and I will pay more in personal rates."

Mr. SHAVIRO. Yes.

The CHAIRMAN. I am diverting. Basically, just make it simpler, with incentives for U.S. as opposed to foreign companies, and that will help.

Mr. SHAVIRO. Well, a lower U.S rate would tend to increase investment in the U.S., and income that is reported by businesses which have enormous discretion—they will report more as U.S. income.

The CHAIRMAN. Right. Mr. Hodge?

Mr. HODGE. I think the quicker that we make our corporate tax system look like the rest of the world, the sooner we will be more competitive.

The U.S. has a Niemen Marcus tax system for corporations in a world in which everyone else has Wal-Mart tax systems. Seventy-five countries have cut their corporate rate in the last 4 years alone, and many of those have moved to a territorial tax system.

As I mentioned to Senator Wyden, Britain and Japan were the latest to do that, and those countries are becoming more competitive at our expense. And the sooner that we cut our corporate tax

rate dramatically and change to a territorial system that looks like the rest of the world, the sooner the U.S. economy will recover, and the more competitive we will be, and the more jobs will stay here.

The CHAIRMAN. But if we cut the corporate rate significantly, we have to pay for it. Most people think it has to be revenue-neutral. So, if it is a significant cut, 25–26 percent, that is a lot of revenue. How do we make it up?

Mr. HODGE. Senator, I would suggest that, instead of looking at this in a revenue-neutral way, we look at it in a budget-neutral way. I would cut corporate welfare spending, for instance, as a means of offsetting some of those revenue losses. I would eliminate some of the tax expenditures on the corporate code, although that only allows you to lower the rate to about 29 percent.

The CHAIRMAN. That is right. There is not a lot there, I do not think.

Mr. HODGE. Right, right. So that is why I think you need to look on the spending side of the ledger, but also I think we need to understand that our high rate is essentially losing revenue as income gets shifted overseas, as profits do not stay in the United States. Lowering rates will actually increase revenue.

The CHAIRMAN. This is a difficult forum to negotiate in, to talk in. There is not a lot of time.

Ms. Aron-Dine?

Ms. ARON-DINE. I just want to underscore what Mr. Shaviro said, that corporate reform really would have to be paid for. If not, I think you are well-aware that our deficits and debt over the long run are themselves economic concerns, and simply cutting the rate and adding to those deficits and debt is not likely to be growth-enhancing.

I actually think if you cleaned up the code, as Mr. Shaviro suggested, and eliminated some of that preferential treatment for certain kinds of corporate deductions, that could actually itself add to the benefits of anything else you did through corporate reform.

The CHAIRMAN. Let me ask this question. Do you lower the corporate rate specifically, then have the larger pass-throughs be treated as corporations—the large pass-throughs, because there are some pass-throughs that are making a lot. It is individual, not corporate, and they are businesses. We are talking about business income here.

Why not have the large pass-throughs' business income pay a corporate rate and have a lower corporate rate?

Ms. ARON-DINE. It is outside my area of expertise. It certainly sounds to me like an idea worth considering.

The CHAIRMAN. Mr. Reynolds?

Mr. REYNOLDS. Many countries with much lower corporate rates than we have collect a lot larger share of GDP from corporate taxes.

The CHAIRMAN. That is right. We are very low on a percentage basis.

Mr. REYNOLDS. I know. We do not collect much from it. That should tell you something, that there is transfer pricing going on, and there is debt. How do you get the effective rate below the statutory rate? You borrow up to your eyebrows. Do we want that? Is that a good thing? Not when times get bad, it is not a good thing.

The CHAIRMAN. Would you limit the deductibility of debt?

Mr. REYNOLDS. I would just question the static revenue estimates. That is a major reform, and that is interesting. I would like to make an additional point. The countries, the BRIC countries, what did they do?

Remember, a lot of businesses are still taxed as individuals. Brazil cut their top tax rate from 55 to 27.5 percent individual rate. India cut it from 60 to 30; South Korea from 89 to 36; Russia from 60 to 13; Singapore from 55 to 20.

You want to know how to compete with those countries? It is not by raising the highest tax rates.

The CHAIRMAN. I am way over my time.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

I think all four of you have been very interesting for me today, and I think everybody else, for that matter.

As to Senator Wyden's exchange with Ms. Aron-Dine, we need to be careful about the use of the term "loophole."

The foreign tax credit system is designed to eliminate double taxation of U.S.-based companies' foreign income. Likewise, deferral is a complicated and perhaps not a perfect system. In fact, I am sure it is not perfect, and going to a better system, it seems to me, would be a wise move for us.

Now, it modifies the unique U.S. system worldwide—tax system worldwide—it modifies that system so that U.S.-based companies are not on a level playing field with foreign-owned companies.

Now, these are not loopholes. They are broad-based policies that we are trying to take care of. Perhaps not perfect policies, but nevertheless, not loopholes. So I just want to mention that.

Ms. Aron-Dine, you recommend expanding the EITC. Now, how would that increase the percentage of those who do not pay taxes?

Ms. ARON-DINE. In my testimony, I specifically recommended potentially expanding the EITC for people without children, and this is the one category of people—we are talking about people not paying income taxes. These people actually begin to owe income taxes before their earnings reach the poverty line.

That is because the maximum EITC for them is about $450, which is not enough to eliminate their income—to offset their income tax liability, even when they are still in poverty.

So that is why I think this group potentially deserves your attention if you are thinking about ways to improve the tax code.

Senator HATCH. Let me ask Mr. Hodge and Mr. Reynolds this. I would like to focus on income mobility, and, while I am sure many would like to claim that the rich are getting richer, I would like you to comment on two findings by the Treasury Department's Office of Tax Analysis.

First that, of the richest 1 percent in 1996, 75 percent were in a lower income group by 2005. And second, during that same timeframe, the median income of the lowest income quintile increased by 90.5 percent, while the median income for the highest income quintile increased by only 10 percent.

Could you comment on that, Mr. Hodge, Mr. Reynolds, and others as well, if you care to?

Mr. HODGE. I think the study very clearly showed that, for the lowest-income individuals in particular, that real wage growth was the driver for them to move from the lowest quintile into higher quintiles over that period of time.

More interestingly, I think, also, is to look at the incidence at the top, where what we find is that it is really one-time events that often move people into the top deciles or even the top 1 percent or .1 percent, where it is the sale of a business, it is the sale of stocks, it is a 1-time event that launches them from maybe an upper middle class income to an exceptionally high income tax, then they move down after that.

So, once they have sold their business—they have made $1 million or $10 million—over time, they move back down toward where they were because that 1-time event is gone, and we find in a study that we did at the Tax Foundation that more than half of all so-called millionaires were only on that list once.

In a similar study that the IRS does on the Fortunate 400, looking at the wealthiest 400, of that 400 people, only 15 percent were on that list more than once. So it is really these one-time events that tend to drive people into those upper income brackets.

Senator HATCH. Mr. Reynolds?

Mr. REYNOLDS. Often, when we compare rich and poor, we are looking at the same people at different stages of their life. It is a snapshot, and life is a motion picture.

I have been in the bottom 10 percent and the top maybe even 1 percent if I sold a lot of stock, and I enjoyed it all. It is a matter of getting old and putting some money away.

But we do tend to forget that rather obvious point. There is plenty of mobility over a lifetime. I have a chapter on this topic in my book "Income and Wealth." I am not here to sell books, but there is a lot of bad data on that topic, as a lot of other topics.

Ms. ARON-DINE. If I could just make two points. One is that I certainly would not dispute that there is mobility, and particularly that some of this is related to age. But when some economists looked at data where they looked at people's earnings over 10 years, as they looked at a whole 10-year period and they looked at people of comparable ages, they found that there was still very substantial inequality, and, for male earners, a rise over time just like you saw in a snapshot picture.

So I do not think it makes these disparities that we have been talking about go away even if you look over a longer period.

The other thing I think we should keep in mind is intergenerational mobility—the potential for people from low-income groups to see their kids do much better—and the level of intergenerational mobility is not as high as I at least would like.

A child born into the bottom quintile of the distribution has a 35-percent chance of getting to the middle income or better, but a 42-percent chance of staying stuck at the bottom. And I think there are things we could do to provide more opportunity that would be very worth doing.

Senator HATCH. My time is up, Mr. Chairman. I think I am going to have to leave.

The CHAIRMAN. Thank you all very much. This is a long, involved process. I think, clearly, the corporate and individual tax code has

to be reformed, and I am uncertain how long it is going to take. But these hearings help a lot, and I want to thank you very much for your very thoughtful analysis and taking the time to come and talk to us and answer our questions.

The hearing record will be left open for several days. Today is Monday. At least until the end of the week. So, if Senators have questions, I will ask them to get them to you by the close of business today, and, if you could get the responses back by the end of the week, I would deeply appreciate it.

Thank you very much. The hearing is adjourned.

[Whereupon, at 11:56 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Prepared Testimony for Finance Committee Hearing
Is the Distribution of Tax Burdens and Tax Benefits Equitable?
May 3, 2011
Aviva Aron-Dine
Ph.D. Candidate, Department of Economics, MIT

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

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[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.

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[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.

Senate Finance Committee Hearing
"Is the Distribution of Tax Burdens and Tax Benefits Equitable?"
May 3, 2011
Responses to Questions for Ms. Aviva Aron-Dine

Questions from Senator Orrin Hatch

1. Ms. Aron-Dine, on page 4 of your written testimony, you write, "the level and the share of national resources going to those with the highest incomes have increased dramatically in recent decades." Please specify exactly which national resources have gone to high income individuals. Are you referring to personal income or private property? Do you think the assets and resources of individuals belong to those individuals or to the government?

In my written testimony, I referenced data on the distribution of income from the Congressional Budget Office.[1] The CBO dataset provides information on the distribution of both pre- and post-tax income, where pre-tax income includes wages and salaries, investment income, business income, pension income, and income from cash (e.g. Social Security) and some non-cash (e.g. Medicare and Medicaid) transfer programs. The CBO data show that the share of total pre-tax income going to the top 1 percent of households rose from 9.3 percent in 1979 to 19.4 percent in 2007 (the latest year for which these data are available). The share of after-tax income going to the top 1 percent of households rose from 7.5 percent in 1979 to 17.1 percent in 2007.

With respect to the question about property rights, my view is that the federal government should impose taxes in order to pay for programs and services including public goods, social insurance, and the safety net and that tax burdens should be allocated based on ability to pay.

Questions from Senator John Kerry

1. During the hearing, a statistic from the Joint Committee was repeatedly referenced. For 2009, the Joint Committee on Taxation estimated 51 percent of all households, which includes filers and non-filers, had either zero, or negative income tax liability for tax year 2009. The Committee also found that 30 percent of tax units received a refundable tax credit. Can you explain how the 51 percent that do not pay income taxes contribute their fair share in taxes? In addition, can you explain the type of refundable tax credits received by 30 percent of tax units?

In thinking about whether individuals are paying their "fair share" in taxes, what matters is the overall fairness of the fiscal system, rather than how many people pay one particular federal tax. In the United States, 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

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

taken into account, CBO finds that even the lowest-income fifth of households pay 4 percent of their income in federal taxes, while the second-lowest income group pays 11 percent of its income in federal taxes.[2] In addition, state and local tax systems are typically regressive and often impose significant additional tax burdens on low- and moderate-income families.

Fairness should also be assessed relative to ability to pay, and so it's worth noting that the households not owing federal income taxes are mostly elderly households dependent on Social Security income, single individuals with incomes below the poverty line, and families with children with incomes below twice the poverty line.

As you note, the Joint Committee on Taxation estimates that in 2009, 30 percent of households received refundable tax credits. Many of these households likely received the Earned Income Tax Credit, a refundable tax credit that increases the returns to work for low-wage workers by supplementing earnings and offsetting payroll tax burdens. In addition, some of the households receiving refundable credits would have benefited from the refundable portion of the Child Tax Credit. The Child Tax Credit provides a tax benefit of $1,000 per child to middle- and upper-middle-income households and, because it is partially refundable, low-income households can benefit from it as well (though they often do not receive the full $1,000 per child credit). Finally, in 2009 and 2010 only, working households could also benefit from the refundable Making Work Pay Credit, a $400 per worker credit enacted as a stimulus measure. However, this credit has now expired and will not be available for 2011.

2. Did the economic downturn impact tax liability for 2009?

The economic downturn sharply reduced incomes, thereby reducing income tax liability and increasing the share of households not owing federal income taxes.

3. What role do you think temporary tax credits such as the Make Work Pay Tax Credit enacted to help working families during the economic downturn had an impact on tax liability for 2009?

The Making Work Pay Credit and the partial income tax exemption for unemployment benefits, both of which were enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA), were intended to help struggling families by reducing their income tax liability. As a result, they naturally reduced the share of families owing income taxes. Both of these tax provisions have now expired.

Without these provisions, and once the labor market truly recovers from the recession, one would expect that 35-40 percent of households (rather than 51 percent) will owe no federal income tax.

4. Do you think refundable credits such as the Make Work Pay Tax Credit, the Earned Income Tax Credit, and the Child Tax Credit help stimulate the economy during an economic downturn? If so, do you think tax cuts to the top 1 percent have the same impact on the economy during a downturn?

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

Refundable credits almost certainly provide significant economic stimulus during a downturn, since they go to low- and moderate-income families that are struggling to make ends meet and that are therefore very likely to spend any additional income they receive. More generally, the fact that the share of households with no income tax liability rises during recessions is a form of "automatic" stimulus. Because the income tax is progressive, tax liability automatically falls when incomes fall (as they do during recessions), which leaves families with more cash to spend and thus stimulates the economy.

In contrast, tax cuts for high-income households provide very little stimulus, since these households are likely to save rather than spend much of the additional income. When economist Mark Zandi simulated the effects of various tax measures on GDP, he found that extending the income tax cuts enacted in 2001 and 2003 would increase GDP by only about $0.35 per dollars spent. Extending the refundable credit measures from ARRA, on the other hand, would increase GDP by about $1.20 per dollar spent.[3]

5. I have always believed a tax system should be progressive and at the same time fair. Revenue should be collected to help fund the government and we should also take into account the ability to pay. I am concerned about rising high-end income concentration. As income increased for the top one percent, did their tax liability decrease because of the 2001 and 2003 tax cuts? Do you believe those in the top 1 percent benefit less from tax expenditures than those in the middle?

Now that they are fully in effect, the Urban-Brookings Tax Policy Center estimates that the 2001 and 2003 tax cuts reduce federal tax liability by an average of $72,000 per year for households in the top 1 percent of the income distribution, raising after-tax incomes by 7 percent for this group.[4] These tax cuts are much larger (in dollar terms and as a share of income) for high-income households than for middle- or low-income households.

But the trend toward lower tax rates on high-income households actually began well before the 2001 and 2003 tax cuts. As I explained in my written testimony, the federal tax system has become less progressive over the last several decades, with total federal effective tax rates falling the most for the high-income households that saw the strongest growth in their before-tax incomes. 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 tax rates on high-income households fell over the same period in which their pre-tax incomes increased so dramatically.[5] Put differently, if federal 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 contributing the

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[3] Mark Zandi, "Too Soon to Pull Back Fiscal Policy Support," Moody's Analytics, December 6, 2010, available at http://www.cbpp.org/files/2010-12-6econ.pdf.

[4] Urban-Brookings Tax Policy Center Table T10-0232, available at http://www.taxpolicycenter.org/numbers/Content/PDF/T10-0232.pdf.

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

extra $150,000. (Roughly half of the reduction in average effective tax rates took place before the 2001 tax cuts.) Moreover, economists Thomas Piketty and Emmanuel Saez have documented that the drop in federal tax rates since the 1970s was even larger for households with even higher incomes, for example, those in the top tenth of 1 percent.[6]

The distribution of tax expenditures varies depending on the particular tax expenditure in question: tax deductions largely benefit upper-income households, while refundable tax credits benefit low- and moderate-income households. But it is certainly the case that high-income taxpayers benefit more than middle- or low-income taxpayers from all federal tax expenditures considered together, mostly because the total cost of tax deductions far exceeds the total cost of refundable tax credits. The Urban-Brookings Tax Policy Center recently published estimates of the distribution of all federal individual income tax expenditures. These estimates show that these tax benefits increase after-tax incomes by an average of $273,000, or 19 percent, for the top 1 percent of households, as compared to $3,800, or 8 percent of income, for households in the middle fifth of the income distribution, and $1,100, or 9 percent of income, for households in the bottom fifth.[7]

Questions from Senator Robert Menendez

1. I noted several examples of families who may not have an income tax liability during the hearing. These include a single parent works two jobs with no vacation, at the minimum wage. They barely make ends meet despite spending almost every waking hour working. Or an Army Sergeant with 6 years of experience who has a salary scale of about $31,500. If they have a family, chances are they're below the threshold for owing federal income taxes.

   What does it mean to make more moderate income families get some "skin in the game?"

   Do you believe, in these tough economic times, it would be good policy to redistribute the tax burden downward? That is, do you think it's wise tax policy would be to make middle class families shoulder more of the tax burden in order to lighten the tax burden for the wealthiest and most successful?

   Just because a family doesn't earn enough to have an income tax obligation, do you think this automatically means they care less about how our government operates? Are these families who don't pay any income tax "takers" and should we make sure that they have to write a check to the federal government no matter their circumstances?

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[6] See Aviva Aron-Dine, "New Study Finds 'Dramatic' Reduction in the Progressivity of the Federal Tax System," Center on Budget and Policy Priorities, March 29, 2007, http://www.cbpp.org/files/3-29-07tax.pdf and Thomas Piketty and Emmnauel Saez, "How Progressive Is the U.S. Federal Tax System? A Historical and International Perspective," *Journal of Economic Perspectives,* Winter 2007.

[7] Urban-Brookings Tax Policy Center Table T11-0087, available at http://www.taxpolicycenter.org/numbers/Content/PDF/T11-0087.pdf.

As a policy matter, meaningfully increasing the share of families owing federal income taxes would require taking one of the following steps. Policymakers could eliminate or pare back the partial income tax exemption for Social Security benefits, so that more elderly households relying on Social Security income would owe taxes. Alternatively, they could reduce the personal exemption or standard deduction, so that more single individuals living in poverty would owe income taxes (single individuals without children with incomes at the poverty line already do). Or they could reduce the Earned Income Tax Credit or refundable Child Tax Credit, thus raising taxes for working families with children with incomes below twice the poverty line. Even with the help of these credits, millions of children in this country grow up in poverty, but without the tax credits, millions more would do so.

In my view, it would be far better to stop fixating on the headcount of households paying this one particular federal tax and to instead consider the overall fairness of the tax system and what we want it to accomplish. 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. [8] In addition, state and local tax systems are typically regressive and often impose significant additional tax burdens on low- and moderate-income families.

It is also worth noting that most of the households that end up not owing income tax in some particular year do pay income tax at other points in their lives. For example, the large increase in the share of households not owing 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 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.

Finally, it is obviously not the case that, just because a family pays no income tax, or even no net federal taxes, in a particular year, it somehow lacks a "stake in the system." The people who receive the most help from the income tax system are working parents raising children. They clearly have a tremendous stake in the future of our society and in having government operate as efficiently and effectively as possible.

2. Roberton Williams of TPC has noted that even if the $2.9 trillion of new tax cuts for the wealthy included in the Ryan budget was offset, the net result would be: "very likely to make the tax code much more regressive than it is today. Measures to lower the top rates to 25 percent and repeal the health reform law's payroll tax increase on people with incomes over $250,000 are tilted heavily toward the most affluent households. It is difficult to imagine a politically plausible series of tax expenditure reforms that would not only raise enough money to offset most of these new costs but also would raise so much of that money from high-income households that the overall result wouldn't be regressive."

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

Do you think the Ryan budget would result in a downward redistribution of the tax burden?

Yes: I agree with Williams' reasoning that, because Representative Ryan's proposal would make such large cuts in top income tax rates and would also retain the lower tax rates on capital gains and dividends, it would be virtually impossible to offset the costs of the proposed tax cuts in any way that did not redistribute the tax burden downwards. Of course, Representative Ryan's tax proposals should also be considered in the context of his spending proposals, which include large cuts to Medicaid, Food Stamps (SNAP), and other means-tested programs and which over time would also impose large additional costs on elderly households. Thus, regardless of whether and how Representative Ryan's budget cuts tax expenditures, the result of his proposal would be large tax cuts for high-income households financed by budget cuts that primarily affect low- and middle-income households.

Questions from Senator Ron Wyden

1. In an effort to broaden the tax base and lower tax rates, the bipartisan tax-reform bill I've introduced with Sen. Coats of Indiana -- The Bipartisan Tax Fairness and Simplification Act of 2011 (S. 727) -- would change the federal subsidy for state and local tax-exempt bonds from a exemption to a tax credit.

   Tax-credit bonds can be more cost effective for the federal government according to both the Congressional Budget Office and the Congressional Research Service, because it costs the federal government less to direct development funds to state and local governments through tax credits than through tax exemptions.

   In addition, this change would make the tax code more equitable, because the value of tax credits is the same for all taxpayers, whereas the value of tax exemptions rises with a taxpayer's income.

   It's true is it not that the value of tax credits are the same for all taxpayers (whatever their income) whereas the value of tax exemptions rise in line with a taxpayer's income and don't you agree that changing tax-exempt bonds as they now exist into tax-credit bonds would make the tax code more equitable?

It is certainly the case that tax deductions offer the largest tax benefits to high-income households (because the benefits depend on the tax filer's marginal tax bracket), while a tax credit offers the same tax benefit to all filers (provided the credit is refundable, so that low-income households can receive it). Thus, when the federal government's goal is to encourage all individuals to engage in some desirable behavior (for example, going to college or saving for retirement), a refundable credit is generally a more efficient and more equitable means of furthering that goal than a deduction.

The tax exemption for state and local bond interest is a bit different, however. Here, the ultimate goal is not really to change individuals' investment portfolios but rather to subsidize state and

local government investment. Consistent with that objective, economists generally believe that the "incidence" (the economic benefits) of the tax exemption go mostly to states, and not to the individuals that hold the bonds. The reason is that, because the interest on these bonds is tax-exempt, individuals are willing to hold the bonds even if they pay a below-market interest rate. In fact, economic theory would predict that the interest rate on the tax-exempt bonds should fall to the point where individuals are indifferent between holding a taxable and a tax-exempt bond. Thus, the individual holding the bond should end up getting roughly the same after-tax return as he would from holding a taxable bond, while the state government issuing the bond should benefit from paying lower interest rates. Because the ultimate benefits go mostly to state governments, rather than to individuals, the equity concerns that arise in the case of most tax deductions don't really apply here.

Nonetheless, there may be other reasons to reform the tax exemption for state and local bond interest. For example, in the American Recovery and Reinvestment Act of 2009 (ARRA), the subsidy for "Build America Bonds" was provided in the form of a direct, flat rate payment to states (somewhat similar to a flat rate credit), instead of as a tax deduction for bond interest. While this is outside my area of expertise, I know that many experts believe that this is a more efficient way for the federal government to subsidize state and local government investment projects than the current tax exemption for state and local bond interest.

COMMITTEE ON FINANCE
NEWS RELEASE
Max Baucus (D-Mont.)
http://finance.senate.gov

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Fairness and the Tax Code
As prepared for delivery

Anne-Robert-Jacques Turgot, the noted 18th century French economist, said:

"...the more a man enjoys the advantages of society, the more he ought to hold himself honored in contributing to those expenses."

Turgot laid out a key measure for evaluating a tax system – determining whether the country's citizens are paying their fair share.

Americans want to see a fairer and more equitable tax system. In a recent, independent poll, most taxpayers said they believe the taxes they currently pay are fair. But an article by the Associated Press detailing this new study also revealed a perception among average Americans that the wealthy don't pay their fair share.

The perception is that tax loopholes and benefits exist that average Americans don't know about and can't access. The wealthy folks can hire attorneys and accountants to find every credit and deduction, while average Americans can't afford that time and that expertise.

One factor behind this perception may be the way changes to the code have affected people differently. Since 1986, Congress has made over 15,000 changes to the tax code. In most cases, these changes haven't benefited all taxpayers.

According to IRS data, the 400 taxpayers with the highest adjusted gross incomes had an effective tax rate of just below 17 percent for the 2007 tax year. The average income for those taxpayers was $345 million per household. But the effective tax rate of folks earning between $1 million and $1.5 million was much higher at 24 percent.

How is that possible?

The U.S. has a fairly progressive income tax system. The tax brackets rise with income.

But we also must consider the tax incentives that affect a person's tax liability and bring down tax rates.

Two prime examples of this inequality are deductions and exclusions. Many of these incentives only benefit people who earn higher incomes, and the size of the benefit they receive is also often dependent on income.

Look, for example, at the charitable deduction. Only families who itemize their tax returns are able to take advantage of this deduction, and only one-third of taxpayers itemize their returns. That leaves two-thirds of all Americans unable to receive a tax benefit for charitable deductions.

Among those who do receive the deduction there is also a disparity. A taxpayer with a 35 percent tax rate saves 35 cents in taxes for every dollar given to charity, while a taxpayer with a 10 percent tax rate only saves 10 cents for every dollar they give.

Take, for example, two taxpayers making $1,000 donations for the Alabama tornado relief efforts. This donation would cost a taxpayer with $35,000 in income $1,000 after taxes because they almost certainly would not itemize. But this same donation would cost a taxpayer with $435,000 in income much less; $650 after the benefit.

We should also consider that the Tax Policy Center estimates that 47 percent of Americans didn't pay income taxes in 2009. But that doesn't mean they didn't pay any taxes at all. Many of these same folks paid payroll and excise taxes. A large share of them are seniors and the remainder are families living in poverty.

The general perception of inequity in the tax code may also stem from the fact that economic prosperity is not shared as widely as it once was.

Over the last 30 years, households with incomes in the highest one percent have seen their before-tax income grow by 240 percent. But over the same period, 90 percent of Americans have seen essentially no increase at all, and this disparity is also apparent in after-tax income.

These past 30 years have been very different from the 30 years before that, when economic growth was widely shared.

As we focus on tax reform, we must ask whether our tax code has contributed to this disparity in income growth. We should consider whether our tax system should take these disparities into account in some way, and we must question whether our tax code can better promote economic mobility and opportunity.

So let us remember that taxpayers are more likely to willingly pay taxes that they perceive as fair. And let us make our tax system work for all Americans, not just those that can afford to pay high priced attorneys and accountants.

Senator Chuck Grassley
Statement for Senate Finance Committee Hearing
"Is the Distribution of Tax Burdens and Benefits Equitable?"
May 3, 2011

The topic of today's hearing – whether the distribution of tax benefits and burdens is equitable – is an important one. However, I would argue that there is a more important question we should be debating before we answer this question. That is: what is the purpose of the federal income tax? We can't talk about whether taxpayers are paying their fair share if we don't know why we want them paying taxes in the first place.

We are in a situation where people are talking about increasing taxes on higher income people because, supposedly, they can afford it – and probably they can afford it. But I get sick and tired of the demagoguery that goes on in Washington of taxing higher income people. According to the Joint Committee on Taxation's latest analysis, 49% of households are paying 100% of the income taxes coming in to the Federal Government, while 51 percent of the people in this country don't pay any income tax whatsoever. How high do taxes have to go, generally, to satisfy the appetite of the people in this Congress to spend money? And particularly, how high do marginal tax rates have to go to satisfy those clamoring for higher taxes that the wealthiest in this country are paying enough money?

Mr. Chairman, I ask unanimous consent to have printed in the record an article from *Investor's Business Daily.*

According to this article, even if the government confiscated all of the income of people earning $250,000 a year, the money would fund the Federal Government today for a mere 140 days.

Funding the government should be one of – if not THE – primary goal of the income tax laws. Note here that I am specifically focusing on income taxes. This is because payroll taxes are not used to fund the government per se. Social security and Medicare taxes are, in fact, insurance premiums. Individuals who pay them expect a benefit when they are at the appropriate age.

It is clear that some believe that the tax code should be used to reduce the growing income disparity between the lowest and highest income quintiles. This assumes a key objective of the federal government, through the federal income tax laws, should be to ensure that income is distributed equally throughout the country. In other words, these folks believe that the federal government is the best judge of how income should be spent. Personally, I find it hard to believe that is what our founding fathers intended.

In addition to considering the purpose of tax revenue, we ought to have some principles of taxation that we abide by. I abide by the principle that 18 percent of the GDP of this country is good enough for the government to spend. That leaves 82 percent in the pockets of the taxpayers for them to decide how to spend, because if 535 of us decide how to divide up the resources of

this country, we would not have the economic growth we have. We would be Europeanizing our economy, and we know that is bad.

In evaluating whether people are paying their fair share, experts frequently look at whether a proposal retains or improves the progressivity of our tax system. Critics of lower tax rates continue to attempt to use distribution tables to show that tax relief proposals disproportionately benefit upper income taxpayers. We keep hearing that the rich are getting richer while the poor are getting poorer. This is not an intellectually honest statement as it implies that those who were poor stay poor and those who are rich stay rich.

Mr. Chairman, I ask unanimous consent to insert in the record a 2007 report from the Department of Treasury titled "Income Mobility in the U.S. from 1996 to 2005".

The key findings of this study include, and I quote:

- There was considerable income mobility of individuals in the U.S. economy during the 1996 through 2005 period as over half of taxpayers moved to a different income quintile over this period.

- Roughly **half** of taxpayers who began in the bottom income quintile in 1996 moved up to a higher income group by 2005.

- Among those with the very highest incomes in 1996 – the top 1/100 of 1 percent – only 25 percent remained in this group in 2005. Moreover, the median real income of these taxpayers declined over this period.

- The degree of mobility among income groups is unchanged from the prior decade (1987 through 1996).

- Economic growth resulted in rising incomes for most taxpayers over the period from 1996 to 2005. Median incomes of all taxpayers increased by 24 percent after adjusting for inflation. The real incomes of two-thirds of all taxpayers increased over this period. In addition, the median incomes of those initially in the lower income groups increased more than the median incomes of those initially in the higher income groups.

Therefore, whoever is saying that once rich, Americans stay rich, and once poor, they stay poor, is purely mistaken. Internal Revenue Service data supports this analysis. A report on the 400 tax returns with highest income reported over 14 years shows that in any given year, on average, about 40 percent of the returns that were filed were not in the top 400 in any of the other 14 years.

Mr. Chairman, I ask unanimous consent that this IRS report be inserted in the record.

I welcome this data on this important matter for one simple reason: it sheds light on what America really is all about--vast opportunities and economic mobility.

Built by people from all over the world, our country truly provides unique opportunities for everyone. These opportunities include better education, healthcare services, land financial security. But most importantly, our country provides people with freedom to obtain necessary skills to climb the economic ladder and live better lives.

We are a free nation. We are a mobile nation. We are a nation of hard-working, innovative, skilled and resilient people who like to take risks when necessary in order to succeed. We have an obligation as lawmakers to incorporate these fundamental principles into our tax system.

SUBMITTED BY SENATOR GRASSLEY

From *Investor's Business Daily*

Viewpoint

Tax The Rich? Good Luck With That

By Walter Williams

April 11, 2011

I've often said that I wish there were some humane way to get rid of the rich. If you asked why, I'd answer that getting rid of the rich would save us from distraction by leftist hustlers promoting the politics of envy.

Not having the rich to fret over might enable us to better focus our energies on what's in the best interest of the 99.99% of the rest of us. Let's look at some facts about the rich laid out by Bill Whittle citing statistics on his RealClearPolitics video "Eat the Rich."

This year, Congress will spend $3.7 trillion dollars. That turns out to be about $10 billion per day. Can we prey upon the rich to cough up the money?

According to IRS statistics, roughly 2% of U.S. households have an income of $250,000 and above. By the way, $250,000 per year hardly qualifies one as being rich. It's not even yacht and Learjet money.

All told, households earning $250,000 and above account for 25%, or $1.97 trillion, of the nearly $8 trillion of total household income. If Congress imposed a 100% tax, taking all earnings above $250,000 per year, it would yield the princely sum of $1.4 trillion. That would keep the government running for 141 days, but there's a problem because there are 224 more days left in the year.

How about corporate profits to fill the gap? Fortune 500 companies earn nearly $400 billion in profits. Since leftists think profits are little less than theft and greed, Congress might confiscate these ill-gotten gains so that they can be returned to their rightful owners.

Taking corporate profits would keep the government running for another 40 days, but that along with confiscating all income above $250,000 would only get us to the end of June. Congress must search elsewhere.

According to the Forbes 400, America has 400 billionaires with a combined net worth of $1.3 trillion. Congress could confiscate their stocks and bonds, and force them to sell their businesses,

yachts, airplanes, mansions and jewelry. The problem is that after fleecing the rich of their income and net worth, and the Fortune 500 corporations of their profits, it would only get us to mid-August.

The fact of the matter is there are not enough rich people to come anywhere close to satisfying Congress' voracious spending appetite. They're going to have to go after the non-rich.

But let's stick with the rich and ask a few questions. Politicians, news media people and leftists in general entertain what economists call a zero-elasticity view of the world. That's just fancy economic jargon for a view that government can impose a tax and people will behave after the tax just as they behaved before the tax, and the only change is more government revenue.

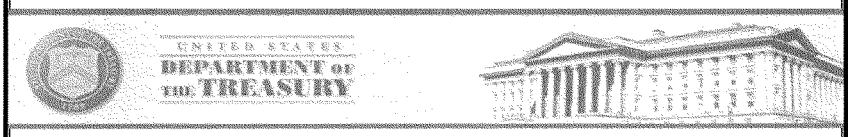
One example of that vision, at the state and local levels of government, is the disappointing results of confiscatory tobacco taxes. Confiscatory tobacco taxes have often led to less state and local revenue because those taxes encourage smuggling.

Similarly, when government taxes profits, corporations report fewer profits and greater costs. When individuals face higher income taxes, they report less income, buy tax shelters and hide their money. It's not just rich people who try to avoid taxes, but all of us — liberals, conservatives and libertarians.

What's the evidence? Federal tax collections have been between 15% and 20% of GDP every year since 1960. However, between 1960 and today, the top marginal tax rate has varied between 91% and 35%.

That means whether taxes are high or low, people make adjustments in their economic behavior so as to keep the government tax take at 15% to 20% of GDP. Differences in tax rates have a far greater impact on economic growth than federal revenues.

So far as Congress' ability to prey on the rich, we must keep in mind that rich people didn't become rich by being stupid.



Income Mobility in the U.S. from 1996 to 2005

Report of the

DEPARTMENT OF THE TREASURY

November 13, 2007

Typographical revisions - March 2008

Summary

This study examines income mobility of individuals over the past decade (1996 through 2005) using information reported on individual income tax returns.

While many studies have documented the long-term trend of increasing income inequality in the U.S. economy, there has been less focus on the dynamism of the U.S. economy and the opportunity for upward mobility. Comparisons of snapshots of the income distribution at points in time miss this important dimension and can sometimes be misleading.

Economic historian Joseph Schumpeter compared the income distribution to a hotel where some rooms are luxurious, but others are small and shabby. Important aspects of fairness are that those in the small rooms have an opportunity to move to a better one, and that the luxurious rooms are not always occupied by the same people. The frequency with which people move between rooms is a crucial aspect of the trends in income inequality in the United States.

The key findings of this study include:

- There was considerable income mobility of individuals in the U.S. economy during the 1996 through 2005 period as over half of taxpayers moved to a different income quintile over this period.
- Roughly half of taxpayers who began in the bottom income quintile in 1996 moved up to a higher income group by 2005.
- Among those with the very highest incomes in 1996 – the top 1/100 of 1 percent – only 25 percent remained in this group in 2005. Moreover, the median real income of these taxpayers declined over this period.
- The degree of mobility among income groups is unchanged from the prior decade (1987 through 1996).
- Economic growth resulted in rising incomes for most taxpayers over the period from 1996 to 2005. Median incomes of all taxpayers increased by 24 percent after adjusting for inflation. The real incomes of two-thirds of all taxpayers increased over this period. In addition, the median incomes of those initially in the lower income groups increased more than the median incomes of those initially in the higher income groups.

The degree of mobility in the overall population and movement out of the bottom quintile in this study are similar to the findings of prior research on income mobility.

Income Mobility in the U.S. from 1996 to 2005

Many studies have documented the long-term trend of increasing income inequality in the U.S. economy. U.S. Census data, for example, show that the share of household income of the top 20 percent of households increased from 44.1 percent in 1980 to 50.4 percent by 2005, with the share of the bottom 20 percent decreasing from 4.2 percent to 3.4 percent.[1] Similarly, Piketty and Saez (1998, 2007) find that the share of income of the top 10 percent of taxpayers increased from 31.7 percent in 1960 to 44.3 percent in 2005, while the share of the top 1 percent increased from 8.4 percent to 17.4 percent. Economists have suggested a variety of factors as possible explanations for these trends, including increased returns to skill and education, greater globalization of labor markets, the decline in unionization, increased immigration, and changes in the supply of highly educated workers.

To get a broader perspective on these trends, one must look at the opportunity for upward mobility in the United States, which has sometimes been seen as a defining characteristic of the nation's economy.[2] Comparisons of snapshots of the income distribution at points in time miss this important dimension and can sometimes be misleading. Research shows that the distribution of lifetime incomes is more equal than a one-time snapshot implies because a household's relative position in the income distribution often changes over time. Concerns about income inequality at a particular point in time may be assuaged if low incomes are temporary and income mobility provides individuals and families with the opportunity to improve their economic situation over time. In addition, different policy prescriptions might be appropriate for assisting those who are persistently low-income as compared to those whose incomes are only temporarily low.

Economic historian Joseph Schumpeter compared the income distribution to a hotel where some rooms are luxurious, but others are small and shabby. The rooms are always occupied, but often by different people.[3] Important aspects of fairness are that those in the small rooms to have an opportunity to move to a better one, and that the luxurious rooms are not always occupied by the same people. Mobility means that over time people move between rooms. The frequency with which people move between rooms is a crucial aspect of the changing trends in income inequality in the United States.

Another aspect of discussions of income distribution is the extent to which all income rises over time with an expanding economy. Some have likened this process to an escalator where the opportunity for mobility means that no matter which step a person starts on, he or she can move up. With an escalator, while one can get ahead faster by walking up the steps, much of the movement is due to the escalator itself.[4] That is, the

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[1] U.S. Census Bureau (2006).

[2] Litan and Slemrod (1999) state that "A defining ethic of America has long been that, no matter which step you first land on or how great the distance to the higher steps, you have a good shot at moving up if, as President Clinton has frequently said, 'you work hard and play by the rules.'"

[3] See Sawhill and Condon (1992) for more discussion of the hotel analogy.

[4] Litan and Slemrod (1999) use the escalator analogy, while McMurrer and Sawhill (1996b) use a similar analogy of moving up and down the economic ladder. In climbing a ladder, however, all the progress is due to individual effort. Holtz-Eakin, et al., (2000) connect mobility with Horatio Alger success stories.

real incomes of households can increase over time with the growth of the overall economy.

Using three different measures of income mobility that track changes in the incomes of a large sample of individual taxpayers over time, this study presents new evidence on income mobility over the decade from 1996 through 2005. Key findings include:

- There is considerable income mobility of individuals in the U.S. economy over the 1996 through 2005 period. More than half of taxpayers (56 percent by one measure and 55 percent by another measure) moved to a different income quintile between 1996 and 2005. About half (58 percent by one measure and 45 percent by another measure) of those in the bottom income quintile in 1996 moved to a higher income group by 2005.

- Median incomes of taxpayers in the sample increased by 24 percent after adjusting for inflation. The real incomes of two-thirds of all taxpayers increased over this period. Further, the median incomes of those initially in the lowest income groups increased more in percentage terms than the median incomes of those in the higher income groups. The median inflation-adjusted incomes of the taxpayers who were in the very highest income groups in 1996 declined by 2005.

- The composition of the very top income groups changes dramatically over time. Less than half (40 percent or 43 percent depending on the measure) of those in the top 1 percent in 1996 were still in the top 1 percent in 2005. Only about 25 percent of the individuals in the top $1/100^{th}$ percent in 1996 remained in the top $1/100^{th}$ percent in 2005.

- The degree of relative income mobility among income groups over the 1996 to 2005 period is very similar to that over the prior decade (1987 to 1996). To the extent that increasing income inequality widened income gaps, this was offset by increased absolute income mobility so that relative income mobility has neither increased nor decreased over the past 20 years.

Prior Studies of Income Mobility

Previous research on income mobility over the past several decades has generally found that about half of those in the bottom quintile move to a higher quintile and also that more than half of households move to a different income quintile within about 10 years.[5] Sawhill and Condon (1992), for example, used the Panel Study of Income Dynamics (PSID) to examine the mobility of individuals between the ages of 25 and 54 for the periods 1967-1976 and 1977-1986. Using a measure of relative mobility that compares households within their sample, they found that over 60 percent of individuals were in a different family income quintile a decade later. Among individuals initially in the lowest income quintile, 44 percent moved to a higher quintile between 1967 and 1976 and 47

[5] McMurrer and Sawhill (1996a) summarize a number of the early mobility studies.

percent moved to a higher quintile between 1977 and 1986. Downward mobility from the top quintile was experienced by 47 percent and 50 percent in the two periods, respectively. A later study by McMurrer and Sawhill (1996b) concluded that mobility rates had remained unchanged during this 20-year period.

Two 1992 Treasury studies (1992a and 1992b) examined mobility during the period from 1979 to 1988 using a panel that followed 14,351 income tax returns over the period and controlled for changes in the definition of income due to changes in the tax law.[6] The Treasury data showed that 86 percent of taxpayers in the lowest income quintile in 1979 had moved to a higher quintile by 1988 and 15 percent of them had moved all the way to the top quintile. Among those who were in the top quintile in 1979, 65 percent remained in the top quintile in 1988, and only 1 percent had dropped to the lowest quintile. The high degree of mobility reported by this study resulted from several features of the analysis, most importantly the inclusion of taxpayers under age 25, the lack of data on Social Security benefits for older taxpayers, and comparison to the full taxpayer population. When the sample was limited to taxpayers age 25 to 64 and compared to taxpayers in the panel, rather than to all taxpayers aged 25 to 64, the Treasury study showed that 50 percent of the lowest income quintile had moved to a higher quintile after 10 years.[7] Thus, the results were very similar to Sawhill and Condon when a comparable sample and mobility measure were used.

Bradbury and Katz (2002a, 2002b) used PSID data to examine relative income mobility in the 1970s, 1980s and 1990s. Their results also show that about half of households in the bottom quintile moved out after 10 years (51 percent for 1969-1979, 50 percent for 1979-1989, 47 percent for 1988-1998). They argue that relative mobility declined slightly in the 1990s as 40 percent of households remained in the same income quintile as compared to 36 percent in the 1970s and 37 percent in the 1980s.[8] They also show that the income gaps widened over this period, which would make mobility across quintiles more difficult, and may account for the small decline in relative mobility.[9]

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[6] The 1992 Treasury studies limited the sample to non-dependent taxpayers who had filed in all 10 years from 1979 to 1988. Income was defined as real constant law adjusted gross income (AGI). Real constant law income includes capital gains, but excludes Social Security benefits because they were not taxable until 1984 and thus no data were available for earlier years. For a more detailed description of constant law AGI, see U.S. Treasury (1992a). Income percentiles for each year were computed using the IRS Statistics of Income cross-section samples, which represent the full population of income tax returns filed each year.

[7] See U.S. Treasury (1992b). Since Social Security benefits were not taxable prior to 1984, the Treasury income measure excluded Social Security benefits. Dropping the elderly from the sample eliminated spurious downward mobility when households stopped earning wages but were not credited with Social Security benefits. Similarly, dropping those under age 25 eliminated the effects of dramatic income increases when students leave school and get their first full-time jobs.

[8] Gittleman and Joyce (1999) also conclude that income mobility rates differed little between the 1970s and 1980s. Comparable data for the 1990s would not yet have been available for their 1999 study.

[9] It is unclear whether absolute mobility increased or decreased in these data as this study does not examine absolute income mobility. Table 1 in Bradbury and Katz (2002b) shows that average real incomes of families in the lowest quintile in 1988 increased from 1988 to 1998 after declining in the previous two decades, which may suggest some increase in absolute mobility.

New Results on Income Mobility – 1996-2005

This study examines income mobility over the period from 1996 through 2005 using data from a large sample of individual income tax returns for these two years. The panel uses a large sample of approximately 96,700 tax returns with 169,300 primary and secondary (i.e., spouses on joint returns) taxpayers who filed for tax years 1996 and 2005.[10] The sample represents 117.1 million taxpayers on 76.9 million income tax returns. While the income data are as reported on tax returns, the analysis includes both primary and secondary taxpayers who are each followed separately. Thus, if a married couple filed a joint tax return in 1996, divorced, and then filed separate tax returns in 2005, each person is followed separately, even if one or both of them appear as a secondary taxpayer on another tax return. To avoid counting transitions from school to work as mobility, the analysis follows the common practice in previous research of excluding taxpayers who were under the age of 25 in 1996.[11] Income is defined as cash income as reported on individual income tax returns and supplemented by data on Social Security benefits reported on information returns filed with the Internal Revenue Service (IRS).[12] So as to remove the effects of inflation, cash income is adjusted to 2005 dollars using the Consumer Price Index Current Methodology Series.

In order to provide a more complete picture of the different dimensions of income mobility, the analysis provides three different measures: two measures of relative income mobility and one measure of absolute income mobility.[13] Relative income mobility shows how the income of households changes over time relative to the incomes of other households, while absolute income mobility measures show how the real incomes of households change over time.

Taxpayers are grouped by income quintiles (the lowest 20 percent, the second 20 percent, etc.). Results for the top 1 percent, 5 percent, and 10 percent of the population are also reported.[14] The two measures of relative income mobility are illustrated using a

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[10] The sample is based on the IRS Statistics of Income Individual Income Tax Files. The sample used for the study excludes dependent filers and follows primary and secondary taxpayers separately. The construction of the panel sample used for the analysis is discussed in more detail in the Technical Appendix.

[11] For example, Sawhill and Condon (1992) examine individuals age 25 through 54 in the initial year, while Gittleman and Joyce (1999) limit their sample to individuals between age 25 and 64 in both the initial and ending years.

[12] The definition of cash income is discussed in more detail in the Technical Appendix.

[13] Other income mobility measures include income variance over time, the correlation between income in one year and income in another year, and the percentages of households that are in a top income class or fall below the poverty level at least once in a period of years as compared to the percentages in a single year. Instead of following the income of specific individuals or households over time, some studies compare similar population groups at different points in time. For example, a recent CBO study (May 2007) reported that the average income of households with children in the lowest income quintile in 2005 was 35 percent higher than the average income of comparable households in 1991 after adjusting for inflation. Since this approach does not follow the incomes of specific households over time, it does not measure income mobility as generally understood.

[14] Since primary and secondary taxpayers are followed separately, they are counted separately in determining the income quintiles of the taxpayer population. Thus, a married couple filing jointly is

transition matrix that shows the movement of individuals across the population quintiles. For individuals in each income quintile in 1996, the transition matrix shows the percentages that end up in each income quintile in 2005. The measure of absolute income mobility groups taxpayers by income quintile in 1996 and shows the distribution of percentage changes in real income by 2005.

The first measure of mobility considers how the incomes of taxpayers in each income group in 1996 changed relative to the incomes of all taxpayers in the filing population in 2005 (Table 1). The income thresholds in 1996 and 2005 for the income quintile groups in this measure are based on all taxpayers age 25 and over in the population of all tax return filers in these two years. The table shows a high degree of income mobility over this period. Nearly 58 percent of households (i.e., 57.6 = 100 – 42.4) in the lowest income quintile in 1996 had moved to a higher quintile by 2005. While 29 percent moved up to the second quintile, the same percentage moved up at least two quintiles, and about 5 percent moved all the way to the top quintile.

Table 1: More than 50 percent of taxpayers in the bottom quintile moved to a higher quintile within ten years

Income Mobility Relative to the Total Tax Filing Population, 1996 to 2005

1996 Income Quintile	2005 Income Quintile								
	Lowest	Second	Middle	Fourth	Highest	Total	Top 10%	Top 5%	Top 1%
Lowest	42.4	28.6	13.9	9.9	5.3	100.0	2.3	1.3	0.2
Second	17.0	33.3	26.7	15.1	7.9	100.0	3.0	1.2	0.1
Middle	7.1	17.5	33.3	29.6	12.5	100.0	4.2	1.4	0.3
Fourth	4.1	7.3	18.3	40.2	30.2	100.0	8.6	2.7	0.3
Highest	2.6	3.2	7.1	17.8	69.4	100.0	43.4	22.5	4.4
Top 10%	2.6	2.2	4.9	11.8	78.6	100.0	61.1	37.6	8.3
Top 5%	2.6	1.8	3.9	8.6	83.1	100.0	71.6	54.4	15.2
Top 1%	3.2	1.3	2.2	4.9	88.4	100.0	82.7	75.0	42.6
All Income Groups	13.2	16.8	19.6	23.3	27.1	100.0	13.4	6.4	1.2

Notes: The rows sum to 100 percent across the five quintiles in the first five columns. The table uses the tax returns of primary and secondary non-dependent taxpayers who were age 25 or over in 1996 and filed for both 1996 and 2005. Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the taxpayer is age 25 and over. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: Tabulations by the U.S. Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005.

Middle-income taxpayers also did well with respect to mobility across income quintiles in the population. A much larger portion moved up to a higher income quintile (42.1 percent = 29.6 +12.5) than dropped to a lower quintile (24.6 percent = 7.1 +17.5). About one-third of the taxpayers in the middle income quintile in 1996 were still in the middle quintile in 2005. While households in the top quintile had a higher probability of staying there in 2005, over 30 percent had dropped to a lower quintile, and 2.6 percent dropped all the way to the bottom quintile. While not shown directly in the table, 56 percent of

counted as two observations. Similar procedures have been followed in some prior studies, some of which count all members of a household (including children) separately in determining the population quintiles.

the households filing tax returns in 1996 had moved to a different income quintile in 2005.[15]

The mobility of the top 1 percent of the income distribution is also important. More than half (57.4 percent = 100 – 42.6) of the top 1 percent of households in 1996 had dropped to a lower income group by 2005. This statistic illustrates that the top income groups as measured by a single year of income (i.e., cross-sectional analysis) often include a large share of individuals or households whose income is only temporarily high. Put differently, more than half of the households in the top 1 percent in 2005 were not there nine years earlier. Thus, while the share of income of the top 1 percent is higher than in prior years, it is not a fixed group of households receiving this larger share of income. As suggested by the Schumpeter hotel analogy, many of the more luxurious rooms are occupied by different people at different times.

The second measure of income mobility shows how the incomes of taxpayers in each income quintile in 1996 changed relative to that same group of taxpayers in 2005 (Table 2). Note that unlike Table 1 in which the comparison is to all taxpayers age 25 and over in the filing population in 2005, the comparison in Table 2 is only to the other taxpayers included in the panel. Unlike Table 1, the construction of Table 2 means that in the bottom row showing all taxpayers, 20 percent of the 1996 taxpayers are in each of the 2005 quintiles.[16] Since no new lower-income households enter the comparison population in this table, there is no overall upward movement of these taxpayers within the overall income distribution. Thus, under this measure of income mobility, taxpayers in the bottom income quintile are less likely to rise in to a higher quintile because the only new entrants to the bottom quintile are taxpayers whose incomes have fallen. Nevertheless, almost half of the lowest income quintile (44.9 percent) moved to a higher quintile by 2005. Total mobility was approximately the same as in the first mobility measure, as 55 percent of taxpayers moved to a higher or lower income quintile compared to 56 percent in Table 1.[17] As compared to Table 1, this measure of relative income mobility also implies more downward mobility.[18] For example, a larger portion of taxpayers in the 1996 top quintile were in a lower income quintile in 2005: 39 percent (38.6 = 100 – 61.4) as compared to 31 percent in Table 1. Nearly 60 percent of taxpayers in the top 1 percent in 1996 dropped out of the top 1 percent by 2005, although 87 percent of them remained in the top quintile.

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[15] This figure is calculated by summing all of the non-diagonal cells and dividing this number by 5. The diagonal cells contain households in the same quintile in both years. Dividing by 5 adjusts for the fact that the percentages in each quintile row sum to 100 percent, or 500 percent for all five rows.

[16] This is because Table 2 is constructed by classifying the same group of tax households based on their 1996 income and then by income percentiles based on their 2005 income. There are no additional young or new immigrant taxpayers against which the incomes of these taxpayers are being compared as in Table 1.

[17] The 55 percent figure is calculated by summing all of the non-diagonal cells and dividing this number by 5 as was done previously for Table 1.

[18] Table 2 shows greater downward mobility because for every household that moves up another must move down. The table construction combined with the fact discussed previously that new entrants into the population have lower incomes on average results in more downward mobility using this measure.

Table 2: The degree of mobility remains substantial after restricting the analysis to taxpayers included in the panel of tax returns

Income Mobility Relative to the Panel Population, 1996 to 2005

1996 Income Quintile	2005 Income Quintile								
	Lowest	Second	Middle	Fourth	Highest	Total	Top 10%	Top 5%	Top 1%
Lowest	55.1	23.7	10.8	6.9	3.6	100.0	1.7	0.9	0.1
Second	24.7	37.2	21.9	10.6	5.6	100.0	2.0	1.0	0.1
Middle	10.8	23.4	34.1	23.0	8.7	100.0	3.2	1.2	0.2
Fourth	6.0	11.0	24.2	38.1	20.8	100.0	6.4	2.1	0.3
Highest	3.5	4.7	9.0	21.5	61.4	100.0	36.7	19.8	4.3
Top 10%	3.5	3.4	6.5	13.9	72.8	100.0	54.4	33.5	7.9
Top 5%	3.2	2.8	5.0	9.6	79.4	100.0	67.2	49.7	14.4
Top 1%	3.9	1.7	3.0	4.9	86.5	100.0	80.3	73.0	40.3
All Income Groups	20.0	20.0	20.0	20.0	20.0	100.0	10.0	5.0	1.0

Notes: The rows sum to 100 percent across the five quintiles in the first five columns. The table uses the tax returns of primary and secondary non-dependent taxpayers who were age 25 or over in 1996 and filed for both 1996 and 2005. Income breaks for the quintiles and top percentiles are based on only the tax returns of the panel population. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: Tabulations by the U.S. Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005.

The third measure examines absolute income mobility, that is, the extent to which taxpayers' incomes rose or fell over time. Table 3 shows that median taxpayer income rose by 24 percent after adjusting for inflation.[19] [20] Real income increased for two-thirds (67.5 percent = 17.7 +14.3 +15.8 +19.7) of taxpayers between 1996 and 2005.

Percentage increases in real income were the largest for taxpayers with the lowest incomes in 1996. Among those taxpayers in the lowest income quintile in 1996, median income increased by 90 percent by 2005. Real incomes increased over the period for 82 percent (81.7 = 8.6 + 8.7 + 15.0 +49.4) of these low-income taxpayers and at least doubled for nearly half of this group (49.4 percent).

Among taxpayers in the highest income quintile in 1996, real income increased for over half (54.7 percent = 19.5 +14.0 +12.7+8.5) and doubled for only 8.5 percent. The median real income of taxpayers in the top quintile in 1996 rose by 10 percent, while the median income of those in the top 1 percent in 1996 declined by 25.8 percent. While this study does not examine these results in detail, the likely causes include the typical life cycle of income and "mean reversion" in which the incomes of taxpayers whose incomes were temporarily high in 1996 revert to a level closer to their long-run average.[21]

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[19] By comparison, in the U.S. Census data (2006), median household real income increased by 5.4 percent from $43,967 to $46,326 over this time period in 2005 dollars. One difference is that the Census data measures changes in the full cross-section population including new entrants, while the data in Table 3 show changes in incomes of individuals that filed income tax returns in 1996 and 2005.

[20] Median income refers to the income of the individual in the middle of the income distribution, with half having higher incomes and half having lower incomes. Mean or average income is the arithmetic average of the all taxpayers in the sample. In each case, the calculations are weighted to reflect the total tax-filing population.

[21] The results of Auten and Gee (2007) illustrate the effects of the life cycle of incomes. Taxpayers age 45 to 54 had the highest incomes of any age group in 1987, but the median inflation-adjusted income of these taxpayers declined by 1996. By comparison, taxpayers age 25 to 34 had the lowest incomes in 1987, but the most rapid increases in incomes between 1987 and 1996.

Among households in the middle income quintile in 1996, median income increased by 23.3 percent. Real income increased for about two-thirds of taxpayers in this group and at least doubled for 14.5 percent. The results reported in Table 3 demonstrate that over the 1996 to 2005 period, incomes rose for the majority of households, and that upward income mobility was the greatest among those that began the period in the lowest income groups.

Table 3: Were taxpayers better off in 2005 than in 1996?

Absolute Income Mobility, 1996 to 2005

	Distribution of Percentage Changes in Income from 1996 to 2005 in $2005								Percent Change in:	
1996 Income Quintile	Decreased more than 50%	Decreased 25 to 50%	Decreased up to 50%	Increased up to 25%	Increased 25 to 50%	Increased 50 to 100%	Increased 100% or more	Total	Mean Income	Median Income
Lowest	6.8	4.6	6.9	8.6	8.7	15.0	49.4	100.0	232.5	90.5
Second	6.7	7.8	12.6	16.6	14.7	17.5	24.1	100.0	70.6	34.8
Middle	6.6	10.1	14.8	20.2	15.5	18.3	14.5	100.0	43.1	23.3
Fourth	7.9	10.6	17.3	21.7	17.6	15.8	9.1	100.0	28.3	16.6
Highest	14.0	14.0	17.3	19.5	14.0	12.7	8.5	100.0	26.2	10.0
Top 10%	18.6	15.6	16.4	17.1	10.9	12.0	9.6	100.0	27.6	2.9
Top 5%	25.0	16.3	15.4	13.3	9.4	9.6	11.1	100.0	29.5	-6.8
Top 1%	38.9	13.8	12.1	8.6	6.0	7.6	13.0	100.0	12.5	-25.8
All Income Groups	8.6	9.7	14.2	17.7	14.3	15.8	19.7	100.0	38.0	24.2

Notes: The table uses the tax returns of primary and secondary non-dependent taxpayers who were age 25 or over in 1996 and filed for both 1996 and 2005 Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over Income is cash income in 2005 dollars as defined in the Technical Appendix

Source: Tabulations by the U S Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005

Income Dynamics of the Top 1/100, 1/10, and 1 Percent of the Population

One of the advantages of using data from income tax returns to examine income mobility is that these data include a very detailed and complete sample of the very highest income taxpayers. In contrast, most survey data used to study income dynamics, such as the PSID, include only a few high-income households and exclude the very highest income households altogether. This section examines the income mobility of the top 1 percent of the population in detail.

Approximately 117 million taxpayers who filed tax returns for 1996 and 2005 are represented in the sample for this study. Thus, the top 1 percent included about 1.17 million taxpayers, the top 0.1 percent was about 117,000 thousand taxpayers and the top 0.01 percent was about 11,700 taxpayers. Table 4 below shows the income mobility of the top 1 percent compared to the total tax filing population in 2005. This table uses the same measure of relative income mobility as Table 1, but shows the top 1 percent in greater detail.

The central theme that emerges from an examination of the very highest income taxpayers is that the composition of this group changes dramatically over time (Table 4). The vast majority of taxpayers in this group at the beginning of the 10 year period are

absent from this group 10 years later; that is, the very top of the income distribution is highly transient. Among those in the top 0.01 percent in 1996, only 25 percent remained in this group in 2005. While over 80 percent (82.4 = 24.2 + 32.9 + 25.3) of these taxpayers remained within the top 1 percent in 2005, 6 percent dropped out of the top income quintile. Similarly, about 25 percent of those who were in the top 0.1 percent in 1996, but below the top 0.01 percent, remained in this group in 2005. About 3.8 percent of these taxpayers moved to the top 0.01 percent and over 70 percent moved further down in the income distribution.

Table 4: How did the incomes of the top 1 percent of taxpayers in 1996 change relative to the total population?

Income Mobility of the Top 1 Percent Relative to the Total Population

1996 Income Percentile	Percent Distribution by 2005 Income Percentile							
	Below top 20%	10 to 20%	5 to 10%	1 to 5%	0.1 to 1%	0.01 to 0.1%	Top .01%	All
0.1 to 1%	12.0	6.0	8.1	34.2	35.1	4.2	0.3	100.0
0.01 to 0.1%	8.4	2.9	4.3	16.8	39.1	24.7	3.8	100.0
Top .01%	6.0	1.1	1.6	9.1	24.2	32.9	25.3	100.0
All Income Groups	72.9	13.7	7.0	5.2	1.0	0.1	0.0	100.0

Notes: The table includes taxpayers age 25 or over and in the top 1 percent of tax returns in 1996 who filed for both 1996 and 2005. Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: Tabulations by the U.S. Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005.

The data also indicate that the incomes of many taxpayers at the highest income levels are very volatile. Table 5 shows that real incomes increased for about 26 percent (25.6 = 4.8 + 3.5 +4.9 + 12.4) of taxpayers in the top .01 percent in 1996. On the other hand, 59 percent of taxpayers in the top 0.01 percent experienced declines in real income of at least 50 percent. Similarly, 52 percent of those in the top 0.1 percent, but below the top 0.01 percent, experienced income declines of at least 50 percent. These results illustrate that the incomes of a significant portion of those in the very highest income classes in a given year are transitory and not maintained over time.

Table 5: Absolute Income Mobility of the Top 1 Percent in 1996: Distribution of Changes in Income by 2005

1996 Income Percentile	Distribution of Percentage Changes in Income in $2005							
	Decreased more than 50%	Decreased 25 to 50%	Decreased up to 25%	Increased up to 25%	Increased 25 to 50%	Increased 50 to 100%	Increased 100% or more	Total
0.1 to 1%	37.4	14.1	12.6	8.9	6.2	7.9	13.0	100.0
0.01 to 0.1%	51.9	10.8	8.1	6.0	4.4	5.6	13.2	100.0
Top .01%	59.1	9.3	6.2	4.8	3.5	4.9	12.4	100.0
All Income Groups	8.6	9.7	14.2	17.7	14.3	15.8	19.7	100.0

Notes: The table includes taxpayers age 25 or over and in the top 1 percent of tax returns in 1996 who filed for both 1996 and 2005. Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: Tabulations by the U.S. Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005.

Table 6 shows the mean and median incomes of taxpayers in the top 1 percent in 1996 and 2005 and the percentage changes over time. As in Table 5, this table shows that the real incomes of the majority of those in the very top income classes in a given year are likely to be lower in a later year. Thus, the median income of those in the top 0.01 percent of taxpayers in 1996 fell by 64.6 percent from $11.6 million to $4.1 million. The pattern was similar, if less dramatic, for the other subgroups of the top 1 percent in 1996. The basic result is that the income of many of the highest-income taxpayers is transitory. Thus, for the majority of this group at least, the rich do not get richer. Instead, their income drops to a lower level, albeit generally to a level well above average.

Table 6: How did the Absolute Incomes of the Top 1 Percent in 1996 Change by 2005?

1996 Income Percentile	Mean Income			Median Income		
	1996	2005	% Change	1996	2005	% Change
0.1 to 1%	654,953	801,672	22.4	557,503	412,433	-26.0
0.01 to 0.1%	2,854,752	3,150,686	10.4	2,375,946	1,180,878	-50.3
Top 0.01%	17,518,043	14,391,130	-17.8	11,592,130	4,102,806	-64.6
All Income Groups	70,420	97,206	38.0	48,684	60,487	24.2

Notes: The table includes taxpayers age 25 or over and in the top 1 percent of tax returns in 1996 who filed for both 1996 and 2005. Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over. Income is cash income as defined in the Technical Appendix.

Source: Tabulations by the U.S. Department of the Treasury, Office of Tax Analysis, using data from IRS Statistics of Income, Individual Income Tax Files for tax years 1996 and 2005.

Has Income Mobility Increased or Decreased Over Time?: Comparing 1996-2005 to 1987-1996

Some studies have argued that income mobility decreased in the 1990s as compared to earlier periods.[22] The income tax data used for this study can be used to compare income mobility in the 1996 to 2005 period with income mobility in the 1987 to 1996 period.[23] Both time periods begin and end roughly during the middle of periods of economic expansion and thus should allow for comparisons that are not greatly affected by the business cycle.

Table 7 shows comparable mobility data for the two time periods using the first measure of relative income mobility that compares each initial period sample to the total population in the ending year. While the mobility measure in this table is comparable to that in Table 1, the sample population follows tax households as measured by the tax

[22] See, for example, Bradbury and Katz (2002a, 2002b). Kopczuk, Saez and Song (2007) conclude that both short-term and long-term earnings mobility among all workers has been fairly constant since about 1950.

[23] The mobility data for the 1987 to 1996 period are taken from Auten and Gee (2007) who examined income mobility for that period using a large panel sample of individual income tax returns and income and mobility measures similar to those in this study.

return of the primary taxpayer.[24] This sample restriction is necessary in order to allow comparable analysis for the two time periods.[25]

For each initial income quintile, the upper row shows the income mobility over the 1987 to 1996 period and the lower row shows the income mobility over the 1996 to 2005 period. Thus, one can examine how income mobility changed by comparing the upper and lower rows for the various initial and final income quintile combinations. For example, the upper left part of the table shows that 38.9 percent of taxpayers in the lowest income quintile in 1987 remained in the lowest quintile in 1996, while 37.8 percent of those in the lowest quintile in 1996 were in the lowest quintile in 2005. Thus, the degree of upward mobility from the lowest quintile periods is essentially the same in the two time periods: 61.1 percent from 1987 to 1996 and 62.2 percent from 1996 to 2005.

The 1.1 percentage point difference (37.8 percent versus 38.9 percent) for the upper left cells is neither economically nor statistically meaningful, nor are other differences of a few percentage points. The reason is that each cell of the table is based on a sample, albeit a very large one, and the values are subject to sampling error, as well as measurement error from misreported incomes. An examination of the various cells suggests that income mobility was approximately the same in almost all income groups during these time periods. This result may seem surprising given that other studies have reported widening income gaps over time. However, it may indicate that increases in absolute mobility have been able to offset any effects of wider income gaps.

A few differences, however, may be large enough for further analysis. For example, the percentage of households in the top income quintile that remained there increased from roughly 68 percent to 73 percent. Interestingly, the percentage of the top 1 percent that remained in the top 1 percent stayed the same, about 45 percent to 46 percent in both periods. This result suggests that the decrease in downward mobility occurred among households in the top 20 percent, but below the top 1 percent of the population.[26] In addition, the percentage of households in the middle-income quintile that moved to a higher income quintile increased by 4.8 percentage points (4.8 = (31.1 – 28.4) + (16.3 – 14.2)), a change that may suggest slightly greater upward mobility among middle-income households. While these differences are interesting, more careful analysis is needed to understand them, such as whether they represent changes among certain income or

[24] The analysis in this section is based on households as defined for income tax purposes, which differs in some cases from households as defined for Census studies and in various surveys. Since the definitions of "income tax units" and "households" are the same in most cases, this section uses the term "households" in describing the family units reflected on the income tax returns.

[25] Auten and Gee (2007) examined the income mobility of tax households, following the primary taxpayer. The sample for Tables 7 and 8 differs from the sample used for the prior sections of the current study in that secondary taxpayers are not followed if they file separately in the ending year. An extension of the analysis would be to apply the analytical framework of the current study by tracking primary and secondary taxpayers separately in the data for the earlier period.

[26] The more detailed version of this table provided in the Technical Appendix (Table A.4) shows that the percentages of households remaining in the top 5 percent and top 10 percent of households increased. Thus, the decrease in downward mobility occurred for all but the top 1 percent of households.

occupational groups. The basic finding of this analysis is that relative income mobility is approximately the same in the last 10 years as it was in the previous decade.

Table 7: Income Mobility Relative to the Total Tax Filing Population, Age 25 and Over, 1987-1996 and 1996-2005

Initial Income Quintile	Time Period	End of Period Income Quintile (1996 or 2005)						
		Lowest	Second	Middle	Fourth	Highest	Total	Top 1%
Lowest	1987-1996	38.9	28.3	14.9	10.6	7.3	100.0	0.3
	1996-2005	37.8	27.1	16.1	11.8	7.2	100.0	0.3
Second	1987-1996	14.2	33.8	26.4	16.4	9.3	100.0	0.2
	1996-2005	15.8	30.1	28.0	17.2	9.0	100.0	0.2
Middle	1987-1996	6.1	17.4	33.9	28.4	14.2	100.0	0.3
	1996-2005	5.9	14.0	32.6	31.1	16.3	100.0	0.3
Fourth	1987-1996	3.0	7.5	19.4	40.1	30.0	100.0	0.5
	1996-2005	3.1	5.7	15.5	41.9	33.8	100.0	0.3
Highest	1987-1996	1.8	2.5	7.3	20.6	67.8	100.0	5.4
	1996-2005	2.0	2.0	5.7	17.2	73.2	100.0	4.8
Top 1%	1987-1996	2.1	0.9	2.5	4.7	89.9	100.0	46.0
	1996-2005	2.7	1.0	1.5	4.5	90.3	100.0	44.7
All Income Groups	1987-1996	11.3	16.5	20.1	24.1	28.0	100.0	1.5
	1996-2005	11.7	14.7	19.1	24.4	30.0	100.0	1.3

Notes: For each initial income quintile, the upper row shows the 1987-1996 period and the lower row shows the 1996-2005 period. Each row sums to 100 percent across the five quintiles. The table includes returns of households where the primary taxpayer filed in both years and is age 25 or over in the initial year. Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: U.S. Treasury Department, Office of Tax Analysis, 1987-1996 Family Panel, Tax Year 1996 and 2005 Individual Income Tax Files.

An important related question is whether absolute income mobility changed over this time period. As shown in Table 8 below, absolute income mobility increased at all income levels in the 1996 to 2005 time period as compared to the 1987 to 1996 time period. For example, median incomes of taxpayers in the lowest income quintile increased by 81 percent in the 1987 to 1996 period, but by 109 percent in the more recent period. Similarly, median incomes of taxpayers in the middle quintile increased by 9 percent in the earlier period and 26 percent in the more recent period. Median incomes of taxpayers in the top quintile declined nearly 2 percent in the earlier period, but increased nearly 9 percent in the more recent period. Finally, the median income of taxpayers initially in the top 1 percent for each period declined by about 23 percent to 24 percent in each time period. The percentages of each initial income group whose real incomes doubled also increased for every income group. The percentage of taxpayers initially in the lowest income quintile whose income doubled increased from 47.3 percent to 53.5 percent, for example. Overall, the table shows that upward absolute income mobility increased in the most recent decade as compared to the previous decade.

Table 8: Absolute Income Mobility of Households Age 25 and Over, 1987-1996 and 1996-2005

Initial Income Quintile	Time Period	Percent Distribution of Changes in Income in 2005 Dollars						% Change in:	
		Decreased more than 50%	Decreased 5 to 50%	No change	Increased 5 to 50%	Increased 50 to 100%	Increased 100% or more	Mean Income	Median Income
Lowest	1987-1996	8.7	10.3	4.0	17.0	12.8	47.3	247.5	80.6
	1996-2005	6.8	9.3	2.6	14.2	13.7	53.5	284.6	108.7
Second	1987-1996	6.0	22.0	8.7	28.0	14.8	20.6	53.9	22.1
	1996-2005	6.6	17.1	5.3	28.4	15.9	26.8	82.6	38.0
Middle	1987-1996	7.0	29.2	10.7	28.7	13.2	11.2	30.9	9.1
	1996-2005	6.0	20.2	7.6	31.0	17.0	18.3	52.5	26.2
Fourth	1987-1996	8.1	34.5	10.2	30.9	9.6	6.6	15.6	2.3
	1996-2005	6.7	25.1	7.9	34.1	15.6	10.7	15.6	17.0
Highest	1987-1996	14.2	36.3	9.1	25.6	7.4	7.5	9.6	-1.8
	1996-2005	12.5	28.9	8.3	30.2	11.9	8.2	25.0	8.7
Top 1%	1987-1996	37.0	26.7	4.8	14.3	6.6	10.7	1.6	-23.8
	1996-2005	36.7	25.8	4.3	13.3	7.3	12.6	13.6	-23.4
All Income Groups	1987-1996	9.0	27.6	8.8	26.4	11.3	17.0	24.1	11.1
	1996-2005	7.9	20.8	6.5	28.1	14.7	22.0	41.0	30.2

Notes: For each initial income quintile, the upper row shows the distribution of changes over the 1987-1996 period and the lower row shows the 1996-2005 period Each row sums to 100 percent across the first six columns The table includes returns of households where the primary taxpayer filed in both years and is age 25 or over in the initial year Income breaks for the base year quintiles and top percentiles are based on the tax returns of primary taxpayers whose age is 25 and over Income is cash income in 2005 dollars as defined in the Technical Appendix

Source: U S Treasury Department, Office of Tax Analysis, 1987-1996 Family Panel, Tax Year 1996 and 2005 Individual Income Tax Files

Conclusions

This study examined income mobility of individual taxpayers age 25 and over for the period from 1996 through 2005 using information reported on individual income tax returns. The key findings are that there was considerable income mobility of individuals in the U.S. economy during the 1996 through 2005 period and that the degree of income mobility among income groups is unchanged from the prior comparable period (1987 through 1996).

The analysis found that more than half of taxpayers (56 percent by one measure and 55 percent by another measure) moved to a different income quintile between 1996 and 2005. About half (58 percent by one measure and 45 percent by another measure) of those in the bottom income quintile in 1996 moved to a higher income group by 2005.

Economic growth resulted in rising incomes for most taxpayers over the period from 1996 to 2005. Median incomes of all taxpayers increased by 24 percent after adjusting for inflation. In addition, the real incomes of two-thirds of all taxpayers increased over this period. Further, the median incomes of those initially in the lower income groups increased more than the median incomes of those in the higher income groups.

The analysis also found that the composition of the very top income groups changes dramatically over time. Less than half (40 percent or 43 percent by different measures) of those in the top 1 percent in 1996 were still in the top 1 percent in 2005. Only about 25 percent of individuals in the top 0.01 percent in 1996 remained in the top 0.01 percent in 2005.

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Technical Appendix

The data for this study are based on income reported on individual income tax returns, supplemented by data on Social Security benefits from Form SSA-1099 for lower-income households that are not required to report this information on their income tax returns. The 1996 base year sample uses income tax data for the 1996 tax year from the 1996 IRS Statistics of Income (SOI) Individual Income Tax File and from late-filed returns included in the 1997 and 1998 income tax files. Tax returns for which the primary taxpayer is under age 25 or a dependent filer in 1996 are excluded. In order to obtain the maximum number of matches for 2005, the corresponding data for 2005 were obtained from the IRS Individual Returns Master File at the IRS Computer Data Warehouse. Data for 2005 were obtained for both primary and secondary taxpayers in cases where taxpayers who filed jointly in 1996 filed separately or were a secondary taxpayer in a different tax unit for 2005. Since the data for late-filed tax returns are not yet available for tax year 2005, the analysis does not include such returns. Late-filed tax returns are generally 1 percent or 2 percent of tax returns filed, and are generally more complex tax returns of high-income tax households. Matches were found for 88 percent of the primary and secondary taxpayers in the 1996 sample. This attrition rate is relatively low for this time period, and is likely primarily accounted for by the death of the taxpayer.

Cash income is defined to include wages and salaries, tip income, taxable and tax-exempt interest, dividend income, alimony, net income from business (sole proprietorships, partnerships, and S corporations), farm income, net rental income, royalty income, net capital gain or loss in adjusted gross income (AGI), other gain or loss, unemployment compensation, taxable and non-taxable pension and annuity income, Social Security benefits (including the non-taxable portion), and other income included in AGI. Net operating losses carried over from prior years are added back. Alimony payments are subtracted to reflect cash income. These sources of income are as reported on individual income tax returns and supplemented by data from information returns on Social Security benefits received but not subject to tax. The inclusion of tax-exempt interest and Social Security benefits are important improvements to income as generally measured on income tax returns. The inclusion of Social Security benefits is particularly important because it is the main source of income of many older households. Transfer payments subject to tax and thus included in income tax return data accounted for about 84 percent of all cash transfer payments in 1995, the closest year to 1996 for which data were available. (See Technical Appendix A in Auten and Gee, 2007).

Overall, the income measure used in this study should generally provide a good measure of cash income for most households, though it may understate income for households receiving significant amounts of tax-exempt income from workers' compensation, Supplemental Security Income, family assistance, or certain veterans disability programs. In addition, the refundable portion of the Earned Income Tax Credit is not included because cash income is a before-tax measure. Cash income can be affected by changes in financial and compensation arrangements. For example, in recent years many mutual funds have altered how they manage their portfolios so as to reduce currently taxable capital gains of investors (i.e., capital gains distributions), even though the market values

of the mutual fund shares have been increasing. This change could reduce the incomes of households that owned mutual funds in 2005 compared to the income that would have been reported absent the change.

The definition of cash income used in this analysis is similar, but not identical, to measures used in other studies. For example, the definition used here includes capital gains income, while the Census measure of money income does not include capital gains. Some CBO and Treasury analyses have used measures of income that include employer-paid payroll taxes such as the employer share of Social Security taxes and unemployment insurance taxes. These employer-paid taxes are considered to be part of the economic income of households, but are not included in cash income in this study as households are unlikely to regard such items as part of their cash income. Income is adjusted for inflation using the Consumer Price Index Research Series Using Current Methods (CPI-U-RS).

Table A.1 shows the cash income levels for the income quintiles and the top 10 percent, 5 percent, and 1 percent of the taxpayer population.

Table A.1: Income Breaks for Population Quintiles for 1996 and 2005 (in 2005 dollars)

Income Quintile or Percentile	1996 Income Cutoff	2005 Income Cutoff
Bottom	Under 15,326	Under 19,488
Second	15,326	19,488
Middle	25,787	33,120
Median	31,785	41,242
Third	38,881	51,257
Fourth	60,897	83,138
Top 10%	85,387	120,211
Top 5%	116,425	171,856
Top 1%	284,603	463,615

Source: IRS, Statistics of Income 1996 and 2005 Individual Income Tax Files.

Since the data for this study is based on income tax returns, an important question is the extent to which the sample accurately represents the total population. The sample includes individuals who are either primary or secondary non-dependent taxpayers on tax returns filed in 1996. Table A.2 shows that as of 1996, the population of income tax filers used in this study included 85.5 percent of the population age 25 and over and 90.7 percent of the resident population age 25 to 64. Thus, the sample is highly representative of the population aged 25 to 64. In addition, to low-income individuals, the 9.1 percent of individuals in the non-filing population includes non-compliant taxpayers who should have filed returns, late filers, individuals who filed but were claimed as dependents on other tax returns, and individuals who retired and began collecting Social Security benefits prior to age 65. Representation of younger and older individuals was not as complete. About 69 percent of individuals age 20 to 24 and 56 percent of individuals age

65 and over were represented on tax returns. The filing rate for older households declines because Social Security benefits constitute a large portion of the incomes of many older households, but are not subject to tax until modified adjusted gross income exceeds $32,000 for married couples filing jointly and $25,000 for non-married individuals.

Table A.2: Comparison of the Adult Tax Filing Population with the U.S.

Age in 1996	Resident Population, July 1, 1996	1996 Primary and Secondary Taxpayers	Taxpayers as Percent of Resident Population
20-24	17,508	12,604	72.0
25-64	158,675	143,856	90.7
55-64	21,353	18,831	88.2
65 and over	33,956	20,893	61.5
25 and over	192,631	164,749	85.5

Notes: Secondary taxpayer refers to the spouse of the taxpayer on joint tax returns filed by married taxpayers. Dependent taxpayers who are claimed as dependents on other tax returns are excluded from the numbers of primary and secondary taxpayers.

Source: Resident population from *Resident Population Estimates of the United States by Age and Sex: April 1, 1990 to July 1, 1999*, U.S. Census Bureau. Numbers of taxpayers from U.S. Treasury Department, IRS Statistics of Income, Individual Income Tax Files.

As shown in the table below, overall attrition in the panel was 16.2 percent. Of the 18,646 returns for which no tax return was found for 2005, information returns for Social Security benefits were found in 4,161 instances or 22 percent. These 4,161 individuals are not included in the analysis because of the lack of information about other potential sources of income such as interest, dividends, wages and self-employment income. While information on the deaths of taxpayers is not available for this panel, based on experience with the tax panel for the 1987-1996 period, it is likely that as many as half of the missing returns are attributable to the death of the taxpayer. This is suggested by the fact that of 14,485 not accounted for by Social Security recipient non-filers, 6,251 or 43 percent were accounted for by taxpayers over age 65 in 1996. It is likely that several thousand additional late-filed 2005 returns could be found in later years. After accounting for these factors, the remaining attrition due to factors including non-compliance and income falling below the filing threshold appears to be relatively small.

Table A.3: Attrition in the 1996-2005 Panel of Tax Returns

1996 Income Quintile	Numbers of Non-Dependent Returns				Percent Attrition From 1996 Sample		
	1996 Sample	Only Social Security	No 2005 Match	1996-2005 Panel	Only Social Security	No 2005 Match	Total Attrition
Lowest	11,295	925	2,137	8,233	8.2	18.9	27.1
Second	8,851	889	1,493	6,469	10.0	16.9	26.9
Middle	9,977	636	1,493	7,848	6.4	15.0	21.3
Fourth	11,418	415	1,421	9,582	3.6	12.4	16.1
80-90th pct	6,725	165	776	5,784	2.5	11.5	14.0
90-95th pct	4,867	106	496	4,265	2.2	10.2	12.4
95-99th pct	14,795	257	1,900	12,638	1.7	12.8	14.6
99-99.9 pct	18,700	309	2,045	16,346	1.7	10.9	12.6
99.9-99.99 pct	19,022	297	1,821	16,904	1.6	9.6	11.1
Top .01 pct	9,666	162	903	8,601	1.7	9.3	11.0
Total	115,316	4,161	14,485	96,670	3.6	12.6	16.2
1996 Age							
25-34	13,251	82	1,568	11,601	0.6	11.8	12.5
35-44	25,574	160	2,529	22,885	0.6	9.9	10.5
45-54	31,134	349	2,538	28,247	1.1	8.2	9.3
55-64	22,732	1,316	1,599	19,817	5.8	7.0	12.8
65 and over	22,625	2,254	6,251	14,120	10.0	27.6	37.6
Total	115,316	4,161	14,485	96,670	3.6	12.6	16.2

Notes: The column labeled "Only Social Security" shows the numbers of cases in which Form SSA-1099 information returns were found for 2005 but no income tax return was filed. The column labeled "No 2005 Match" shows the numbers of cases for which neither Form SSA-1099 nor a tax return were found for 2005.

Source: IRS, Statistics of Income 1996 and 2005 Individual Income Tax Files.

The following tables provide the complete mobility comparisons between the 1987-1996 period and the 1996-2005 period. These more detailed tables show the results for the top 5 percent and top 10 percent as well as the results for the second measure of relative income mobility.

Table A.4: Income Mobility Relative to the Total Tax Filing Population, Age 25 and Over, 1987-1996 and 1996-2005

Initial Income Quintile	Time Period	End of Period Income Quintile (1996 or 2005)								
		Lowest	Second	Middle	Fourth	Highest	Total	Top 10%	Top 5%	Top 1%
Lowest	1987-1996	38.9	28.3	14.9	10.6	7.3	100.0	3.4	1.7	0.3
	1996-2005	37.8	27.1	16.1	11.8	7.2	100.0	2.9	1.5	0.3
Second	1987-1996	14.2	33.8	26.4	16.4	9.3	100.0	3.2	1.2	0.2
	1996-2005	15.8	30.1	28.0	17.2	9.0	100.0	3.5	1.5	0.2
Middle	1987-1996	6.1	17.4	33.9	28.4	14.2	100.0	5.6	2.3	0.3
	1996-2005	5.9	14.0	32.6	31.1	16.3	100.0	5.8	2.0	0.3
Fourth	1987-1996	3.0	7.5	19.4	40.1	30.0	100.0	10.3	3.8	0.5
	1996-2005	3.1	5.7	15.5	41.9	33.8	100.0	11.2	3.8	0.3
Highest	1987-1996	1.8	2.5	7.3	20.6	67.8	100.0	42.6	23.9	5.4
	1996-2005	2.0	2.0	5.7	17.2	73.2	100.0	46.7	24.6	4.8
Top 10%	1987-1996	1.8	1.5	4.4	13.6	78.7	100.0	60.6	38.9	9.9
	1996-2005	2.2	1.2	2.9	7.4	86.3	100.0	75.1	58.3	15.7
Top 5%	1987-1996	1.9	1.4	3.2	8.2	85.2	100.0	73.3	56.3	17.3
	1996-2005	2.7	1.0	1.5	4.5	90.3	100.0	85.0	77.7	44.7
Top 1%	1987-1996	2.1	0.9	2.5	4.7	89.9	100.0	83.3	75.8	46.0
	1996-2005	2.7	1.0	1.5	4.5	90.3	100.0	85.0	77.7	44.7
All Income Groups	1987-1996	11.3	16.5	20.1	24.1	28.0	100.0	14.4	7.3	1.5
	1996-2005	11.7	14.7	19.1	24.4	30.0	100.0	15.3	7.3	1.3

Notes: For each initial income quintile, the upper row shows the 1987-1996 period and the lower row shows the 1996-2005 period The table includes returns of households where the primary taxpayer filed for both years and is age 25 or over in the initial year Income breaks for the quintiles and top percentiles are based on the full cross-sections of tax returns for each year, where the primary taxpayer is age 25 and over Income is cash income as defined in the Technical Appendix

Source: U S Treasury Department, 1987-1996 Family Panel, Tax Year 1996 and 2005 Individual Income Tax Files

Table A.5: Income Mobility Relative to the Base Year Population, Age 25 and Over, 1987-1996 and 1996-2005

Initial Income Quintile	Time Period	End of Period Income Quintile (1996 or 2005)								
		Lowest	Second	Middle	Fourth	Highest	Total	Top 10%	Top 5%	Top 1%
Lowest	1987-1996	54.6	22.1	11.1	7.5	4.7	100.0	2.2	1.1	0.2
	1996-2005	54.1	22.8	11.1	7.8	4.3	100.0	2.0	1.1	0.2
Second	1987-1996	25.5	36.5	20.3	12.0	5.7	100.0	2.0	0.6	0.2
	1996-2005	27.1	36.7	19.7	10.9	5.7	100.0	2.2	1.1	0.2
Middle	1987-1996	12.0	24.6	32.9	19.9	10.6	100.0	4.2	1.7	0.3
	1996-2005	10.6	26.0	33.1	20.5	9.7	100.0	3.5	1.4	0.3
Fourth	1987-1996	5.1	12.3	25.0	37.0	20.5	100.0	6.8	2.7	0.3
	1996-2005	5.4	10.4	26.7	37.7	19.9	100.0	6.7	2.3	0.3
Highest	1987-1996	2.7	4.6	10.8	23.5	58.4	100.0	34.8	18.9	4.1
	1996-2005	2.8	4.1	9.6	23.1	60.4	100.0	35.7	19.1	4.1
Top 10%	1987-1996	2.5	3.0	6.7	14.9	72.9	100.0	52.9	31.5	7.6
	1996-2005	2.7	2.7	6.0	14.0	74.7	100.0	54.1	33.0	7.6
Top 5%	1987-1996	2.5	2.4	4.6	9.6	80.9	100.0	67.1	47.5	13.5
	1996-2005	2.9	2.3	4.6	8.9	81.4	100.0	68.5	50.6	14.0
Top 1%	1987-1996	2.5	1.6	3.5	6.1	86.3	100.0	80.0	71.6	38.1
	1996-2005	3.4	1.2	2.9	4.7	87.8	100.0	81.9	74.5	40.4
All Income	1987-1996	20.0	20.0	20.0	20.0	20.0	100.0	10.0	5.0	1.0
Groups	1996-2005	20.0	20.0	20.0	20.0	20.0	100.0	10.0	5.0	1.0

Notes: For each initial income quintile, the upper row shows the 1987-1996 period and the lower row shows the 1996-2005 period The table includes returns of households where the primary taxpayer filed in both years and is age 25 or over in the initial year Income breaks for the quintiles and top percentiles use only the tax returns where the primary taxpayer is age 25 and over in the base year and filed in both years Income is cash income as defined in the Technical Appendix

Source: U S Treasury Department, 1987-1996 Family Panel, Tax Year 1996 and 2005 Individual Income Tax Files

Table A.6: Absolute Income Mobility of Households Age 25 and Over, 1987-1996 and 1996-2005

Initial Income Quintile	Base Year	Distribution of Percentage Changes in Income in $2005						Percent Change in:	
		Decreased more than 50%	Decreased 5 to 50%	No change	Increased 5 to 50%	Increased 50 to 100%	Increased 100% or more	Mean Income	Median Income
Lowest	1987-1996	8.7	10.3	4.0	17.0	12.8	47.3	247.5	80.6
	1996-2005	6.8	9.3	2.6	14.2	13.7	53.5	284.6	108.7
Second	1987-1996	6.0	22.0	8.7	28.0	14.8	20.6	53.9	22.1
	1996-2005	6.6	17.1	5.3	28.4	15.9	26.8	82.6	38.0
Middle	1987-1996	7.0	29.2	10.7	28.7	13.2	11.2	30.9	9.1
	1996-2005	6.0	20.2	7.6	31.0	17.0	18.3	52.5	26.2
Fourth	1987-1996	8.1	34.5	10.2	30.9	9.6	6.6	15.6	2.3
	1996-2005	6.7	25.1	7.9	34.1	15.6	10.7	15.6	17.0
Highest	1987-1996	14.2	36.3	9.1	25.6	7.4	7.5	9.6	-1.8
	1996-2005	12.5	28.9	8.3	30.2	11.9	8.2	25.0	8.7
Top 10%	1987-1996	18.0	34.7	8.1	22.6	7.6	8.9	10.3	-4.0
	1996-2005	16.4	29.6	7.8	26.0	11.2	8.9	25.8	4.0
Top 5%	1987-1996	23.2	31.7	6.5	20.3	8.0	10.2	9.4	-8.2
	1996-2005	22.6	29.6	6.8	20.3	10.3	10.4	27.7	-3.7
Top 1%	1987-1996	37.0	26.7	4.8	14.3	6.6	10.7	1.6	-23.8
	1996-2005	36.7	25.8	4.3	13.3	7.3	12.6	13.6	-23.4
All Income	1987-1996	9.0	27.6	8.8	26.4	11.3	17.0	24.1	11.1
Groups	1996-2005	7.9	20.8	6.5	28.1	14.7	22.0	41.0	30.2

Notes: For each initial income quintile, the upper row shows the distribution of changes over the 1987-1996 period and the lower row shows the 1996-2005 period. Each row sums to 100 percent across the first six columns. The table includes returns of households where the primary taxpayer filed in both years and is age 25 or over in the initial year. Income breaks for the base year quintiles and top percentiles are based on the tax returns of primary taxpayers whose age is 25 and over. Income is cash income in 2005 dollars as defined in the Technical Appendix.

Source: U.S. Treasury Department, 1987-1996 Family Panel, Tax Year 1996 and 2005 Individual Income Tax Files.

The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2006

Shown below are four tables from the Statistics of Income Division which contain information from the top 400 individual tax returns for each of Tax Years 1992 through 2006. These data are based on the returns with the largest Adjusted Gross Income reported each specific year shown and do not necessarily reflect the same taxpayers over time. Consequently, tables 1-3 should be used in conjunction with Table 4, which presents the number of times an individual return appeared among the 400 largest adjusted gross incomes over the 15-year period.

Table 1 contains frequencies, money amounts, and average dollar amounts for the major income, deduction, and tax credits reported as part of the Form 1040 (U.S. individual Income Tax Return). It includes salaries and wages, interest income and capital gains. It also shows net income and net losses for returns with income from (1) businesses including farms, and (2) partnerships and S Corporations. Itemized deductions categories include taxes paid, interest paid and charitable contributions. Finally, the table presents several credit items including the foreign tax and general business credits, as well as data for the tentative research credit.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1]
[Money amounts are in thousands of dollars]

Tax year	Cutoff for AGI			
	Number of returns in the top 400	Number of returns in the population	Amount (in whole dollars)	In 1990 dollars [2] (in whole dollars)
	(1)	(2)	(3)	(4)
1992	400	113,604,503	24,421,000	22,760,000
1993	400	114,601,819	22,559,000	20,397,000
1994	400	115,943,131	23,817,000	21,003,000
1995	400	118,218,327	27,261,000	23,380,000
1996	400	120,351,208	37,804,000	31,503,000
1997	400	122,421,991	46,329,000	37,727,000
1998	400	124,770,662	57,449,000	45,812,000
1999	400	127,075,145	67,404,000	52,866,000
2000	400	129,373,500	86,830,000	65,880,000
2001	400	130,255,237	58,233,000	42,977,000
2002	400	130,076,443	47,489,000	34,512,000
2003	400	130,423,626	54,721,000	38,864,000
2004	400	132,226,042	74,546,000	51,589,000
2005	400	134,372,678	100,307,000	67,140,000
2006	400	138,394,754	110,602,000	71,726,000

Tax year	Adjusted gross income					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(5)	(6)	(7)	(8)	(9)	(10)
1992	400	18,716,032	46,790	17,442,714	3,629,129,550	0.52
1993	400	18,527,854	46,320	16,752,129	3,723,339,880	0.50
1994	400	18,466,682	46,167	16,284,552	3,907,517,953	0.47
1995	400	20,345,145	50,863	17,448,666	4,189,353,615	0.49
1996	400	29,883,593	74,709	24,902,995	4,535,974,492	0.66
1997	400	37,216,831	93,042	30,308,865	4,969,949,986	0.75
1998	400	44,195,098	110,488	35,243,300	5,415,972,847	0.82
1999	400	53,543,167	133,858	41,994,641	5,855,467,909	0.91
2000	400	69,566,247	173,916	52,781,675	6,365,376,648	1.09
2001	400	52,439,444	131,099	38,700,697	6,170,603,942	0.85
2002	400	41,623,784	104,059	30,249,843	6,033,585,532	0.69
2003	400	52,496,848	131,242	37,284,551	6,207,108,793	0.85
2004	400	69,110,866	172,777	47,827,589	6,788,805,130	1.02
2005	400	85,565,478	213,914	57,272,743	7,422,495,663	1.15
2006	400	105,322,274	263,306	68,302,383	8,030,842,945	1.31

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Salaries and wages						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(11)	(12)	(13)	(14)	(5)	(16)	(17)
1992	366	4,907,119	13,407	26.22	4,573,271	2,805,703,266	0.17
1993	345	3,073,467	8,909	16.59	2,778,904	2,892,120,390	0.11
1994	352	1,873,910	5,324	10.15	1,652,478	3,026,777,706	0.06
1995	348	2,870,395	8,248	14.11	2,461,746	3,201,456,569	0.09
1996	345	3,329,743	9,651	11.14	2,774,786	3,376,871,545	0.10
1997	343	4,374,872	12,755	11.76	3,562,599	3,813,918,456	0.12
1998	354	5,542,892	15,658	12.54	4,420,169	3,879,762,259	0.14
1999	342	7,851,599	22,958	14.66	6,158,117	4,132,473,459	0.19
2000	336	11,619,416	34,582	16.70	8,815,945	4,456,167,438	0.26
2001	330	8,010,118	24,273	15.27	5,911,527	4,565,229,218	0.18
2002	337	4,902,371	14,547	11.78	3,562,770	4,559,690,903	0.11
2003	334	5,986,367	17,923	11.40	4,251,681	4,649,900,493	0.13
2004	330	8,653,750	26,223	12.52	5,988,754	4,921,806,344	0.18
2005	332	7,380,281	22,230	8.63	4,939,947	5,155,407,373	0.14
2006	334	7,806,073	23,371	7.41	5,062,304	5,469,370,119	0.14

Tax year	Taxable interest						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(18)	(19)	(20)	(21)	(22)	(23)	(24)
1992	400	1,383,629	3,459	7.39	1,289,496	162,343,280	0.85
1993	400 **	1,328,386	3,321	7.17	1,201,072	131,140,527	1.01
1994	400 **	1,414,669	3,537	7.66	1,247,504	126,169,276	1.12
1995	400	1,935,406	4,839	9.51	1,659,868	154,780,536	1.25
1996	400	1,650,595	4,126	5.52	1,375,496	165,672,564	1.00
1997	400	1,815,364	4,538	4.88	1,478,309	171,700,242	1.06
1998	400 **	1,704,744	4,262	3.86	1,359,445	178,333,632	0.96
1999	400	1,667,937	4,170	3.12	1,308,186	175,675,236	0.95
2000	400	2,735,136	6,838	3.93	2,075,217	199,321,670	1.37
2001	400 **	2,936,385	7,341	5.60	2,167,074	198,177,814	1.48
2002	400	2,308,472	5,771	5.55	1,677,669	149,024,899	1.55
2003	400 **	2,577,760	6,444	4.91	1,830,795	127,159,692	2.03
2004	400 **	2,969,623	7,424	4.30	2,055,102	125,474,158	2.37
2005	400 **	5,740,724	14,352	6.71	3,842,520	162,432,720	3.53
2006	400 **	8,167,563	20,419	7.75	5,296,734	222,707,445	3.67

Tax year	Dividends [3]						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(25)	(26)	(27)	(28)	(29)	(30)	(31)
1992	390	1,088,731	2,792	5.82	1,014,660	77,925,720	1.40
1993	388	1,031,674	2,659	5.57	932,797	79,728,631	1.29
1994	388	1,389,080	3,580	7.52	1,224,939	82,410,237	1.69
1995	390	2,107,223	5,403	10.36	1,807,224	94,592,325	2.23
1996	394	1,904,296	4,833	6.37	1,586,913	104,254,986	1.83
1997	393	1,524,587	3,879	4.10	1,241,520	120,493,432	1.27
1998	400 **	1,410,781	3,527	3.19	1,125,025	118,479,991	1.19
1999	400 **	2,027,848	5,070	3.79	1,590,469	132,465,522	1.53
2000	400 **	1,926,856	4,817	2.77	1,461,954	146,987,679	1.31
2001	400 **	2,216,558	5,541	4.23	1,635,836	119,533,324	1.85
2002	392	2,118,196	5,404	5.09	1,539,387	103,241,332	2.05
2003	390	4,136,220	10,606	7.88	2,937,656	115,141,232	3.59
2004	400 **	8,184,710	20,462	11.84	5,664,159	146,838,808	5.57
2005	393	5,894,885	15,000	6.89	3,945,706	166,482,004	3.54
2006	400 **	7,894,647	19,737	7.50	5,119,745	199,359,146	3.96

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Net capital gains less loss in AGI						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(32)	(33)	(34)	(35)	(36)	(37)	(38)
1992	391	6,752,378	17,270	36.08	6,292,990	118,229,536	5.71
1993	393	8,895,189	22,634	48.01	8,042,666	144,171,901	6.17
1994	400 **	9,649,968	24,125	52.26	8,509,672	142,288,352	6.78
1995	400 **	8,971,380	22,428	44.10	7,694,151	170,415,206	5.26
1996	400 **	18,945,650	47,364	63.40	15,788,042	251,816,934	7.52
1997	400 **	24,845,175	62,113	66.76	20,232,227	356,083,267	6.98
1998	400 **	32,220,889	80,552	72.91	25,694,489	446,083,839	7.22
1999	400 **	39,071,339	97,678	72.97	30,644,188	542,758,116	7.20
2000	400 **	49,970,972	124,927	71.83	37,914,243	630,542,431	7.93
2001	400 **	34,712,848	86,782	66.20	25,618,338	326,527,451	10.63
2002	400 **	25,627,089	64,068	61.57	18,624,338	238,788,770	10.73
2003	400 **	31,809,611	79,524	60.59	22,592,053	294,354,009	10.81
2004	400 **	39,295,353	98,238	56.86	27,194,016	473,661,638	8.30
2005	400 **	49,946,781	124,867	58.37	33,431,580	668,015,218	7.48
2006	400 **	66,094,372	165,236	62.75	42,862,757	779,462,354	8.48

Tax year	Capital gains subject to preferential rates [4]						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(39)	(40)	(41)	(42)	(43)	(44)	(45)
1992	391	6,169,759	15,779	32.97	5,750,008	74,762,692	8.25
1993	393	7,894,939	20,089	42.61	7,138,281	87,938,073	8.98
1994	400 **	9,353,043	23,383	50.65	8,247,834	96,384,824	9.70
1995	400 **	8,241,430	20,604	40.51	7,068,122	112,243,598	7.34
1996	400 **	17,586,362	43,966	58.85	14,655,301	177,473,299	9.91
1997	365	23,440,787	64,221	62.98	19,088,589	316,215,652	7.41
1998	372	31,046,340	83,458	70.25	24,757,847	413,878,616	7.50
1999	364	36,170,392	99,369	67.55	28,368,935	479,944,123	7.54
2000	372	44,526,424	119,695	64.01	33,783,326	573,477,238	7.76
2001	313	29,832,816	95,313	56.89	22,016,838	310,242,169	9.62
2002	291	23,017,326	79,097	55.30	16,727,708	238,916,040	9.63
2003	383	32,062,540	83,714	61.08	22,771,690	358,815,034	8.94
2004	393	43,487,966	110,656	62.92	30,095,478	554,147,952	7.85
2005	392	51,328,960	130,941	59.99	34,356,734	741,629,959	6.92
2006	400 **	67,607,908	169,020	64.19	43,844,298	860,961,539	7.85

Tax year	Net business income (from both Schedule C and F)						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(46)	(47)	(48)	(49)	(50)	(51)	(52)
1992	96	974,454	10,151	5.21	908,159	181,901,076	0.53
1993	83	243,195	2,930	1.31	219,887	184,040,454	0.13
1994	73	289,313	3,963	1.57	255,126	193,743,145	0.15
1995	85	339,155	3,990	1.67	290,870	198,072,953	0.17
1996	84	206,567	2,459	0.69	172,139	207,046,452	0.10
1997	73	106,553	1,460	0.29	86,769	217,815,200	0.05
1998	59	111,331	1,887	0.25	88,781	232,834,123	0.05
1999	60	567,791	9,463	1.06	445,326	240,890,428	0.23
2000	51	511,530	10,030	0.74	388,111	250,574,438	0.20
2001	56	933,353	16,667	1.78	688,821	254,852,543	0.36
2002	44	510,549	11,603	1.23	371,038	260,608,227	0.19
2003	58	188,088	3,243	0.36	133,585	273,378,464	0.07
2004	55	163,885	2,980	0.24	113,415	294,933,673	0.06
2005	67	606,318	9,050	0.71	405,835	320,510,505	0.19
2006	74	661,172	8,935	0.83	428,776	337,949,366	0.20

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Net business loss (from both Schedule C and F)						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(53)	(54)	(55)	(56)	(57)	(58)	(59)
1992	58	51,265	884	-0.27	47,777	30,434,929	0.16
1993	56	20,050	358	-0.11	18,128	32,002,222	0.06
1994	56	67,913	1,213	-0.37	59,888	34,917,657	0.18
1995	43	65,111	1,514	-0.32	55,842	36,579,268	0.17
1996	45	29,058	646	-0.10	24,215	37,207,298	0.07
1997	46	32,748	712	-0.09	26,668	37,921,427	0.08
1998	52	48,666	936	-0.11	38,808	38,367,785	0.12
1999	54	41,257	764	-0.08	32,359	38,719,277	0.10
2000	50	116,029	2,321	-0.17	88,034	45,743,802	0.24
2001	57	38,053	668	-0.07	28,084	49,084,828	0.07
2002	64	124,358	1,943	-0.30	90,377	54,244,375	0.22
2003	58	155,034	2,673	-0.30	110,109	56,094,670	0.26
2004	64	71,381	1,115	-0.10	49,399	60,955,591	0.11
2005	62	66,922	1,079	-0.08	44,794	62,978,235	0.10
2006	72	363,397	5,047	-0.35	235,666	71,753,424	0.51

Tax year	Partnership and S Corporation net income						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(60)	(61)	(62)	(63)	(64)	(65)	(66)
1992	222	3,304,620	14,886	17.66	3,079,795	128,704,285	2.57
1993	253	3,686,744	14,572	19.90	3,333,403	133,437,568	2.76
1994	250	4,131,387	16,526	22.37	3,643,198	154,276,614	2.68
1995	236	4,340,601	18,392	21.33	3,722,643	166,418,667	2.61
1996	224	4,071,411	18,176	13.62	3,392,843	190,739,214	2.13
1997	226	4,574,354	20,241	12.29	3,725,044	213,559,410	2.14
1998	197	4,261,621	21,633	9.64	3,398,421	240,836,136	1.77
1999	171	3,968,428	23,207	7.41	3,112,493	269,757,830	1.47
2000	190	5,868,124	30,885	8.44	4,452,294	285,424,865	2.06
2001	180	4,931,068	27,395	9.40	3,639,165	301,558,966	1.64
2002	205	6,962,676	33,964	16.73	5,060,084	314,665,137	2.21
2003	213	8,041,129	37,752	15.32	5,711,029	333,029,137	2.41
2004	186	9,886,476	53,153	14.31	6,841,852	398,690,527	2.48
2005	252	14,951,290	59,331	17.47	10,007,557	492,020,754	3.04
2006	228	15,134,921	66,381	14.37	9,815,124	528,224,522	2.87

Tax year	Partnership and S Corporation net loss						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(67)	(68)	(69)	(70)	(71)	(72)	(73)
1992	142	292,809	2,062	-1.56	272,888	41,052,774	0.71
1993	119	362,054	3,042	-1.95	327,354	40,569,503	0.89
1994	124	528,910	4,265	-2.86	466,411	39,890,769	1.33
1995	136	767,159	5,641	-3.77	657,941	40,666,189	1.89
1996	139	653,567	4,702	-2.19	544,639	43,959,596	1.49
1997	140	678,163	4,844	-1.82	552,250	45,236,146	1.50
1998	173	1,653,302	9,557	-3.74	1,318,423	53,481,544	3.09
1999	193	2,076,113	10,757	-3.88	1,628,324	58,685,867	3.54
2000	173	3,650,145	21,099	-5.25	2,769,457	72,511,266	5.03
2001	178	1,942,839	10,915	-3.70	1,433,829	76,448,871	2.54
2002	167	1,797,180	10,762	-4.32	1,306,090	76,697,948	2.34
2003	160	1,581,495	9,884	-3.01	1,123,221	78,972,015	2.00
2004	189	1,727,217	9,139	-2.50	1,195,306	82,697,364	2.09
2005	135	1,741,938	12,903	-2.04	1,165,956	89,694,035	1.94
2006	166	2,827,995	17,036	-2.69	1,833,979	102,747,208	2.75

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Total statutory adjustments						
	Number of returns in the top 400	Amount	Average	Percent of AGI	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(74)	(75)	(76)	(77)	(78)	(79)	(80)
1992	169	7,149	42	0.04	6,663	35,464,254	0.02
1993	189	10,279	54	0.06	9,294	36,624,273	0.03
1994	248	14,418	58	0.08	12,714	39,103,321	0.04
1995	255	14,725	58	0.07	12,628	41,139,577	0.04
1996	245	16,300	67	0.05	13,583	42,646,933	0.04
1997	238	17,432	73	0.05	14,196	46,954,680	0.04
1998	249	14,777	59	0.03	11,784	51,530,709	0.03
1999	217	22,758	105	0.04	17,850	56,698,800	0.04
2000	223	34,077	153	0.05	25,855	58,609,518	0.06
2001	219	37,030	169	0.07	27,328	60,572,768	0.06
2002	216	17,635	82	0.04	12,816	77,161,432	0.02
2003	218	18,925	87	0.04	13,441	87,575,677	0.02
2004	229	15,690	69	0.02	10,858	98,046,679	0.02
2005	276	153,441	556	0.18	102,705	109,396,547	0.14
2006	287	176,875	616	0.17	114,705	113,845,357	0.16

Tax year	Total itemized deductions claimed on Form 1040						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(81)	(82)	(83)	(84)	(85)	(86)	(87)
1992	400 **	1,832,264	4,581	80.83	1,707,609	481,945,831	0.38
1993	400 **	2,256,254	5,641	83.73	2,040,013	490,403,708	0.46
1994	400 **	2,243,299	5,608	83.38	1,978,218	493,654,068	0.45
1995	394	2,304,947	5,850	82.28	1,976,798	527,374,034	0.44
1996	400 **	3,600,586	9,001	82.91	3,000,489	572,541,293	0.63
1997	400 **	4,255,766	10,639	82.54	3,465,608	620,810,172	0.69
1998	394	5,050,380	12,818	83.98	4,027,416	676,460,336	0.75
1999	400 **	6,381,236	15,953	83.98	5,004,891	741,376,847	0.86
2000	400 **	9,348,219	23,371	84.67	7,092,731	822,360,510	1.14
2001	392	7,902,719	20,160	86.39	5,832,265	884,528,260	0.89
2002	392	5,672,772	14,471	85.59	4,122,654	898,047,320	0.63
2003	400 **	7,099,025	17,748	84.76	5,041,921	901,864,834	0.79
2004	400 **	10,009,341	25,023	85.48	6,926,880	998,238,457	1.00
2005	400 **	12,142,594	30,356	85.72	8,127,573	1,121,810,935	1.08
2006	400 **	16,391,842	40,980	90.64	10,630,248	1,229,237,288	1.33

Tax year	Itemized deductions limitation						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(88)	(89)	(90)	(91)	(92)	(93)	(94)
1992	400 **	440,036	1,100	19.37	410,099	12,751,272	3.45
1993	400 **	438,500	1,096	16.27	396,474	12,755,843	3.44
1994	400 **	447,241	1,118	16.62	394,393	13,356,396	3.35
1995	394	496,269	1,260	17.72	425,617	15,557,237	3.19
1996	400 **	742,314	1,856	17.09	618,595	19,082,977	3.89
1997	400 **	900,051	2,250	17.46	732,940	23,263,469	3.87
1998	393	963,298	2,451	16.02	768,180	26,948,018	3.57
1999	394	1,217,595	3,090	16.02	954,977	31,965,547	3.81
2000	400 **	1,693,078	4,233	15.33	1,284,581	38,068,131	4.45
2001	392	1,244,910	3,176	13.61	918,753	30,982,180	4.02
2002	392	955,409	2,437	14.41	694,338	26,986,526	3.54
2003	400 **	1,276,808	3,192	15.24	906,822	28,947,046	4.41
2004	400 **	1,700,673	4,252	14.52	1,176,936	36,761,913	4.63
2005	400 **	2,023,546	5,059	14.28	1,354,449	45,323,612	4.46
2006	400 **	1,692,441	4,231	9.36	1,097,562	35,152,244	4.81

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Taxes paid deduction						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(95)	(96)	(97)	(98)	(99)	(100)	(101)
1992	400 **	1,075,363	2,688	47.32	1,002,202	160,452,525	0.67
1993	393	1,103,936	2,809	40.97	998,134	169,850,372	0.65
1994	400 **	883,201	2,208	32.83	778,837	175,847,631	0.50
1995	390	1,063,870	2,728	37.98	912,410	188,643,888	0.56
1996	394	1,417,642	3,598	32.64	1,181,368	203,775,741	0.70
1997	400 **	1,491,390	3,728	28.93	1,214,487	220,628,058	0.68
1998	393	1,553,566	3,953	25.83	1,238,888	241,782,812	0.64
1999	392	1,867,109	4,763	24.57	1,464,399	265,365,133	0.70
2000	400 **	3,073,794	7,684	27.84	2,332,165	294,711,547	1.04
2001	387	2,207,999	5,705	24.14	1,629,519	307,974,817	0.72
2002	390	1,755,690	4,502	26.49	1,275,938	302,653,989	0.58
2003	400 **	2,122,963	5,307	25.35	1,507,786	310,896,704	0.68
2004	400 **	2,830,805	7,077	24.17	1,959,035	362,608,853	0.78
2005	400 **	3,679,185	9,198	25.97	2,462,640	400,390,045	0.92
2006	400 **	4,614,691	11,537	25.52	2,992,666	432,774,100	1.07
Tax year	Interest paid deduction						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(102)	(103)	(104)	(105)	(106)	(107)	(108)
1992	332	417,411	1,257	18.37	389,013	208,655,776	0.20
1993	327	519,187	1,588	19.27	469,428	200,189,793	0.26
1994	329	584,225	1,776	21.71	515,189	197,240,013	0.30
1995	327	574,304	1,756	20.50	492,542	215,077,974	0.27
1996	336	548,764	1,633	12.84	457,303	233,150,728	0.24
1997	342	759,779	2,222	14.74	618,712	250,599,197	0.30
1998	340	872,425	2,566	14.51	695,713	271,624,314	0.32
1999	358	1,128,802	3,153	14.85	885,335	291,552,907	0.39
2000	365	1,785,187	4,891	16.17	1,354,467	322,931,506	0.55
2001	343	1,631,385	4,756	17.83	1,203,974	349,900,751	0.47
2002	351	916,434	2,611	13.83	666,013	351,495,773	0.26
2003	353	1,087,138	3,080	12.98	772,115	340,319,125	0.32
2004	358	1,066,382	2,979	9.11	737,981	356,355,994	0.30
2005	362	2,272,802	6,278	16.04	1,521,287	405,718,259	0.56
2006	354	3,069,162	8,670	16.97	1,990,377	470,474,844	0.65
Tax year	Total contributions deduction						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(109)	(110)	(111)	(112)	(113)	(114)	(115)
1992	392	656,663	1,675	28.90	611,988	63,843,281	1.03
1993	385	1,010,312	2,624	37.49	913,483	68,354,293	1.48
1994	391	1,168,191	2,988	43.42	1,030,151	70,544,542	1.66
1995	386	1,131,003	2,930	40.38	969,986	74,991,519	1.51
1996	388	2,351,424	6,060	54.14	1,959,520	86,159,305	2.73
1997	394	2,859,871	7,259	55.47	2,328,885	99,191,962	2.88
1998	389	3,555,211	9,139	59.12	2,835,096	109,240,078	3.25
1999	387	4,536,193	11,721	59.70	3,557,798	125,798,548	3.61
2000	400 **	6,083,718	15,159	54.92	4,600,696	140,681,631	4.31
2001	386	5,066,754	13,126	55.39	3,739,302	139,241,476	3.64
2002	385	3,624,230	9,414	54.68	2,633,888	140,571,365	2.58
2003	388	4,652,030	11,990	55.54	3,303,999	145,702,137	3.19
2004	391	7,334,681	18,759	62.64	5,075,904	165,564,388	4.43
2005	393	7,558,864	19,234	53.36	5,059,481	183,390,686	4.12
2006	393	9,692,724	24,663	53.60	6,285,813	186,646,644	5.19

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Net limited miscellaneous deductions						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(116)	(117)	(118)	(119)	(120)	(121)	(122)
1992	23	40,867	1,777	1.80	38,087	27,118,104	0.15
1993	37	49,547	1,339	1.84	44,799	28,763,926	0.17
1994	23	23,147	1,006	0.86	20,412	29,496,003	0.08
1995	26	31,236	1,201	1.12	26,789	31,027,496	0.10
1996	27	24,334	901	0.56	20,279	34,042,566	0.07
1997	25	42,205	1,688	0.82	34,369	37,426,844	0.11
1998	18	28,163	1,565	0.47	22,459	40,546,291	0.07
1999	21	60,456	2,879	0.80	47,416	44,730,274	0.14
2000	32	116,717	3,647	1.06	88,556	51,241,173	0.23
2001	37	154,433	4,174	1.69	113,972	57,909,182	0.27
2002	35	157,700	4,506	2.38	114,608	63,551,146	0.25
2003	31	155,398	5,013	1.86	110,368	63,181,572	0.25
2004	33	208,127	6,307	1.78	144,033	68,533,122	0.30
2005	35	227,431	6,498	1.61	152,229	76,183,408	0.30
2006	44	325,744	7,403	1.80	211,247	76,666,241	0.42

Tax year	Total unlimited miscellaneous deductions						
	Number of returns in the top 400	Amount	Average	Percent of itemized deductions	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(123)	(124)	(125)	(126)	(127)	(128)	(129)
1992	23	81,944	3,563	3.61	76,369	2,411,721	3.40
1993	34	2,177	64	0.08	1,968	2,769,771	0.08
1994	25	31,777	1,271	1.18	28,022	3,571,981	0.89
1995	19	803	42	0.03	688	4,450,123	0.02
1996	24	736	31	0.02	613	4,614,234	0.02
1997	17	2,572	151	0.05	2,095	5,880,372	0.04
1998	19	4,314	227	0.07	3,440	7,037,020	0.06
1999	16	6,272	392	0.08	4,919	9,194,694	0.07
2000	16	1,881	118	0.02	1,427	10,570,755	0.02
2001	19	87,060	4,582	0.95	64,251	11,665,756	0.75
2002	15	174,126	11,608	2.63	126,545	13,190,741	1.32
2003	17	358,300	21,076	4.28	254,474	13,100,751	2.73
2004	131	270,018	2,061	2.31	186,863	16,924,756	1.60
2005	175	426,716	2,438	3.01	285,620	19,114,049	2.23
2006	192	381,963	1,989	2.11	247,706	21,987,875	1.74

Tax year	Taxable income					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(130)	(131)	(132)	(133)	(134)	(135)
1992	400	16,883,751	42,209	15,735,090	2,395,695,907	0.70
1993	400 **	16,277,681	40,694	14,717,614	2,453,542,706	0.66
1994	400 **	16,229,104	40,573	14,311,380	2,597,980,066	0.62
1995	400	18,040,169	45,100	15,471,843	2,813,826,386	0.64
1996	400 **	26,284,026	65,710	21,903,355	3,089,667,389	0.85
1997	400	32,961,052	82,403	26,841,247	3,429,109,165	0.96
1998	400	39,144,688	97,862	31,215,860	3,780,838,200	1.04
1999	400 **	47,165,706	117,914	36,992,711	4,136,119,714	1.14
2000	400 **	60,219,004	150,548	45,689,684	4,544,242,424	1.33
2001	400 **	44,536,876	111,342	32,868,543	4,268,506,425	1.04
2002	400 **	35,966,789	89,917	26,138,655	4,096,127,651	0.88
2003	400 **	45,421,173	113,553	32,259,356	4,200,218,439	1.08
2004	400 **	59,104,404	147,761	40,902,702	4,670,165,637	1.27
2005	400 **	73,437,178	183,593	49,154,737	5,137,165,874	1.43
2006	400 **	88,980,271	222,451	57,704,456	5,579,145,443	1.59

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Alternative minimum tax					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(136)	(137)	(138)	(139)	(140)	(141)
1992	21	14,982	713	13,962	1,357,063	1.10
1993	75	34,636	462	31,317	2,052,790	1.69
1994	63	26,102	414	23,018	2,212,094	1.18
1995	55	23,178	421	19,879	2,290,576	1.01
1996	69	43,086	624	35,905	2,812,746	1.53
1997	85	40,255	474	32,761	4,005,101	1.01
1998	83	40,607	489	32,382	5,014,549	0.81
1999	60	42,954	716	33,690	6,477,697	0.66
2000	91	126,799	1,393	96,205	9,600,840	1.32
2001	83	99,574	1,200	73,486	6,756,705	1.47
2002	85	40,245	473	29,248	6,853,901	0.59
2003	82	64,108	782	45,531	9,469,803	0.68
2004	98	106,532	1,087	73,725	13,029,239	0.82
2005	105	146,788	1,398	98,251	17,421,071	0.84
2006	139	308,237	2,218	199,894	21,564,586	1.43

Tax year	Total credits					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(142)	(143)	(144)	(145)	(146)	(147)
1992	250	136,855	547	127,544	5,690,280	2.41
1993	281	140,218	499	126,780	5,858,492	2.39
1994	296	163,584	553	144,254	6,141,494	2.66
1995	300	163,427	545	140,160	6,894,461	2.37
1996	315	216,846	688	180,705	7,740,814	2.80
1997	314	145,930	465	118,835	8,410,868	1.74
1998	298	159,990	537	127,584	27,823,908	0.58
1999	327	204,402	625	160,315	33,974,279	0.60
2000	336	297,213	885	225,503	35,753,613	0.83
2001	339	186,559	550	137,682	44,160,998	0.42
2002	295	358,785	1,216	260,745	38,747,463	0.93
2003	309	330,084	1,068	234,434	41,069,375	0.80
2004	330	434,705	1,317	300,834	51,599,346	0.84
2005	347	605,701	1,746	405,422	54,571,100	1.11
2006	343	877,951	2,560	569,358	58,141,809	1.51

Tax year	Foreign tax credit					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(148)	(149)	(150)	(151)	(152)	(153)
1992	217	110,307	508	102,803	2,047,275	5.39
1993	244	110,836	454	100,213	2,217,865	5.00
1994	256	126,009	492	111,119	2,308,948	5.46
1995	268	133,344	498	114,360	2,965,313	4.50
1996	296	183,957	621	153,298	3,538,835	5.20
1997	293	116,879	399	95,178	4,073,461	2.87
1998	273	118,132	433	94,205	4,677,022	2.53
1999	300	177,530	592	139,239	4,941,010	3.59
2000	320	277,103	866	210,245	5,990,360	4.63
2001	308	168,462	547	124,327	6,254,559	2.69
2002	264	303,975	1,151	220,912	5,933,600	5.12
2003	282	270,953	961	192,439	5,805,555	4.67
2004	314	382,270	1,217	264,548	6,757,994	5.66
2005	324	553,084	1,707	370,203	9,361,989	5.91
2006	321	821,302	2,559	532,621	10,958,470	7.49

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	General business credit					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(154)	(155)	(156)	(157)	(158)	(159)
1992	59	18,448	313	17,193	574,633	3.21
1993	54	15,867	294	14,347	578,304	2.74
1994	78	21,456	275	18,921	690,038	3.11
1995	82	14,339	175	12,297	702,906	2.04
1996	77	9,919	129	8,266	742,891	1.34
1997	62	8,691	140	7,077	826,320	1.05
1998	72	19,943	277	15,903	732,487	2.72
1999	82	7,805	95	6,121	783,920	1.00
2000	61	3,979	65	3,019	764,253	0.52
2001	79	8,209	104	6,058	713,974	1.15
2002	70	7,620	109	5,538	750,855	1.01
2003	90	18,385	204	13,058	612,744	3.00
2004	90	15,540	173	10,754	635,391	2.45
2005	111	32,026	289	21,436	877,850	3.65
2006	107	47,808	447	31,004	1,302,464	3.67

Tax year	Prior year minimum tax credit					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(160)	(161)	(162)	(163)	(164)	(165)
1992	29	5,000	172	4,660	283,960	1.76
1993	29	8,083	279	7,308	256,340	3.15
1994	17	8,986	529	7,924	376,558	2.39
1995	25	9,939	398	8,524	468,755	2.12
1996	25	17,165	687	14,304	669,545	2.56
1997	30	11,484	383	9,352	681,282	1.69
1998	25	9,905	396	7,899	818,389	1.21
1999	44	12,077	274	9,472	996,461	1.21
2000	35	11,681	334	8,863	1,287,661	0.91
2001	19	6,324	333	4,667	1,438,041	0.44
2002	22	7,169	326	5,210	976,398	0.73
2003	22	4,705	214	3,342	916,538	0.51
2004	28	13,684	489	9,470	902,000	1.52
2005	38	18,199	479	12,181	1,081,252	1.68
2006	18	4,323	240	2,803	1,032,247	0.42

Tax year	Tentative research credit [5]					
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total
	(166)	(167)	(168)	(169)	(170)	(171)
1992	36	13,190	366	12,293	65,900	20.02
1993	31	12,019	388	10,867	123,343	9.74
1994	35	10,047	287	8,860	95,833	10.48
1995	35	5,023	144	4,308	76,197	6.59
1996	36	4,059	113	3,382	61,864	6.56
1997	28	6,519	233	5,308	137,473	4.74
1998	30	12,263	409	9,779	122,884	9.98
1999	33	2,322	70	1,821	124,706	1.86
2000	24	2,256	94	1,711	96,402	2.34
2001	33	4,875	148	3,597	103,835	4.69
2002	39	4,200	108	3,052	171,934	2.44
2003	38	10,116	266	7,184	169,229	5.98
2004	39	6,990	179	4,837	240,861	2.90
2005	54	12,122	224	8,114	273,068	4.44
2006	75	22,646	302	14,686	387,959	5.84

Footnotes at end of the table.

Table 1 -- Selected Items for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006 [1] -- Continued
[Money amounts are in thousands of dollars]

Tax year	Income tax						Average tax rate
	Number of returns in the top 400	Amount	Average	In 1990 dollars [2]	Total for all returns	Top 400 returns' percent of total	Percent
	(172)	(173)	(174)	(175)	(176)	(177)	(178)
1992	400	4,936,897	12,342	4,601,023	476,238,785	1.04	26.38
1993	400	5,437,295	13,593	4,916,180	502,767,806	1.08	29.35
1994	400	5,275,239	13,188	4,651,887	534,856,339	0.99	28.57
1995	400 **	6,088,571	15,221	5,221,759	588,419,030	1.03	29.93
1996	400 **	8,309,376	20,773	6,924,480	658,244,750	1.26	27.81
1997	400 **	8,991,855	22,480	7,322,358	731,321,399	1.23	24.16
1998	400	9,731,299	24,328	7,760,206	788,541,979	1.23	22.02
1999	400 **	11,900,254	29,751	9,333,533	877,401,489	1.36	22.23
2000	400 **	15,507,223	38,768	11,765,723	980,845,201	1.58	22.29
2001	400	11,981,382	29,953	8,842,349	887,973,968	1.35	22.85
2002	400 **	9,522,648	23,807	6,920,529	796,986,268	1.19	22.88
2003	400 **	10,250,277	25,626	7,280,026	748,017,488	1.37	19.53
2004	400 **	12,550,332	31,376	8,685,351	831,976,333	1.51	18.16
2005	400 **	15,599,966	39,000	10,441,744	934,835,769	1.67	18.23
2006	400	18,086,563	45,216	11,729,288	1,023,920,139	1.77	17.17

[1] The definitions for items used in the table can be found in Publication 1304, *Statistics of Income Individual Income Tax Returns*, Section 4, at the following link: http://www.irs.gov/pub/irs-soi/06inisec4.pdf.

[2] Inflation-adjusted data were calculated using the consumer price index from Bureau of Labor Statistics, based on 1990=100.

[3] For Tax Year 2003, qualified dividends totaled $3,321,254 of the dividends amount. For Tax Year 2004, qualified dividends totaled $7,409,969 of the dividends amount.
For Tax Year 2005, qualified dividends totaled $4,930,549 of the dividends amount. For Tax Year 2006, qualified dividends totaled $6,253,127 of the dividends amount.

[4] For Tax Years 2003, 2004, 2005, and 2006 includes qualified dividends.

[5] This research credit was before any limitation for tax or alternative minimum tax. The research credit after these limitations were applied was included in the general business credit totals.

** Return frequency rounded to protect the confidentiality of tax return information.

The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2006

Table 2 shows ranges of marginal tax rate for the various statutory rates (including the alternative minimum tax rates) in effect for tax years 1992 through 2006. Please note that statutory rates changed several times over this period, so the grouping allows for underlying trends to be shown.

Table 2 -- Marginal Tax Rates for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006

Tax Year	Marginal tax rate			
	0 percent under 26 percent	26 percent and 28 percent	31 percent	35 percent and over
	(1)	(2)	(3)	(4)
1992	58	--	342	--
1993	14	75	--	311
1994	30	65	--	305
1995	21	56	--	323
1996	43	69	--	288
1997	36	86	--	278
1998	56	84	--	260
1999	65	60	--	275
2000	47	91	--	262
2001	54	83	--	263
2002	40	85	--	275
2003	53	84	--	263
2004	51	102	--	247
2005	50	107	--	243
2006	27	140	--	233

The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2006

Table 3 shows the range of average tax rates up to 35 percent and over, computed as total income tax divided by adjusted gross income. Total income tax is defined as income tax after credits plus the alternative minimum tax for tax years 1992 through 1999. Due to a legislative change, income tax after credits included the alternative minimum tax for tax years 2000 through 2006.

Table 3 -- Effective (Average) Tax Rates for Taxpayers with the Top 400 Adjusted Gross Income (AGI), 1992-2006

Tax Year	Effective (average) tax rate						
	0 percent under 10 percent	10 percent under 15 percent	15 percent under 20 percent	20 percent under 25 percent	25 percent under 30 percent	30 percent under 35 percent	35 percent and over
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1992	6	10	17	62	234	71	--
1993	9	5	15	50	147	77	97
1994	9	4	16	55	156	64	96
1995	7	5	13	32	148	85	110
1996	3	7	24	61	180	57	68
1997	7	10	70	141	67	42	63
1998	7	31	109	146	28	27	52
1999	7	31	104	133	27	34	64
2000	11	29	96	141	36	35	52
2001	19	30	108	94	22	44	83
2002	10	34	86	110	38	60	62
2003	24	75	116	53	52	80	--
2004	27	112	103	34	51	73	--
2005	23	121	111	39	47	59	--
2006	31	113	125	34	50	47	--

The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2006

Table 4 presents data for the 400 taxpayers reporting the highest adjusted gross incomes (AGI). This table shows the number of times that these returns were in this group for each of Tax Years 1992 through 2006. In interpreting the data presented in Tables 1-3, two aspects of the selection of returns are particularly important. First, the 400 returns with the highest AGI were selected in each year, although the total number of returns filed increased every year (except 2002) between 1992 and 2006. Thus, the top 400 returns represent a slightly declining share of the total number of returns filed. Second, 400 returns were separately identified each year based on AGI in that year. Therefore, it did not matter for identification whether the taxpayer had been in the top 400 in any prior year or appeared in the top 400 in any subsequent year. Over the 15 tax years a total of 6,000 returns were identified for the table. There were 3,305 different taxpayers representing the top 400 returns of each year. Of these taxpayers, a little more than 27 percent appear more than once and slightly more than 15 percent appear more than twice (see columns 2 and 3). In any given year, on average, about 40 percent of the returns were filed by taxpayers that are not in any of the other 14 years (see columns 4 and 5). In each year, 8 (or 2.0 percent) of the returns are for taxpayers who can be found in all 15 years. Thus, the data shown in the table mostly represent a changing group of taxpayers over time, rather than a fixed group of taxpayers.

Table 4--Frequency of Appearing in the Top 400 Tax Returns by Adjusted Gross Income, Tax Years 1992-2006 [1]

Number of years in Top 400	Number of primary filers in group [2]	Percent of primary filers represented by each group	Number of returns in total Top 400 population over 15-year period	Percent of returns represented by each group
(1)	(2)	(3)	(4)	(5)
1	2,394	72.44	2,394	39.90
2	408	12.34	816	13.60
3	173	5.23	519	8.65
4	97	2.93	388	6.47
5	62	1.88	310	5.17
6	34	1.03	204	3.40
7	31	0.94	217	3.62
8	21	0.64	168	2.80
9	17	0.51	153	2.55
10	13	0.39	130	2.17
11	12	0.36	132	2.20
12	12	0.36	144	2.40
13	17	0.51	221	3.68
14	6	0.18	84	1.40
15	8	0.24	120	2.00
Total	3,305	100.00	6,000	100.00

[1] The top 400 returns on the basis of adjusted gross income (AGI) were selected from the Individual Income Tax Complete Report Files prepared by the Statistics of Income Division of IRS for Tax Years 1992 through 2006. These files contain samples of income tax returns that were processed by the IRS in Processing Years 1994 through 2007 (for example, the Tax Year 1992 file is based on a sample of returns processed by IRS in 1993). Because very high-income returns are sampled at a 100% rate, all of the top 400 returns were included in the sample for each year.

[2] The number of primary filers was determined by comparing social security numbers (SSNs) reported by primary filers (and secondary filers on joint returns) on all 6,000 returns over the fifteen years. An SSN that never appeared on a joint return in the top 400 was always a "primary filer." For an SSN that appeared on one or more joint returns with the same spousal SSN, one SSN was considered the "primary filer" for the return(s). If an SSN appeared on one or more joint and one or more non-joint returns all in the top 400, it was considered a "primary filer." The other SSN appearing on the joint return(s) was only counted as a "primary filer" if it also appeared on a non-joint return (or, on a joint returns with a different spouse) in the top 400. The frequency of appearance counts are simply a count of the number of returns in the top 400 over the ten years filed with each "primary filer" SSN counted once in the "Total" row. In a few instances, IRS processed, and SOI sampled more than one return in the top 400 with the same primary SSN; in these instances, the returns were counted as multiple appearances of the primary SSN.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF MAY 3, 2011 IS THE DISTRIBUTION OF TAX BURDENS AND TAX BENEFITS EQUITABLE?

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the burdens and benefits of distribution within the U.S. tax code:

The debate that we will have here today on the distribution of tax burdens has a long and distinguished pedigree.

From my perspective, I have not heard anyone get the better of former Prime Minister Margaret Thatcher, who addressed this issue in her last speech before the House of Commons on November 22, 1990.

This is how she responded to a liberal colleague who made the mistake of thinking that he could get one by her.

The honorable Gentleman is saying that he would rather that the poor were poorer, provided that the rich were less rich. That way one will never create the wealth for better social services, as we have. What a policy. Yes, he would rather have the poor poorer, provided that the rich were less rich. That is the Liberal policy.

This quote, more than 20 years old, is uncannily applicable to the subject of today's hearing.

Our examination of the burdens and benefits of the tax code is taking place in the shadow of a debate as to whether a group of people, described as "the rich" are paying what others call their "fair share."

The canned answer for those asking this question is that the rich are never paying their fair share, and must pay more for the good of the whole.

A certain percentage of the population obsesses over this issue — making sure that the so-called rich do not exceed their allotted share of the fruits of their own labor.

How Washington politicians hope to determine this fair share in an even-handed way that does no harm to our economy and job creators remains a mystery to me.

As we head into this debate, there are a few basic facts we need to acknowledge. According to the Urban Brookings Tax Policy Center, in 2009, the top quintile of the population, in terms of income distribution, earned 53.4 percent of income, but paid 67.2 percent of all taxes.

When we look at only federal income taxes, the numbers show that the so-called wealthy are paying an even greater share relative to everyone else. According to the Tax Foundation, for calendar year 2008, the most recent year for which actual tax data is available, the top 1 percent of the population in terms of income paid 38 percent of all federal individual income taxes. The top 5 percent paid approximately 58.7 percent of all income taxes, while everyone else — the bottom 95 percent — paid 41.3 percent of federal income taxes.

I don't have a Ph.D. in math, but I'm pretty sure 41.3 is less than 58.7.

Meanwhile, the Tax Policy Center, estimated that for tax year 2010, approximately 45 percent of households, or about 69 million households, ended up owing nothing in federal income taxes for last year.

Now I'm no linguist, but I think that the proper term for that level of income tax liability is zilch.

Finally, the Joint Committee on Taxation estimates that approximately 51 percent of all households, which includes filers and non-filers, had either zero, or negative income tax liability for tax year 2009. Just think about that. More than half of all tax units either paid no income taxes, or got money back.

There is a lot we can make of this information, and that's why we are having this hearing. I think many taxpayers are skeptical that the answer to our fiscal problems is for them to sacrifice more, when almost half of all households are not paying any income taxes.

The other side argues that those 69 million households pay other taxes, like employment taxes. But this point avoids the larger issue.

Those who promote higher income tax rates in the name of equality and deficit reduction need to come clean about what this entails. With the income tax base so narrow, meaningful reductions in our deficits would require far more than taxes on the rich. Those tax increases would hit squarely in the middle class, which the President promised is off limits.

As I said earlier, it is estimated that the top quintile of population, in terms of income, pays more than 67 percent of all taxes to the Federal government.

Margaret Thatcher understood that by artificially forcing equal outcomes through confiscatory taxation, we undermine the vibrant and dynamic economy that encourages productivity and the creation of resources and wealth. And by doing so we actually diminish the revenues that would otherwise be available to the government to perform its limited constitutional functions.

In short, the quest for social equality through government tinkering actually results in fewer resources and worse outcomes for the nation as a whole and the poor in particular.

There are some who have become so fixated on what other people have that they see the tax code as a sort of utopian sociology experiment, and are willing to kill the goose laying the golden eggs.

When we talk about raising income taxes, we need to be clear about what we are doing. We are not taxing wealth. We are taxing income, and by doing so we are discouraging productivity, entrepreneurship, and risk-taking.

The millionaire Thurston Howell, III already has his money, and he's taking an extended vacation on Gilligan's Island.

Trust me.

Thurston and Lovey don't care if you raise the income tax.

The people who would care if income tax rates were jacked-up in the name of social and economic equality are the people who are not rich now, but might be in the future. It is the entrepreneurs and small business owners who would get hurt. In the name of socking it to Thurston and Lovey, it is the Skipper and Gilligan who get whacked.

Why would anyone take risks and work harder if they knew in advance they would not be allowed to enjoy the fruits of their own labors?

What this hearing is fundamentally about is whether the tax code is a means of funding the basic and essential functions of a constitutional republic, or whether it is a means for a small elite to try to create their vision of a utopia. I think the answers to these questions about the equitability of tax burdens and tax benefits will become apparent once we actually determine the purpose of the federal tax code.

I hope that in the end we can agree that it is a good thing for all people, rich and poor, to do better.

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"Is the Distribution of Tax Burdens and Tax Benefits Equitable?"

By Scott A. Hodge
President, Tax Foundation

Hearing Before the U.S. Senate Committee on Finance

May 3, 2011

Mr. Chairman and members of the Committee:

I am Scott Hodge, president of the Tax Foundation. Thank you for the opportunity to speak to you today about the equity issues surrounding tax burdens and the benefits in the code.

Founded in 1937, the Tax Foundation is the nation's oldest non-partisan, non-profit organization dedicated to promoting economically sound tax policy at all levels of government.

We are guided by the immutable principles of economically sound tax policy – taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

In other words, the ideal tax system should do only one thing – raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy.

By all accounts, the U.S. tax system is far from that ideal.

Introduction

Over the past two decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, save more for retirement, purchase health insurance, buy a home, replace the home's windows, adopt children, put them in daycare, take care of Grandma, buy bonds, spend more on research, purchase school supplies, go to college, invest in historic buildings, and the list goes on.

The U.S. tax system is in desperate need of simplification and reform. The relentless growth of credits and deductions over the past 20 years has made the IRS a super-agency, engaged in policies as unrelated as delivering welfare benefits to subsidizing the manufacture of energy efficient refrigerators. I would argue that were we starting from scratch, these would not be the functions we would want a tax collection agency to perform.

So the question before the committee today is: "Is the distribution of tax burdens and tax benefits equitable?"

My answer is no, they are not. But not in the way most of you may think.

First, while its well understood that the major tax preferences largely benefit upper income taxpayers, the real issue is the harmful effects that these preferences are having on the economy and the people they are intended to benefit. The biggest crises facing working families and the economy are health care, housing, and state and local government finances, yet these are the areas in which government and the tax code is already the most involved. The cure for what ails these industries is to be weaned off the tax code, not given more subsidies through such things as the First Time Homebuyer's Credit, Premium Assistance credits, or more tax free bonds.

Second, as a consequence of trying to use the tax code to help the "middle-class," we have knocked millions of people off the tax rolls, turned the IRS into an extension of the welfare state, and created a growing class of people who are disconnected from the basic cost of government.
We need to have a national discussion over whether it is fair or equitable to have millions of people enjoy the benefits of civil society but contribute nothing to its costs. I believe that it is bad for democracy and bad for the fiscal health of the nation to have so many Americans with no skin in the game.

Lastly, while some people would like to make the tax code more progressive, the fact is that the U.S. already has the most progressive income tax system of any industrialized country. The top 1 percent of taxpayers pays a greater share of the tax burden than the bottom 90 percent combined. Moreover, the nation's tax and spending policies currently combine to redistribute more than $826 billion annually from the top 40 percent of families to the bottom 60 percent. We should have an honest discussion over how much redistribution is considered fair.

The taxpayers who are now shouldering the lion's share of the burden of funding government are what I call the "successful middle class" in America today. These are educated, dual-income families who are the heart of the nation's successful entrepreneurial class. Unlike their parents, their incomes do not fit in the statistical middle of the income scale. They might be considered "rich" by some, but their values are distinctly middle class. We should question the wisdom of placing so much of the tax burden on the people who society values the most – working families and entrepreneurs.

Let's examine these issues one by one.

The Harmful Effects of Tax Expenditures

With massive federal deficits as far as the eye can see, there is growing talk of cutting some of the roughly $1 trillion in "tax expenditures" or preferences in the code that effectively subsidize everything from charitable giving to purchasing electric cars. While it is tempting to look at "closing loopholes" as a honeypot for deficit reduction, the right reason to eliminate these tax preferences is that they are doing harm to the economy and, in many cases, the very people they are intended to help. The best solution for the nation is to eliminate the majority of these tax preferences while dramatically cutting tax rates.

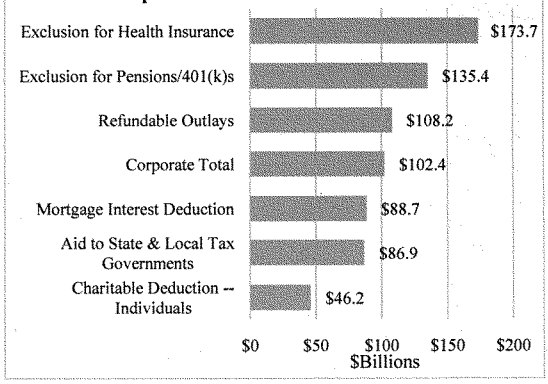
Figure 1 shows the composition of the largest categories of tax expenditures in FY 2011. By far the largest of these, at $174 billion, is the tax exclusion for employer-provided health insurance. The next largest category, at $135 billion, is for the collection of tax exclusions for pensions, 401(k)s, Individual Retirement Accounts, and Keogh plans.

For the sake of comparability, I've included the actual outlay cost of the refundable portion of tax credits even though they are not included in the overall cost of traditional tax expenditures. However, as we will discuss later, they are among the fastest-growing tax preferences and now comprise the third-largest category of preferences in the tax code with an actual cost of $108 billion in 2011.

The amount of corporate "loopholes" is actually much less than what is commonly thought. Overall, the roughly 80 separate corporate tax preferences have a combined budgetary cost of roughly $102 billion in FY 2011, only slightly larger than the cost of the mortgage interest deduction alone.

As Figure 1 shows, the mortgage interest deduction confers roughly $89 billion in benefits to homeowners and the housing industry each year. State and local governments receive about $87 billion in benefits through the combined effects of the deduction for state and local taxes and through tax-exempt bonds. Lastly, charities benefit from about $46 billion in budgetary resources each year.

Figure 1: Major Categories of Tax Expenditures FY 2011



Tax expenditures and distributional issues: Setting aside for the moment the question of the true economic incidence of tax expenditures (i.e. who ultimately benefits from them), the major individual tax expenditures are largely claimed on the returns of upper-income taxpayers. For example, according to the Joint Committee on Taxation, 64 percent of the benefits of the mortgage interest deduction flow to taxpayers earning over $100,000, while 81 percent of the benefits of the deduction for state and local taxes (income, property, and sales) went to the same group.[1] Many rightfully argue that these provisions effectively subsidize high-tax communities at the expense of low-tax communities or subsidize homeowners at the expense of renters.

Similarly, JCT found that 80 percent of the benefits of the charitable deduction went to taxpayers earning over $100,000. To be sure, Americans earning under $100,000 give billions each year to

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1. "Estimates of Federal Tax Expenditures for Fiscal Years 2010—2014," Joint Committee on Taxation, U.S. Government Printing Office, December 15, 2010, p. 55-56.

charity, but because they are not among the roughly one-third of taxpayers who itemize on their tax returns, the tax code does not reward them for their generosity.

Tax expenditures causing today's financial crises: Today, the biggest financial crises facing working families and the economy are health care, housing, and state and local government finances. Ironically, these are the areas in which government is already the most involved.

For example, the tax preference for employer-provided health insurance creates a classic third-party payer problem in which patient-consumers are disconnected from the cost of service. The cost of health care is soaring because we have an unlimited demand for health care since someone else is paying the bills. The market forces that deliver quality goods at low prices for everything from toasters to automobiles have been disrupted in the health care system because it is tax preferred. The recent health care reform legislation will make this problem worse, not better.

Housing suffers a similar problem because of the plethora of tax and spending subsidies intended to promote home ownership. Professor Dennis J. Ventry, Jr. of the UC Davis School of Law, calls the mortgage interest deduction (MID) the "accidental deduction," because the authors of the original tax code never intended the deduction for personal interest expenses to subsidize home ownership.[2]

Economists find that the MID gets capitalized into the price of homes and may amplify price volatility,[3] which offsets whatever effect it has on promoting home ownership. The actual economic benefits of those capitalized costs tend to flow to the home builders and realtors, who have naturally been the most vocal opponents of eliminating the MID. One study determined that the MID is "an ineffective policy to promote homeownership and improve social welfare."[4]

While the lion's share of the blame for the current housing crisis properly rests with government-sponsored enterprises Fannie Mae and Freddie Mac, the MID certainly played a role in encouraging some families to purchase homes that they really could not have afforded otherwise. Canada does not have a mortgage interest deduction, yet its rate of homeownership is equal to that in the U.S. Even the *Washington Post* has editorialized that it is time to "[t]rim the excessive tax subsidy for real estate."[5]

The deduction for state and local taxes and the tax subsidies for municipal bonds allow local governments to raise taxes and pass as much as one-third of those costs to Uncle Sam. This is especially true for high-cost, high-tax suburban communities. Ironically, the state and local tax deduction is the primary reason more and more taxpayers in these high-tax urban areas—largely in so-called Blue States—are being ensnared in the Alternative Minimum Tax. The AMT is not an issue for taxpayers in lower-tax states and communities.

One study found that the state and local tax deduction leads to higher local tax revenues "by increasing the rate of local property taxation." Specifically, the authors found "that if deductibility

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2. Dennis J. Ventry, Jr., "The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest," UC Davis Legal Studies Research Paper Series, *Research Paper No. 196*, November 2009.
3. Dan Andrews, "Real House Prices in OECD Countries: The Role of Demand Shocks and Structural and Policy Factors," *OECD Economics Department Working Papers*, No. 831, OECD Publishing, 2010.
4. Christian A. L. Hilber and Tracy M. Turner, "The mortgage interest deduction and its impact on homeownerhip decisions," August 2010.
5. "Trim the excessive tax subsidy for real estate," *Washington Post*, January 1, 2011.

were eliminated, the mean property tax rate in our sample of 82 communities would fall by 0.00715 ($7.15 per thousand dollars of assessed property), or 21.1 percent of the mean tax rate."[6]

In the same way that the MID encourages some families to purchase larger, more expensive homes than they otherwise could afford, federal tax subsidies for state and local activities may encourage some governments to buy more government than their taxpayers could otherwise afford. In recent years, state and local debt has grown significantly as a share of GDP according to Steven Malanga, a fellow with the Manhattan Institute. He estimates that:

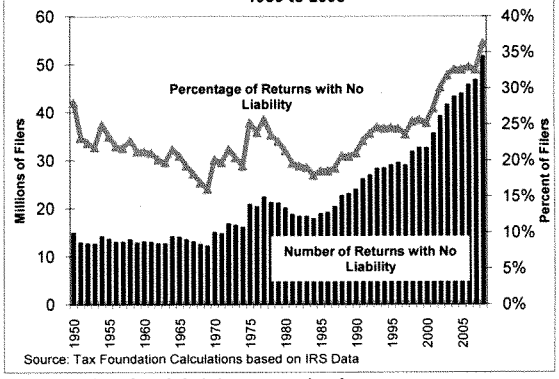
> Over the last decade, through good times and bad, total state and local debt has soared from $1.5 trillion in 2000 to $2.4 trillion (in current dollars). When that debt is added to other growing obligations that governments are racking up, using techniques like not paying their bills on time, state and local liabilities have increased from 15 percent of GDP in 2000 to an estimated 22 percent this year. In 1980, they were 12 percent.[7]

It is very likely that these governments would not have borrowed as much as they did were it not for the fact that tax-free municipal bonds allow them to pass some of that cost off to the federal government.

The Troubling Growth of the Nonpaying Population

While the tax code's benefits to high-income taxpayers is well documented, less attention has been given to the growth in tax benefits targeted to low- and middle-income taxpayers. Since it was enacted in 1913, the income tax code has contained provisions—such as the standard deduction, personal exemption, and dependent exemption—that exempted low-income workers from tax or greatly reduced their income tax burden.

Figure 2: Number and Percentage of "Nonpayers": 1950 to 2008



Source: Tax Foundation Calculations based on IRS Data

Figure 2 shows the fluctuation in the number and percentage of these "nonpayers" since 1950 and how that number has soared over the past decade.[8] The percentage of tax returns with no liability was fairly low in the 1960s and again in the early 1980s. The modern growth in the number of nonpayers was spurred by the expansion of the Earned Income Tax Credit (EITC) and the

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6. Douglas Holtz-Eakin and Harvey S. Rosen, "Federal Deductibility and Local Property Tax Rates," NBER Working Paper Series, Vol. w2427, December 1990.

7. Steven Malanga, "The Muni-Bond Debt Bomb. . . and how to dismantle it," *City Journal*, Summer 2010, Vol. 20, No. 3. http://www.city-journal.org/2010/20_3_muni-bonds.html

8. Individual Income Tax Returns, Tax Year 2008 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income. Internal Revenue Service. http://www.irs.gov/pub/irs-soi/08in01pl.xls.

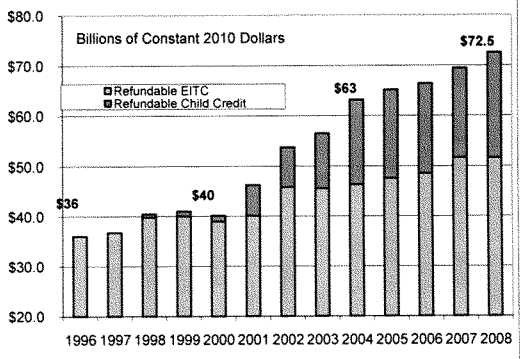
enactment of the $500 per-child tax credit in 1997. The 2001 and 2003 tax bills doubled the value of the credit to $1,000 and added a refundable component.

The number of nonpayers accelerated once again following the enactment of the Economic Stimulus Act of 2008 (which included a tax rebate of $300 per person, $600 per couple) and the American Recovery and Reinvestment Act of 2009, which included President Obama's making-work-pay credit, first-time homebuyer credit, and the American Opportunity tax credit.[9]

While the final IRS data for 2009 and 2010 are not yet available, the data for 2008 shows that the tax rebates boosted the number of nonpayers to nearly 52 million, or roughly 36 percent of all tax filers.[10]

Nonpaying status used to be a sure sign of poverty or near-poverty, but Congress and the President have changed the tax laws to pull much of the middle class into the growing pool of nonpayers. The income level at which a typical family of four will owe no income taxes has risen rapidly, now topping $51,000.

Figure 3: Growth in Refundable Tax Credits from 1996 to 2008



Source: IRS Preliminary Data Tables 1996-2008

Refundable Credits Soar: Some will argue that while the nonpayers may not owe any income taxes, they pay other federal taxes such as payroll taxes and excises taxes and, therefore, are still contributing to the cost of government. Not so.

Many nonpayers receive generous cash payments through "refundable" tax programs such as EITC or the child tax credit which off-set the other taxes they may pay. In fact, as Figure 3 shows, the IRS paid out more than $72 billion in these refundable tax credits in 2008, double the amount of refundable tax credits in 1996.

These credits are so generous, that the Joint Committee on taxation estimates that in 2009, they exceeded the employee share of payroll taxes for 23 million tax filers and exceeded the employer's share of payroll taxes for 15.5 million filers.[11]

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[9] http://www.taxfoundation.org/news/show/24382.html

[10]. Scott A. Hodge, "Record Numbers of People Paying No Income Tax; Over 50 million "Nonpayers" Include Families Making over $50,000," Tax Foundation *Fiscal Fact No. 214*, p. 4.

[11]. Joint Committee on Taxation, Letter to Representative Dave Camp and Senator Kent Conrad, May 28, 2010.

In recent years, more and more tax provisions are resulting in a cash outlay from the IRS. In 2011 there are 13 tax provisions that will result in $108 billion in outlays. In five years, after the Premium Assistance Credit takes effect in 2014, tax outlays will top $117 billion.

What is wrong with so many nonpayers? There are actually more Americans outside of the income tax system than these figures would indicate. There are millions of people who earn some income but are below the threshold for filing a tax return. When these people are added to the nonpayers, the Tax Policy Center at Brookings estimates that 47 percent of all households pay no income taxes.[12]

Beside the fact that we are getting dangerously close to the "tipping point" in which there are more nonpayers than payers, there are many problems with having so many Americans exempted from income tax. On a practical level, we need to ask whether the proper function of the IRS is to deliver welfare benefits and income subsidies. Do we want millions of Americans to see April 15th as "payday" rather than "tax day?"

On a societal level, these citizens have no "skin in the game" yet they benefit greatly from government spending. I would argue that a functioning democracy cannot have nearly half of its citizens with no real connection to the basic cost of government but still have a legal claim on the government's purse. Good citizenship requires that we contribute at least something to the basic cost of government if we are to enjoy the benefits of it.

On an economic level, we need to worry about a phenomenon that economists call "fiscal illusion." When people perceive the cost of government is less than what it really is, they will demand ever more government knowing that someone else is picking up the check. This is already a problem because the $1.5 trillion deficits today are making the cost of government looks cheap for all of us.

Do the Rich Really Not Pay Their "Fair Share"?

There is a common belief that because of the 2001 and 2003 tax cuts – as well as the fact the so many tax expenditures benefit upper-income taxpayers – that the "rich" are not paying their fair share of taxes. Nothing could be further from the truth.

Indeed, the OECD finds that the U.S. has the most progressive income tax system of any industrialized country. What that means is that the top 10 percent of U.S. taxpayers pay a larger share of the income tax burden than do the wealthiest decile in any other industrialized country, including traditionally "high-tax" countries such as France, Italy, and Sweden.[13]

Meanwhile, because of the generosity of such preferences as the EITC and child credit, low-income Americans have the lowest income tax burden of any OECD nation. Indeed, the study reports that

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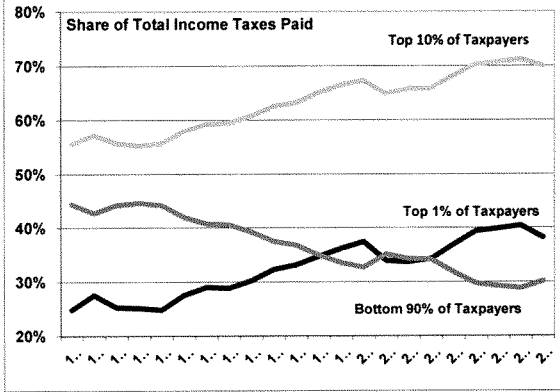
[12] http://www.taxpolicycenter.org/taxtopics/federal-taxes-households.cfm

[13]. "Growing Unequal? Income Distribution and Poverty in OECD Countries," Organization for Economic Cooperation and Development, 2008. p. 112. http://dx.doi.org/10.1787/422013187855. Here income taxes refer to both personal and social insurance taxes.

while most countries rely more on cash transfers than taxes to redistribute income, the U.S. stands out as "achieving greater redistribution through the tax system than through cash transfers."[14]

The share of the income tax burden borne by America's wealthiest taxpayers has been growing steadily for more than two decades. Figure 4 contrasts the share of income taxes paid by the bottom 90 percent, top 10 percent, and top 1 percent of taxpayers between 1987 and 2008.

Figure 4: Tax Burden of the Top 1% and Top 10% of Taxpayers Exceeds the Share Paid by Bottom 90%



Between 1987 and 2008, the tax burden on the top 10 percent of taxpayers grew from 55.6 percent to 70 percent, while the burden on the top 1 percent grew from 24.8 percent to 38 percent. By contrast, the tax burden for the bottom 90 percent of taxpayers fell from 44.4 percent in 1987 to 30 percent in 2008.

In other words, the tax burden on the top 1 percent of taxpayers is greater than the total burden on the bottom 90 percent of taxpayers. And the tax burden on the top 10 percent is more than twice that of the bottom 90 percent combined. By any measure, this is the sign of a very progressive tax system.

Measuring the Distribution of Both Taxes and Spending

While the topic of this hearing is the equity of the tax burden and tax expenditures, it is a mistake to focus solely on the distributional effects of tax policy without considering the distributional effects of spending. After all, federal spending is intended to achieve various policy objectives and benefit different groups of Americans in different ways. Thus, it is important to look at the progressivity of the entire fiscal system, not just the tax side.

In an important 2009 study, Tax Foundation economists measured how much families at various income levels paid in taxes versus how much they received in spending benefits. The results of this analysis show that federal tax and spending policies are very heavily tilted to the poor and middle-class, even before considering the Obama administration's major policy initiatives such as health care reform.

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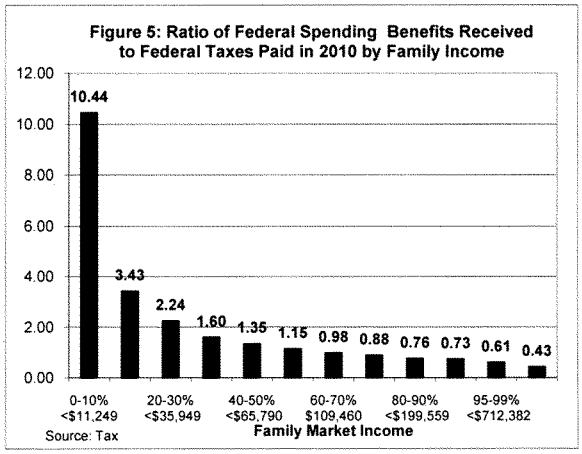
14. Ibid.

Overall, the study found that in 2010, the bottom 60 percent of families – those earning up to about $86,000 – got more in federal spending benefits than they paid in taxes. By contrast, the top 40 percent of families paid more in taxes than they received in federal spending benefits.

Figure 5 illustrates the ratio of taxes paid to spending received on a per-family basis. Not surprisingly, the lowest-income families received $10.44 for every dollar they paid in taxes. Remarkably, however, families in the middle-income group received $1.15 for every dollar they paid in taxes.

By contrast, the highest-income families received 43 cents in government spending for every dollar they pay in taxes, even though they are assumed in this study to disproportionately benefit from public goods such as national defense.

Taken together, federal tax and spending policies work to redistribute more than $826 billion in income from the top 40 percent of families to the bottom 60 percent. In other words, the entire federal fiscal system is very progressive and redistributive.



Putting a Face on America's Successful Middle-Class

In Washington, every tax discussion begins with the premise that tax policies should either help or at least protect the "middle class." And by middle class, most politicians tend to equate the "middle class" with the median taxpayer or those in the statistical middle.

But middle-income is not the same as middle class. Middle-income is a point on the income scale for which only a handful of people can qualify. But middle class is a value system that most Americans identify with. Indeed, polls show that 80 percent of Americans see themselves as middle class. Only 2 percent identify themselves as "upper class."

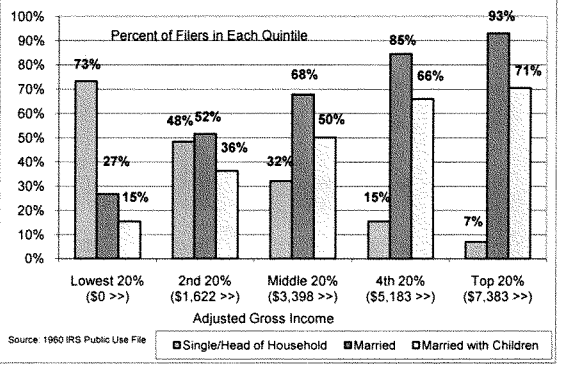
June and Ward have been replaced in the middle by Phoebe and Joey. When we think of middle class families, we think of intact, working couples with children – such as June and Ward Cleaver from the 1950s show "Leave it to Beaver."

Once upon a time, June and Ward did represent the statistical middle, but demographic changes have made those old notions obsolete. Today, these families are considered upper-income or "rich" by some standards.

Figure 6 gives us a snapshot of the distribution of filing status within each quintile in 1960. It shows the percentage of single filers, married filers, and married filers with children within each quintile.

We can see that in 1960, married taxpayers were the majority of filers within every quintile but the lowest. More than 70 percent of filers in the lowest quintile were single workers. However, in the middle quintile, married couples comprised 68 percent of the filers, twice the number of singles. Moreover, 50 percent of all filers in the middle were married couples with children, such as June and Ward Cleaver. In the top two quintiles, nearly every taxpayer was a married couple.

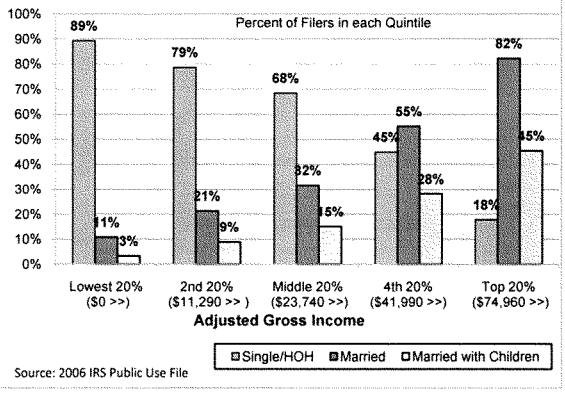
Figure 6: In 1960 The Majority of Statistical Middle-Income Were Married Couples and Families with Children



Over the past five decades there have been many demographic and economic changes that have greatly reshaped the composition of American taxpayers. Figure 7 shows the composition of taxpayers within each quintile in 2006, from the most current IRS public use file.

The most startling change is the dramatic increase in the number of single filers in first three quintiles – especially the middle quintile. Whereas in 1960 there were twice as many married couples in the statistical middle as there were single filers, today there are twice as many single filers as there are married couples.

Figure 7: Today, The Majority of Statistical Middle-Income are Single: Families With Children Are Upper-Class



In other words, in the statistical "middle class," June and Ward have been replaced by Phoebe and Joey from the once popular TV show "Friends."

Where on the distributional charts do we find married couples, especially those with children? They now populate the top two quintiles. Indeed, over 70 percent of married taxpayers with children are now in the top two quintiles. However, even in fourth quintile, just 55 percent of filers are married and only 28 percent are married with children. At the top of the income scale, married taxpayers comprise 82 percent of filers in the highest quintile; some 45 percent are families with children.

Four factors contributed to these demographic and economic shifts. While America has certainly changed a great deal since 1960, there are four main factors that contributed to the vast changes in the composition of taxpayers across the income scales:

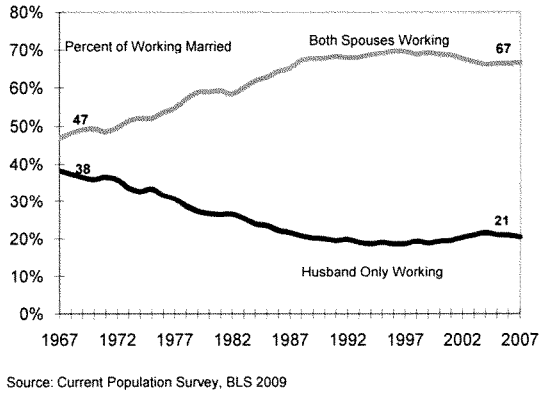
1. The growth of dual-earner couples;
2. The growth of pass-through business entities;
3. The aging of Baby Boomers; and
4. The economic returns to education.

For the sake of brevity, I am going to focus on the first two factors. But previous Tax Foundation research found that taxpayers in the top income group were 50 percent older than taxpayers at the bottom of the income scale. We also found that more than 80 percent of high-income taxpayers had some college education or more, while roughly 62 percent of low-income taxpayers had a only a high school education or less.[15] The education gap in America should probably worry lawmakers much more than the income gap.

As Figure 8 illustrates, America has become a nation of dual-income working couples. While it is clear from the chart that the husband-as-sole-breadwinner stereotypical family of the 1960s was not the norm then, it is even less so today. Moms worked during the 1960s but fewer than half of all married couples during that era were dual-earners. Today, that number has risen to 67 percent, three times the number of sole-earner married couples.

These two-earner couples don't reside in the statistical middle of the income scale. Instead, they populate the top 20 percent of families, and look comparatively "rich" on paper because of their two full-time paychecks.

Figure 8: America Has Become a Nation of Dual-Income Working Couples



Source: Current Population Survey, BLS 2009

[15] Scott A. Hodge, *Putting a Face on America's Tax Returns*, Tax Foundation, 2005.p. 15.

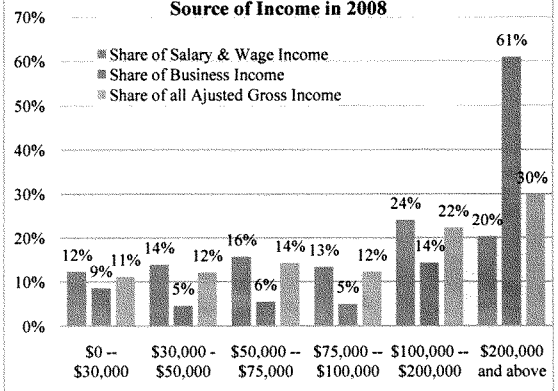
The Successful Middle Class is America's Entrepreneurial Class

What also sets the successful middle class apart from other taxpayers is that they derive a large share of their overall earnings from flow-through businesses such as S-corporations, LLCs, and partnerships. Over the past 30 years, the number of these non-corporate business forms has exploded such that there is now more business income taxed under the individual tax code than the traditional corporate code.

Between 1980 and 2007, for example, the number of sole proprietors grew from 8.9 million to more than 23 million, and the number of S-corporations and partnerships (which include LLCs) grew at a faster rate from 1.9 million to more than 7 million. There are now three and one-half times as many pass-through firms as traditional C-corporations.[16]

While we often here the statistic that only 2 or 3 percent of tax returns pay tax in the top two brackets, the more economically relevant question is how much business income is earned by those in the top tax brackets.

Figure 9: Comparing Business Income to Other Source of Income in 2008



Source: Tax Foundaton calculations based on IRS data

To understand how significant business income is for these upper-income taxpayers, Figure 9 illustrates how much more business income there is at the top of the income scale compared to the amount of salary and wage income or to the broader measure of adjusted gross income (AGI).

Looking first at the distribution of adjusted gross income (AGI) – the measure by which most distributional discussions revolve – we find that it is dispersed roughly equally among taxpayers earning less than $100,000, but 22 percent is earned by taxpayers with incomes between $100,000 and $200,000, and 30 percent is earned by taxpayers with incomes above $200,000.

Salary and wage income follows roughly the same pattern except for the highest earning taxpayers. The largest share of salaries and wages, 24 percent, are earned by families with incomes between $100,000 and $200,000. Interestingly, taxpayers who earn above $200,000 take home 20 percent of overall salary and wage income, less than their share of total AGI. This indicates that other sources of income play a large role in their overall compensation.

[16] Scott A. Hodge, "Over One-Third of New Tax Revenue Would Come from Business Income if High-Income Personal Tax Cuts Expire," Tax Foundation *Special Report* No. 185, September 2010, p. 4.

Indeed, Figure 9 shows that nearly two-thirds of all flow-through business income is earned by taxpayers earning over $200,000, twice the amount of business income earned by all other income groups combined.

Another way of looking at the distribution of business income is to see how many taxpayers at the highest tax brackets have business income. According to Tax Policy Center estimates, more than 74 percent of tax filers in the highest tax bracket report business income, compare to 20 percent of those at the lowest bracket.

While they may be relatively few in number, these statistics clearly indicate that high-income taxpayers represent the most successful flow-through businesses.

Tax Fairness and Mobility

Most debates about the equity of the tax burden are waged over static distributional tables that record the incomes and tax burdens of taxpayers in a single year. However, there is a great deal of mobility in America as people move through the various stages of life. So policies that try to target "the rich" or benefit "the poor" are likely to be ineffective because they are aiming at a moving target.

A recent Tax Foundation study used special Treasury panel data to look at the mobility of taxpayers between 1999 and 2007.[17] The findings suggest that concerns over increased income inequality should be tempered by the fact that a substantial number of households move up or down through the income distribution over time.

Among the key findings:

- Nearly 60 percent of households in the bottom income quintile in 1999 were in a higher quintile in 2007, and roughly 40 percent of tax returns in the top quintile in 1999 were in a lower quintile in 2007.

- Roughly half of millionaires during the1999 through 2007 period attained this status just once during those nine years. Only 6 percent of this group were millionaires in all nine years.

- The volatile nature of capital gains realizations appears to be a major explanation for the transiency of millionaires.

IRS data on the so-called Fortunate 400 also shows that wealthy Americans are not a static elite club that no one can penetrate. Indeed, the report indicates a great deal of churning among the top 400 taxpayers over a 15 year period. Over that period, 3,305 taxpayers had large enough incomes to put them among the Fortunate 400 at least once. However, 73 percent of these taxpayers appeared on the list just once and about 15 percent appeared more than twice. In any given year, 40 percent of these taxpayers had never been on the list in any other year.[18]

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[17] Robert Carroll, "Income Mobility and the Persistence of Millionaires, 1999 to 2007," Tax Foundation Special Report No. 180, June 2010.

[18] http://www.irs.gov/pub/irs-soi/06intop400.pdf

Conclusion

The U.S. tax system is in desperate need of simplification and reform. While targeted tax cuts will always curry more favor with voters than new spending programs, Washington needs to call a truce to using the tax code for social or economic goals. The consequence of trying to micromanage the economy as well as individual citizens' behavior through the tax code has produced a narrow tax base and unnecessarily high tax rates. These high rates are endangering America's global competitiveness and undermining the nation's long-term economic growth.

I suggest that we develop a new way of thinking about equity in the tax code. We should strive to build consensus around these basic concepts:

- An equitable tax system should be free of most credits or deductions and not micromanage individual or business behavior. It should apply a single, low flat rate on most everyone equally. That way, every citizen pays at least something toward the basic cost of government.

- An equitable tax code should be simple – which would save all of us time, money and headache and would save the economy the deadweight loss of the current system.

- An equitable tax code should have dramatically lower rates than we have today – in the mid-20s according the Bowles-Simpson plan – and the government could still raise the same amount of revenues.

I believe that such a tax code would actually generate a more predictable and stable revenue stream to fund government programs as opposed to the roller coaster revenues we have today.

And, most importantly, such a tax code would be conducive to long-term economic growth, which is one of the keys to fixing the long-term fiscal crisis facing the country.

Thank you, I'm happy to answer any questions you may have.

Senate Finance Committee Hearing
"Is the Distribution of Tax Burdens and Tax Benefits Equitable?"
May 3, 2011
Responses to Questions for Mr. Scott Hodge

Questions from Senator Orrin Hatch

1. With regards to labor supply elasticity (work decisions responsiveness to the tax rate) at what point do you believe people decide to work less in order to avoid paying more income tax? Assuming an increase in income tax rates were to occur, is it safe to say that with this reduction in workable hours, our economy would suffer?

Mr. Hodge's response: Different types of income have different elasticities to high taxes. Capital income is very mobile and, thus, very sensitive to high marginal tax rates. Labor is less mobile but still responsive to high tax rates because people will respond by working less to avoid the higher taxes.

In a 2009 Tax Foundation study "The Economic Cost of High Tax Rates," Robert Carroll wrote that:

> Research on the major changes in tax rates over the last several decades – the lower tax rates enacted in 1981, 1986 and 2001 or the higher tax rates enacted in 1993 – finds that the behavioral responses can be large. This research generally finds that for every 1 percent decrease in the after-tax reward from earning income, taxpayers reduce their reported income by about 0.4 percent.

According to Carroll's research, "tax rate changes can have a profound effect on the size of the tax base, with lower tax rates increasing the size of the tax base and higher rates, such as those proposed by President Obama, shrinking the tax base. A shrinking tax base is not only suggestive of the economic cost of high tax rates, but also means that the government will take in less revenue than the casual observer might assume."

So the answer to your questions is an emphatic yes, the economy would suffer greatly from an increase in top marginal tax rates.

2. With regards to the incomes of the wealthy, there seems to be a belief by some that after reductions in income tax rates, the rich get richer at the expense of others, which implies that tax rate reductions lead to the less rich paying a proportionally greater share of taxes. However, haven't income tax rate reductions led to all sectors of society becoming richer, and are the rich becoming richer not because others are shouldering their tax burden, but because a lower rate has encouraged people to put their resources to more productive uses than minimizing tax liability?

Mr. Hodge's response: Sadly, too many people believe that the economy is a fixed pie or a zero-sum game, that one person's prosperity comes at the expense others. The reality is that the

economy is incredibly dynamic and, as John Kennedy and Ronald Reagan both said, a "rising tide lifts all boats."

No one can claim that someone else is shouldering the rich's share of the tax burden. As I wrote in my testimony, today the top 1 percent of taxpayers pays a greater share of the tax burden (32 percent) than the bottom 90 percent of taxpayers combined (30 percent).

When the top marginal tax rates were 70 percent, the wealthy put their money in tax shelters or unproductive assets like art or dry oil wells. When tax rates fell, so too did the incentive for sheltering income and people began putting their investments into productive activities that grew the economic pie. Everyone benefited as a result.

3. Mr. Hodge, public services, such as education and health services, are distributed more equally than income. If we were to quantify and add the cost of these services to the incomes of their recipients, would this substantially reduce inequality between incomes?

Mr. Hodge's response: Most income measures – such as IRS data or Census data – ignore the benefit of transfer programs that low-income families receive. It's as if those programs didn't exist or are doing nothing to benefit those individuals. According to the Heritage Foundation's Robert Rector, the government has spent nearly $16 trillion on anti-poverty programs since the War on Poverty began in 1964, yet those programs have – at least from a statistical standpoint – made no difference in the material wellbeing of low-income people. Certainly, if we were to add to their cash incomes, the value of the services they get from government, it would reduce the amount of inequality between incomes.

4. Mr. Shaviro, in your written testimony, you state that "One of the best-regarded recent studies found that the revenue-maximizing tax rate would be as high as 80 percent if the income tax base were broadened." Elsewhere in your testimony you say that "a higher rate and a broader base function as complements." In terms of the study you cite, who is it well-regarded by? Do you expect that subjecting everyone, regardless of their income, to an 80 percent tax rate and eliminating tax expenditures would maximize income to the government? Should it be the objective of government to maximize revenue in this manner? What impact would this have on economic growth and productivity? Why would someone choose to live someplace with an 80 percent rate when they could move someplace else?

   Mr. Hodge, what impact do you believe a tax rate of 80 percent would have on economic growth and productivity?

Mr. Hodge's Response: As my former colleague Robert Carroll wrote in the July 2009 Tax Foundation study "The Economic Costs of High Tax Rates,"

> High tax rates discourage work, saving and entrepreneurship. They also encourage taxpayers to rearrange their tax affairs to receive more of their compensation in less heavily taxed forms and to take greater advantage of the myriad tax preferences in today's tax code. For example, taxpayers can reduce their tax bill by financing more of a

home purchase, receiving more of their compensation as tax-free fringe benefits, or rebalancing their investment portfolios towards tax-exempt state and local government bonds.

Further, Carroll notes that "The costs of high tax rates is not trivial . . . [the] research generally finds that for every 1 percent decrease in the after-tax reward from earning income, taxpayers reduce their reported income by about 0.4 percent."

If we were to raise the top tax rate from 35 percent to 80 percent, high-income households would receive 20 cents rather than 65 cents from every dollar they earn; that is, the after-tax reward from earning falls by 70 percent. Carroll's findings suggest that high-income households would reduce their reported incomes by more than 27 percent. Based on 2008 IRS data, taxpayers earning more than $200,000 have roughly $2.4 trillion in AGI. This means they would reduce their incomes by about $664 billion per year – which would have a significant impact on the economy.

Questions from Senator Robert Menendez

1. To make your point that you believe the tax system is progressive you quote an OECD study that says "the US stands out as achieving greater redistribution through the tax system than through cash transfers." However, the author of the OECD report also wrote that our system actually: "reduces inequality by less than any other OECD country except Korea," because the overall level of spending is low relative to other countries.

   Do you believe that overall, the US system is progressive relative to its OECD counterparts, or is the progressivity in the tax system you note more a function of us running smaller transfer programs though the tax code that these other countries deliver through another means?

Mr. Hodge's response: The U.S. certainly does not have the cradle-to-grave social welfare system as most European nations. But, as I wrote in my testimony, the entire tax and spending system in the U.S. is very progressive – meaning pro-poor – and very redistributive.

Tax Foundation research shows that the majority of American families now gets more back in government spending benefits than they pay in taxes. The lowest-income families get more than $10 in government spending for every dollar they pay in taxes while those in the middle-income receive $1.15 in spending for every dollar they pay in taxes. The nation's tax and spending policies combine to redistribute more than $826 billion annually from the top 40 percent of families to the bottom 60 percent.

We should have an honest discussion over how much redistribution is considered fair and equitable.

2. Last week, the major big oil companies announced more than $30 billion in profits. And yet the American taxpayer subsidizes the oil industry with over $3 billion in giveaways

> each year. Big Oil claims they need these tax incentives because it helps them keep the price of oil down.
>
> But according to a recent report from Citizens for Tax Justice, Big Oil companies spent most of their profits in the purchase of their own stocks and boosting its dividends. In 2010, four of the largest oil companies allocated only 18 percent of their revenues to exploration but 60 percent on dividends and stock repurchases.
>
> Mr. Hodge, you wrote that "the ideal tax system should do only one thing – raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. Given that you support a dramatic simplification of the code and the fact that Big Oil is not using its enormous revenues to actually help lower gas prices, do you believe it would be fair to eliminate these distortions so they can pay their fair share in taxes and help us reduce the deficit?

Mr. Hodge's response: The profitability of the industry is irrelevant to the issue of whether or not we should keep or eliminate a tax break. The real issue is whether the tax provision is good tax policy or does it have distortionary and harmful effects on the economy.

I encourage you to read my August 2010 study "Putting Corporate Tax 'Loopholes' In Perspective." You'll find that relative to other sectors there are very few tax provisions benefiting the oil industry. For example, while there are roughly $3 billion in tax provisions for the oil industry, there are over $11 billion for renewables and about $13 billion for state and local governments. There are numerous examples of how companies in the renewables industry cannot survive without those tax breaks. That is bad tax policy and those provisions should be eliminated.

Moreover, in my July 2010 study, "Oil Industry Taxes: A Cash Cow for Government," you'll find that according to the Energy Information Administration, that between 1981 and 2008, the direct and indirect taxes paid by the largest oil companies exceeded their corporate profits by 40 percent. I would say that the oil industry is contributing more than its fair share of taxes to all levels of government.

Now to your question about the tax provisions available to the oil and gas industry. As Investor's Business Daily recently noted in a May 5, 2011 editorial:

> The ability to expense intangible drilling costs (enacted in 1916), for example, isn't any different from the tax breaks other companies get for R&D.
>
> And the "percentage depletion allowance" (enacted in 1926) doesn't even benefit Big Oil, but independent producers, and isn't just for the oil industry but all other "extractive industries."

Eliminating these provisions will do no more to reduce the price of oil than eliminating the home mortgage interest deduction.

The Increasing Progressivity of U.S. Taxes

And the Shrinking Tax Base

Alan Reynolds

Senior Fellow
The Cato Institute

Testimony before the
Senate Committee on Finance
May 3, 2011

Alan Reynolds is a Senior Fellow with the Cato Institute. He served as a member of President's Reagan's transition team in 1981, as Research Director of The National Commission on Economic Growth and Tax Reform in 1995-96, and he is the author of the textbook *Income and Wealth* (Greenwood Press 2006).

In 2008, a study of tax policy in two dozen leading economies by the Organization of Economic Cooperation and Development (OECD: 104) found that, "Taxation is most progressively distributed in the United States, probably reflecting the greater role played there by refundable tax credits, such as the Earned Income Tax Credit and the Child Tax Credit . . . . Taxes tend to be least progressive in the Nordic countries, France and Switzerland."

Even aside from the uniquely generous U.S. tax credits, the OECD study found the ratio of taxes paid to income received among the top 10 percent was by far the highest in the U.S. at 1.35, compared with 1.1 for France, 1.07 for Germany, 1.01 for Japan and 1.0 for Sweden.

Table 1 provides a brief history of changes in individual tax rates in the U.S., using *average* tax rates by income from the Congressional Budget Office (CBO). The focus is on 1979, 1989, 1999 and 2007 for simplicity, but also because those years were cyclical peaks.

The first six columns show changes in *average* tax rates among fifths ("quintiles") of U.S. households. By 2007 the average tax rate fell to minus 6.8 percent for the poorest quintile. From 1979 to 2007, the average tax rate fell by 110% for the second quintile, by 56% at the middle, 39% for the fourth quintile, and by 15% for the top 1%.

The disproportionate reductions in average income tax rates for the bottom 80% of potential taxpayers (including negative tax rates for the bottom 40%), are the cumulative result of numerous changes in tax laws.

The 1981 tax cuts left the top tax rate at 50% for earned income but gradually reduced other tax rates 25% by 2004, and doubled the income threshold at which the top tax rate applied. The 1986 tax reform doubled personal exemptions and greatly increased the EITC and standard deduction (but left total deductions unchanged at 23% of AGI). The 2001 and 2003 tax cuts added a new 10% rate, further expanded the EITC and introduced a refundable $1000 tax child

tax credit. By 2009, federal income taxes were *negative*, on average, for 44.7% of Americans (including nonfilers), according to the Joint Committee on Taxation (2010: 54).

While *average* tax rates were reduced by 39-110% for the lowest four quintiles since 1979, the highest *marginal* tax rates on both ordinary income and capital gains were also cut in half. Yet revenue from the individual income tax was virtually unchanged – 8.7% of GDP in 1979 and 8.5% in 2007. Total revenues from all sources were identical at 18.5% in both years, and above the postwar average of 18%.

The reduction of average tax rates among the top 1 percent (to 19% in 1997 from 21.8% in 1979) does *not* imply that top taxpayers in 2007 paid less income tax than they would have if they had still been taxed at the 1979 rates of 70% on interest and dividends and 28% on capital gains. On the contrary, the evidence is unambiguous (Reynolds 1999 and Table 2) that raising the tax rate on capital gains reduces asset sales and therefore shrinks the amount of capital gains to be taxed. Investors contemplating taking profits on an appreciated stock in order to reinvest in a more promising new firm will make not make that trade if the transactions tax on realizations makes it unprofitable. Capital is thus made less mobile and capital allocation less efficient.

Raising the tax rate on interest and dividends likewise reduces that amount of taxable interest and dividend income. Raising the tax on high salaries reduces the incentive to be paid in cash, rather than in deferred compensation and perks. Raising the tax on individual income far above the tax on corporate income encourages professionals and small firms to shelter retained earnings in C-Corporations. For such reasons the punitive tax rates of 1979 resulted in fewer high incomes to tax, so that individual income tax revenues were, in fact, no higher in

1979 than they were after top tax rates had been cut in half, even though *average* tax rates have also fallen sharply on the bottom 80 percent.

Much Lower Tax Rates, Not Lower Revenues

The explanation of the apparent paradox of falling tax rates and unchanged revenues is that reductions in top *marginal* rates – including those on capital gains and dividends – increased *reported* top incomes so dramatically that the resulting additional revenue windfalls from the top one or two percent of taxpayers offset the relatively huge reduction in *average* tax rates for the bottom 80 percent.

The "elasticity of taxable income" (ETI) measures the percentage change in taxable income expected to result from a 1% change in the value of a marginal dollar of after-tax income (the "net of tax rate"). The response measured by the ETI results from changes in real activity (effort, investment and entrepreneurship) but also from changing incentives to avoid reporting income.

As Saez, Slemrod and Giertz observe, "a number of empirical studies have found that the behavioral response to changes in marginal tax rates is concentrated in the top of the income distribution." The reported amount of top income rises when marginal tax rates fall, and vice versa. It follows that what *appear* to be changes in the highest incomes may instead be behavioral responses to changes in various marginal tax rates on labor earnings, business income, dividends and capital gains in 1986-88, 1993, 1997 and 2003.

If the ETI for high-income individual is close to 1.0 or higher, that suggests a higher tax rate would induce high-income taxpayers to reduce reported incomes by such a large amount that the higher tax rate would yield little or no additional revenue. This is largely a matter of tax

avoidance but also work avoidance. Ohanian, Raffo and Rogerson find that "taxes can account for much of the variation in hours worked both over time and across countries."

At the Treasury Department's Office of Tax Analysis (OTA), Heim estimated that the elasticity of *taxable* income is 1.2 at incomes above $500,000. Other OTA economists, Auten and Joulfaian, also find "quite large responses for the highest income groups. . . . The implied long-run taxable income elasticity is about 1.0 for taxpayers in the $500,000 to $2,000,000 income classes." In a longer-run study focused on the top 1 percent in five Anglo-Saxon countries, Atkinson and Leigh estimate an ETI of 1.2 to 1.6.

Focusing on the *earned* income of corporate executives (excluding investment and business income), a Congressional Budget Office study by Eissa and Giertz found, "the estimated elasticity with respect to the current after-tax share rises . . . to 1.35 for executives with more than $650,000 in permanent income, and 1.71 for those with at least one million dollars (all statistically significant). . . . Tax responses appear much larger for all high-income taxpayers than for the subset of top executives."

A dozen earlier studies, including some by the OTA and CBO, typically found a high elasticity of the amount of capital gains that are realized to the top tax rate on capital gains (Reynolds 1999, Ch. 4). **Table 2** shows that a much larger volume of capital gains were *realized* in *taxable* accounts (rather than being *unrealized* or reinvested within tax-deferred or tax-exempt accounts) when the capital gains tax was 15-20% than when the capital gains tax was 28% or more. Realized capital gains only amounted to 2.5% of GDP from 1987 to 1996 when the capital gains tax was 28%, so they accounted for only 6.9% of individual tax revenues and 17.7% of the income reported by the top 1 percent. Realized gains doubled as a share of GDP

from 2003 to 2007, and accounted for 9% of individual tax revenue and 28.1% of the income reported by the top 1 percent.

Top Incomes Rose Because of Capital Gains and Dividends

Table 3 shows the top 1 percent's average real income broken down by specific sources, such as capital gains, dividends and salaries (including bonuses and nonqualified stock options). These estimates, from economist Thomas Piketty and Emmanuel Saez, are the same data President Obama referred to on April 13 when he said, "In the last decade . . . the top 1 percent saw their income rise by an average of more than a quarter of a million dollars each."

Table 3 shows that average real incomes of the top 1 percent over the past decade rose *and fell* almost entirely because of capital gains. The second column shows that average salaries, bonuses and stock options of the top 1 percent have *not* increased since 1999-2000. Total income of the top 1 percent was also lower in 2008 than in 1999-2000, because of the stock market collapse. CBO estimates of top incomes are totally dominated by the amount of capital gains which, in turn, means reductions in the capital gains tax tend to create illusory increases in (reported) top incomes.

The third column shows stronger gains in business income after 2003, which also happened the last time the individual income tax rate was as low as the corporate tax rate, from 1987 to 1992. This is consistent with greater incentives for new and existing firms and professionals to file under the individual income tax (rather than the corporate tax) as partnerships, limited liability companies or Subchapter S corporations.

Just as a high tax on capital gains before 1997 was easily avoided by not selling appreciated assets, a high tax on dividends before 2003 was easily avoided by shunning dividend-paying stocks (except in foundations or IRA and Keogh plans).

The fourth columns shows that the average amount of taxable *dividends* reported by the top 1 percent was essentially stagnant from 1993 to 2002 when the dividend tax was high, but *nearly tripled* by 2007 when the tax rate on qualified dividends was cut to 15 percent. The lower tax rate encouraged more firms to pay more dividends (Chetty and Saez), and also encouraged high-bracket investors to hold more dividend-paying stocks in taxable accounts (Kawano).

Just as the tax on dividends was easily avoided before 2003 by not investing in dividend-paying stocks, the tax on interest income was easily avoided by holding more tax-exempt municipal securities. Both of these 1993-2002 tax strategies held down *reported* pretax top incomes, just as avoiding the 28% capital gains tax did from 1987 to 1996. But that merely illustrates why pretax income reported on individual tax returns is an untrustworthy method of measuring actual incomes.

The fifth columns shows real taxable interest income of the top 1 percent falling sharply as top tax rates increased in 1991 and 1993, then remaining low through 2002. After the top tax rates were reduced in 2003, taxable interest income rose sharply even though interest rates remained low.

The increase in reported dividends, interest income and capital gains after 2003 largely reflects reduced incentives for easy tax avoidance strategies – hang onto appreciated stock unless you have offsetting losses; avoid dividends in taxable accounts; hold more tax-exempt bonds. What has been widely misinterpreted as an increase in top incomes (and wrongly attributed to

big salaries and bonuses) was largely a predictable response to reduced tax incentives to minimize reported income.

The downside of all this is that individual income tax revenue has become precariously dependent on periodic cyclical windfalls from the stock market. Those stock-related windfalls have been imprudently spent in reducing the lowest, least-damaging tax rate and taking more and more Americans off the tax rolls through refundable tax credits and enlarged exemptions.

One unrepeatable source of stock-related revenue windfalls in 1997-2000 (in addition to capital gains) was the proliferation of nonqualified stock options among 11 percent of households by 2001 (according to the Survey of Consumer Finances). Nothing remotely comparable is ever again likely to recur because (1) the NASDAQ stock prices will surely not quintuple in a few years as they did with the launch of the Internet, and because (2) the Financial Accounting Standards Board has squelched stock options for mid-level employees by requiring that firms record the estimated future value of stock options as an actual current expense.

Misconceptions about Tax Expenditures and Tax Reform

Recent discussions of tax reform and tax expenditures, including the 2010 Report of the National Commission on Fiscal Responsibility and Reform, mistakenly assume that static tax expenditure estimates predict that $402.9 billion of *added revenue* could be raised from 2010 to 2014 by taxing capital gains and dividends at the same rate as ordinary income. On the contrary – as those responsible for the tax expenditures estimates understand – such a policy would surely *reduce* federal tax revenue by greatly reducing the reported amount of capital gains and dividends. To see why, examine Tables 2 and 3.

As the Joint Committee on Taxation (2011: 12) explains, "unlike revenue estimates, tax expenditure calculations do not incorporate the effect of the behavioral changes that are anticipated to occur in response to the repeal of a tax provision." The static tax expenditure calculations pretend, against all evidence, that stockholders would realize just as many gains and report just as many dividends at a tax rate of 35-47% as they would at a tax rate of 15%. That is statistically simple, but economically absurd.

A related misunderstanding arises from a common belief that the 28 percent maximum tax rate enacted in the 1986 tax reform was "paid for" by reducing individual deductions. Feldstein writes that, "An important part of the Reagan [Kemp-Kasten] tax reform of 1986 was a reduction of tax expenditures from more than 9 percent of GDP to 6 percent of GDP." Among "tax expenditures that affected individual tax payers" he mentions loss of deductibility for state sales taxes and consumer credit interest. In reality, most of the dramatic reduction in the value of tax expenditures in 1988-90 was because the value of tax breaks is much lower with a top tax rate of 28 percent. *None* of the reduction in tax expenditures resulted from cutting individual tax deductions, because the reduction in itemized deductions was entirely offset by a larger standard deduction: Total deductions amounted to 23.3% of AGI from 1975 to 1984, and 23.1% of AGI from 1988 to 1993 (IRS). Repealing deductibility of credit card interest was designed to finance the family-friendly doubling of personal exemptions, not tax rate reduction (which brought in are far more revenue than expected even as the higher capital gains tax brought in much less).

Another popular misconception is the belief that a tax schedule with low tax rates, such as the 10 percent bracket introduced in 2001, confers an exclusive benefit on low-income taxpayers. In reality, low-income people no longer pay federal income tax, but higher-income taxpayers have their *average* tax rates reduced because of the 10% rate, which saves them more

than $800 per couple. This is why flatter rate schedules produce more revenue. Eliminating the 10% bracket and reducing the top tax rate to 30% would be a *revenue-positive* reform, in static terms, regardless of tax deductions. By contrast, raising the tax rate on capital gains and dividends to 18.8 percent in 2013, as scheduled under current law, would have a far more ambiguous effect on revenues due to predictable behavioral responses.

To summarize, average individual income tax rates fell most dramatically for the bottom 80 percent of taxpayers from 1979 to 2007, with the bottom 40 percent now receiving more in refundable tax credits than is paid in taxes. The highest marginal tax rate fell from 70 percent to 15-35 percent on investment income and from nearly 40 percent on capital gains in 1976-77 to 15 percent after 2003. Revenues from the individual income tax nonetheless remained close to 8 percent of GDP whenever the economy was doing well, regardless of top tax rates, and overall revenues remained close to 18 percent of GDP.

The dramatic tax cuts for the bottom 80 percent was made possible by greatly improved incentives to report and pay taxes on the *highest* incomes in recent years, particularly on realized capital gains, taxable interest and dividends. To put that process into reverse, by moving back toward the higher tax rates of the past, would clearly reduce the amount of capital gains, dividends and other income reported by the top 1 percent. Unfortunately, it would probably also reduce the share of taxes paid by the top 1 percent.

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Table 1
Average U.S. Individual Tax Rates by Income Groups,
Top Marginal Tax Rates,
And Revenues as a Share of GDP

	Avg. Tax Lowest Quintile	Avg. Tax Second Quintile	Avg. Tax Middle Quintile	Avg. Tax Fourth Quintile	Avg. Tax Highest Quintile	Avg. Tax Top 1%	Top Marginal Tax Rate (%)	Top Capital Gains Tax	Individual Tax Revenue % of GDP	Capital Gains as % of Individual Revenue	Total Tax Revenue % of GDP
1979	0	4.1	7.5	10.1	15.7	21.8	70	28	8.7	5.5	18.5
1989	-1.6	2.9	6	8.3	14.6	19.9	28	28	8.3	8.1	18.4
1999	-5.2	1.7	5	8	17.1	24	39.6	20	9.6	12.7	19.8
2007	-6.8	-0.4	3.3	6.2	14.4	19	35	15	8.5	12.3	18.5
Change 1979-2007	NA	-110%	-56%	-39%	-8%	-15%	-50%	-46%	-2%	+124%	0

Table 2
More Long-Term (LT) Capital Gains Were Realized and Taxed
When the Capital Gains Tax Was Reduced

	Top Tax Rate On LT Capital Gains	Realized LT Capital Gains % of GDP	Capital Gains % of Top 1 Percent Incomes	LT Capital Gains % of Individual Tax Revenue
1987-1996	28	2.5	17.7%	6.9%
1997-2002	20	4.6	26.0	9.0
2003-2007	15	5.0	28.1	9.0

Capital Gains share of top 1% incomes (including capital gains) from Thomas Piketty and Emmanuel Saez, Table A8.
Realized LT gains as a percent of GDP and revenues from the U.S. Treasury Department.

Table 3
Sources of Top 1 Percent Pretax Pretransfer Income
Average reported income in 2008 dollars

	Capital Gains	Salary	Business Income	**Dividends**	**Interest**	Rents	Total Income*
1988	166,707	354,978	125,845	45,114	59,361	8,904	760,909
1989	135,744	321,414	126,411	41,948	66,890	10,204	702,611
1990	98,810	335,473	129,206	39,399	64,314	11,588	678,790
1991	81,516	302,796	121,329	34,816	58,027	11,078	609,562
1992	86,838	363,016	139,077	31,823	**41,841**	13,554	676,149
1993	99,273	342,955	131,438	29,270	**34,240**	14,359	651,535
1994	99,389	332,937	150,976	29,857	34,364	15,210	662,733
1995	117,310	361,115	166,528	31,110	35,989	14,640	726,692
1996	178,695	388,561	175,731	33,845	37,099	15,621	829,552
1997	**240,072**	427,208	189,162	36,132	38,257	17,712	948,543
1998	**302,888**	469,996	204,614	36,154	40,000	18,461	1,072,113
1999	**350,250**	515,268	216,562	38,998	39,827	19,084	1,179,989
2000	**406,631**	551,873	216,369	43,799	44,675	19,272	1,282,619
2001	212,167	491,861	211,253	33,482	36,670	19,930	1,005,363
2002	150,016	446,953	200,107	30,673	33,595	19,719	881,063
2003	**181,709**	440,521	**202,698**	**38,052**	30,734	20,489	914,203
2004	**278,386**	474,515	**230,757**	**52,814**	**33,314**	21,126	1,090,912
2005	**371,465**	492,790	**277,869**	**59,351**	**46,761**	23,381	1,271,617
2006	**416,119**	505,874	**284,613**	**69,971**	**63,352**	22,693	1,362,622
2007	**469,981**	513,438	273,941	**83,072**	**74,172**	22,746	1,437,350
2008	248,243	504,402	256,276	**67,918**	50,712	26,262	1,153,813

Adapted by author from Piketty and Saez Tables A4, A6, A7& A8.

*Note: Piketty and Saez provide the breakdown by source as *percentages* of income, where income is defined to *exclude* capital gains. They also estimate average real income of the top 1% (with capital gains excluded), and this table multiplies their percentages by total income in order to display changes in real income by source. Piketty and Saez provide separate estimates of average real income which *includes* capital gains; another table shows the percentage of such income derived from capital gains (but not other sources). Capital gains in this table is total income in including capital gains multiplied by the percentage of that income attributable to capital gains. The last column adds up to a slightly (2 percent) *larger* total than Piketty and Saez series that include capital gain, presumably because the series that ranks the top 1 percent according to the more inclusive measure of income includes more investors and business owners and relatively fewer large salaries.

Senate Finance Committee Hearing
"Is the Distribution of Tax Burdens and Tax Benefits Equitable?"
May 3, 2011
Responses to Questions for Mr. Alan Reynolds

Questions from Senator Orrin Hatch

1. With regards to labor supply elasticity (work decisions responsiveness to the tax rate) at what point do you believe people decide to work less in order to avoid paying more income tax? Assuming an increase in income tax rates were to occur, is it safe to say that with this reduction in workable hours, our economy would suffer?

Mr. Reynolds's Response:

When legislators inquire about the impact of changing tax rates they commonly rely on the Congressional Budget Office (CBO). Recent CBO estimates *assume* unusually low labor supply elasticity. "In CBO's assumptions, the average worker has a total wage elasticity of 0.129, implying that 10 percent increases in both after-tax income and the after-tax wage rate would cause a 1.29 percent increase in hours worked."[1] Unfortunately, those 2007 estimates were based on a subjective 1996 CBO assessment of outdated studies published from1973 to 1993.

If the issue involves changes in the highest tax rates, the response of "average workers" is not clearly relevant, because most people included in that average pay little or no federal income tax. Inexplicably, "CBO assumes that higher-earning workers are less sensitive than lower-income workers to changes in after-tax income and wage rates." That assumption suggests that changes in the lowest tax rates would have more effect on labor supply than changes in the highest tax rates. That counterintuitive assertion is difficult to reconcile with a CBO footnote explaining that "studies of the effect of taxes on taxable income . . . have found the largest response among high-income taxpayers." The CBO predicted in 2007 that the top 10 percent of primary earners would account for 37.9 percent of all labor earnings in 2011, and the bottom 50 percent for only 12 percent. With so large a share of labor income dependent on so few people, the implausibly low CBO estimates of the likely behavioral response of high-income taxpayers (including retirement decisions) result in serious overestimates of revenue available from raising the highest tax rates.

Mr. Shaviro's testimony claims, "There is considerable consensus among economists that taxpayers' labor supply elasticity (i.e., work decisions' responsiveness to the tax rate) is generally extremely low . . . for prime-age males." The trouble is that prime-age males (age 25 to 54) accounted for just 36.4 percent of the labor force in 2008, and the Bureau of Labor Statistics projects that figure to fall to only 34.3 percent in 2018.[2] Women and people older than 54 account for a much larger fraction of the labor force than they did in the earlier era examined by the CBO in 1996, and their decisions to enter or exit the labor force are known to be quite responsive to after-tax incentives.

Recent estimates suggest the U.S. labor supply *is two or three times* as responsive to after-tax income as the CBO assumes. A 2011 estimate from Harvard's Raj Chetty and others estimates the long-run elasticity of labor at 0.25 to 0.5, with a preferred figure of 0.3 for most purposes.[3] There is additional evidence that the customary "micro" estimates from surveys of working individuals may not capture "extensive" participation elasticity – decisions whether or not to work at all in the formal economy – and that elasticity of *participation* may be several times higher than intensive elasticity of *hours*.[4] Potential employees have more control over the participation decision than they do over hours per week or weeks per year. After studying many countries over many years, Davis and Henrekson found that "higher tax rates on labor income and consumption expenditures lead to less work time in the market sector, more work time in the household sector [and] a bigger underground economy. . . ."[5] None of that behavior can be captured by studying variation of work hours among those already working in the formal economy.

Labor supply is also affected by the *implicit* marginal tax rate that arises when benefits are phased-out if earned income rises, such as the earned income tax credit, food stamps and Medicaid eligibility. Krueger and Meyer find that "the empirical work on unemployment insurance (UI) and workers' compensation (WC) insurance finds that the programs tend to increase the length of time employees spend out of work. Most of the estimates of the elasticities of lost work time that incorporate both the incidence and duration of claims are close to 1.0 for unemployment insurance."[6] This is additional evidence that after-tax work incentives matter quite a lot, at the margin.

What matters most to the economy and revenues, as Martin Feldstein emphasized, "is not the change in working hours but the change in labor supply more broadly defined – including effort, occupation, human capital, etc. – and in the mix between taxable cash wages and untaxed fringe benefits."[7]

2. With regards to the incomes of the wealthy, there seems to be a belief by some that after reductions in income tax rates, the rich get richer at the expense of others, which implies that tax rate reductions lead to the less rich paying a proportionally greater share of taxes. However, haven't income tax rate reductions led to all sectors of society becoming richer, and are the rich becoming richer not because others are shouldering their tax burden, but because a lower rate has encouraged people to put their resources to more productive uses than minimizing tax liability?

Mr. Reynolds's Response:

The evidence in my testimony indicates that the amount of taxable income reported in the highest tax bracket (the tax base) is very sensitive to marginal tax rates in general, and to tax rates on capital gains and dividends in particular. This makes it extremely misleading to use income and capital gains reported on individual tax returns as a measure of relative income gains among income groups when tax rates were changing. If tax rates on top incomes and capital gains had *not* been reduced, the evidence is clear that top taxpayers would have reported far less taxable income (due reduced productive activity and increased tax avoidance), with the result that those with lower incomes would have borne a larger share of the tax burden.

After reductions in income tax rates – notably in 1983-84 (when the 1981 tax cuts were phased-in), 1988 and 2003 – top income groups reported more income, and also shifted some income from corporate tax forms to the individual tax forms. After reductions in capital gains tax rates (in 1983-84, 1997 and 2003), realizations of capital gains were greatly increased. As Senator Hatch correctly described it, "a lower rate has encouraged people to put their resources to more productive uses than minimizing tax liability."

The resulting revenue windfalls from top percentile taxpayers (following those tax rate reductions) were used to expand the earned income credit, child credit, standard deductions and personal exemptions. That explains why the average income tax among the bottom 40 percent was below zero by 2007. The tax system has become much more progressive since 1980, mainly as a result of the tax laws of 1986 and 2001-2003.

The average tax rate at high incomes declined slightly from 1979 to 2007 mainly because those high-income taxpayers had an incentive to realize more capital gains and to hold more dividend-paying stocks and taxable bonds. Mr. Shaviro's testimony quotes Emmanuel Saez's claim that recent gains in top income were entirely the result of "an explosion of top wages and salaries." The third table in my own testimony uses data from Mr. Saez (and Thomas Piketty) to prove conclusively that the exact opposite happened over the past ten years. Nearly all of the increase in reported incomes of the top 1 percent from 2003 to 2007 was the consequence of realized capital gains and dividends, with no increase at all in the top 1 percent's real salary income between 1999 and 2007. With a smaller share of top incomes from salaries, and a much larger share from capital gains and dividends taxed at 15 percent, the average tax rate (which is a weighted mixture of tax rates from 15 to 35 percent) was diluted. I discuss this further below, in connection with the top 400 tax returns. Allowing couples an exclusion of $500,000 of capital gain on primary residences since 1997 also contributed to the lower average tax rate among top tax returns.

Suppose realized capital gains had instead been taxed at 28 percent from 1997 to 2007, and dividends had been taxed at 35 percent or more. In that case, the weighted average tax rate would have been higher, but the amount of revenue collected from the top 1 percent would have been lower. Reported capital gains of the top 1% would have at least been reduced by half, and dividends after 2003 would have remained flat instead of tripling as they did.

The tax-based estimates of Piketty and Saez exclude all taxes and all transfer payments, such as Social Security and the EITC. Mr. Shaviro nevertheless alludes to these figures to justify his opinion that tax rates to the rich and/or transfers to the poor need to be changed. Yet tax rates on top incomes could be raised to 80 percent and means-tested transfer payments could be tripled without any *direct* impact whatsoever on distribution of *pretax, pretransfer* income as measured by Piketty and Saez. Those figures completely ignore taxes and transfer payments, including Medicare, Medicaid and transfer payments through refundable tax credits.

Burkhauser, Larrimore and Simon estimate the distribution of after-tax income using internal CPS data without top coding and adjusted for remaining problems in understating super-high incomes. Comparing inequality of after-tax income at cyclical peaks, with only cash transfers included, they find a Gini coefficient of .394 in 1989, .390 in 2000 and .396 in 2007 – indicating

virtually no change in inequality of aftertax money income since 1989. After also including the insurance value of private and public health insurance, the Gini coefficient falls – from .372 in 1989 to .364 in 2000 and .362 in 2007.[8] The raw Census Bureau estimates of disposable income, after taking account of taxes and transfers, also show no broad increase in inequality of living standards after 1988. Taxes and transfers matter quite a lot; it makes no sense to measure income distribution as if they did not exist. It makes even less sense to use such a measure to propose changes in taxes and transfers.

3. Mr. Shaviro, in your written testimony, you state that "One of the best-regarded recent studies found that the revenue-maximizing tax rate would be as high as 80 percent if the income tax base were broadened." Elsewhere in your testimony you say that "a higher rate and a broader base function as complements." In terms of the study you cite, who is it well-regarded by? Do you expect that subjecting everyone, regardless of their income, to an 80 percent tax rate and eliminating tax expenditures would maximize income to the government? Should it be the objective of government to maximize revenue in this manner? What impact would this have on economic growth and productivity? Why would someone choose to live someplace with an 80 percent rate when they could move someplace else?

   Mr. Reynolds, what impact do you believe a tax rate of 80 percent would have on economic growth and productivity?

Mr. Reynolds's Response:

The 2002 study cited by Mr. Shaviro did *not* estimate what the revenue-maximizing tax rate might be (regardless of its effects on the economy). On the contrary, Gruber and Saez wrote, "our estimates suggest the optimal system . . . consists of a large demogrant that is rapidly taxed away for low income taxpayers [similar to phasing-out the EITC], with lower marginal rates at higher income levels."[9]

The alchemy of transforming that recommendation for "lower marginal rates at higher income levels" into a "revenue-maximizing tax rate" happened in a 2004 CBO paper by Giertz. Gruber and Saez found an ETI of 0.40 for *all* taxpayers – *not* for high-income taxpayers. Giertz therefore estimated that "*under a single rate tax system* . . . an ETI of 0.40 would imply a revenue maximizing income tax rate of 70 percent."[10]

To maximize revenue in the short-run (regardless of effects on the economy), the Giertz estimate requires that the tax 70 percent tax rate be applied to *all t*axpayers. That is why he used the Gruber and Saez EPI of 0.40 all taxpayers, rather than the same authors' estimate of 0.57 for taxpayers earning more than $100,000 but less than $1 million. With a 70 percent single tax rate, for example, taxes on the first $17,000 of taxable income on a joint return would rise from the current $1,700 to $11,900 under this "revenue-maximizing "tax. Mr. Shapiro's 80 percent rate on all taxpayers would apply to a much broader base (presumably attempting to tax capital gains and dividends at an 80 percent rate), so the change in effective tax rates would be much greater than this astonishingly high statutory rate suggests.

It is surely self-evident that attempting to impose a "revenue-maximizing" tax of 70-80 percent on the half of American citizens who still pay income taxes would totally demolish most of the U.S. economy and drive the rest underground or overseas. If proof were needed, a Fraser Institute survey of 20 studies concluded that "the evidence from economic research indicates that . . . high and increasing marginal tax rates reduce economic growth by creating strong disincentives to hard work, saving, investment and entrepreneurship."[11]

In another arcane statistical exercise, Saez recently estimated a revenue-maximizing tax rate of 69 percent. But he came up with that figure only by assuming a very low ETI of only 0.25.[12] He describes that ETI of 0.25 as if it was a reasonable mid-point within a range from 0.12 to only 0.40. Yet the singularly low estimate of 0.12 (from Gruber and Saez) was for gross rather than taxable income, and might be relevant only if there were literally no deductions at all (not even for business expenses of partnerships and proprietors). As for the 0.40 estimate at the top of the range, that is actually the middle rather than the top of recent estimates – for *all* taxpayers, not top taxpayers, including the many who do not itemize deductions. Indeed, the fact that 0.40 (rather than 0.25) is a mid-range "consensus" estimate of the ETI is the reason Giertz used that figure when estimating the revenue-maximizing rate of a single tax.

After reviewing 30 studies, the Canadian Ministry of Finance found, "The central ETI estimate in the international empirical literature is about 0.4. An ETI of 0.4 implies that a 10% . . . decrease in the after-tax value of the final dollar of taxable income will result in approximately a 4% . . . decrease in the taxable income reported by the taxpayer."[13] Like every other study, however, the Canadian government also found, "The ETI is found to be significantly higher for taxpayers with very high incomes" (defined as more than C$150,000).

The undisputed finding of all studies that the ETI is much higher among the top 1 percent is, in fact, *the key issue* when it comes to proposals to increase only the *highest* tax rates. As Chetty notes, "The empirical literature on the taxable income elasticity has generally found that elasticities are large (0.5 to 1.5) for individuals in the top percentile of the income distribution."[14]

When discussing an increase in only the *highest* tax rates, rather than a single rate of 70-80 percent on *all* taxpayers, the relevant ETI is for high earners only. The source Saez cited for his ETI estimate of 0.25 – a paper he co-authored with Slemrod and Giertz – obfuscates this essential issue in a footnote: "Note that the ETI for high earners could conceivably be higher than 0.25. . . . With an elasticity of 0.5 for the top 1 percent income earners, the marginal excess burden per dollar of revenues doubles."

To suggest that the ETI for high earners could "conceivably" be higher than 0.25, however, is extremely disingenuous. That same paper also found, "much evidence to suggest that the ETI is higher for high-income individuals." *Every* researcher, including Saez and Giertz, has found an ETI *higher than* 0.5 for high earners. My testimony cited four more recent studies estimating an ETI above 1.0 for the highest incomes. Treasury economist Heim, for example, estimated the ETI is 1.2 at incomes above $500,000, and a CBO study by Eissa and Giertz found an ETI of 1.35 among executives earning more than $650,000.

Saez estimated, in 2004, that the elasticity of gross income (not taxable income) for the top 1 percent was *at least* 0.62 and possibly as high as 1.58.[15] That 0.62 ETI is undoubtedly *underestimated* because, as Gruber and Saez found, "the responsiveness of broad [gross] income is much lower than that of taxable income" (because it rules out aggressive use of mortgage and investment interest deductions, for example, or becoming self-employed with a company car, expense account and generous pension and health benefits).

If the relatively low Saez estimate of 0.62 is plugged into his formula for calculating the revenue-maximizing tax rate, the result is a revenue-maximizing rate of 32 percent for the top 1 percent. But that implies a revenue-maximizing *federal* income tax *no higher than 26 percent* because, as Saez points out, the 32 percent maximum must also take into account "the extra tax rates caused by Medicare payroll taxes [2.9%], state income tax rates [at least 4%] and sales taxes."

The bottom line on all this speculation about a revenue-maximizing tax of 70 percent or more is that the U.S. has already tried that and it did not work. The Table below shows the lowest and highest tax rates since 1951, and the amount of revenue they brought in as a percent of GDP. Clearly, the reductions in top tax rates under Kennedy and Reagan not only "paid for themselves," but also financed large reductions in the low and middle tax rates.

The initial Bush tax cut of 2001 mainly consisted of reducing the lowest tax rate to a post-1941 record of only 10 percent (currently on the first $17,000, which amounts to $850 for every taxable join return). That was *intended* to reduce revenue because of a belief that this would "stimulate demand." However, House and Shapiro show how the phase-in of other rate reductions actually weakened the economy (as did the slow phase-in of 1981 tax cuts in 1983-84).[16] Together with the 10% rate, the phase-in also weakened individual tax revenues through 2003, yet they were back above 8% by 2006 thanks in large part to dividends and capital gains at the top.

Individual Income Tax Rates
And Revenues as a Percent of GDP

	Lowest & highest tax rates	Revenues percent of GDP
1951-63	20-91%	7.7%
1964-81	14-70	8.0
1982-86	11-50	8.3
1988-90	15-28	8.1
1991-92	15-31	7.8
1993-1996	15-39.6	8.0
1997-2002*	15-39.6	9.4
2003-2008	10-35	7.7

U.S. Budget, Historical Tables, Table 2-3. SOI Tax Stats, Historical Table 23.
*Capital gains tax was reduced from 28 percent to 20 percent in 1997 and a new 10% bracket was added in 2001.
1987 is omitted because the 1986 Tax Reform was phased-in, and the surtax years of 1969-70 are also excluded.

Questions from Senator Robert Menendez

1. I'm sure you have seen the IRS data which shows the wealthiest 400 taxpayers in America have seen their effective tax rates plummet in recent years even as their annual incomes have soared past $300 million dollars. Between 1992 and 2007, while most middle class families have seen almost no bump in their salaries, the average adjusted gross income of the richest 400 families has increased by over 400 percent, after adjusting for inflation: from $68 million to $345 million (in 2007 dollars). In 2007, IRS statistics showed that these families who brought in an average of $350 million dollars that year paid an effective tax rate of 16.6 percent, down from 25 percent in 1992. Could it be the case for the richest 400 families that despite the fact that their effective tax rates have been going down, because they have seen such enormous gains in income relative to most other families in America, they would actually be paying a higher percentage of the tax burden?

Mr. Reynolds's Response:

Long-term capital gains accounted for *two-thirds* (65.7%) of the adjusted gross income of the top 400 in 2007, compared with only *one-third* in 1992. The reported income of the top 400 tax returns has not increased so rapidly because of salaries. It increased because of the reduction in the capital gains tax from 28 percent to 20 percent in 1997 and to 15 percent in 2003.

The largest 400 incomes in any given year are typically not recurring, like salary, but one-time windfalls from selling a business, farm, commercial or rental property, or a lump-sum payout from cashing-out restricted stock, options or deferred compensation accumulated over many years. That is why those in the top 400 are very rarely the same people from one year to the next.

Any transactions tax on the sale of property or financial assets is a voluntary tax, because taxpayers have the option of retaining rather than realizing capital gains (which leaves their wealth exactly the same, but their taxes lower). That is why the amount of realized capital gains is so very heavily influenced by the tax rate on realized gains. Reported incomes of the top 400 were also increased since 2003, to a lesser extent, by the reduced tax rate on qualified dividends.

From 1997 to 2007 (when the capital gains tax was 15 -20 percent) long-term capital gains accounted for 62.8 percent of top 400 income.[17] Since the effective tax rate is a weighted average of the capital gains tax and the tax on other income, that weighted average naturally fell after 1997 because (1) the capital gains tax rate was reduced and because (2) that rate reduction encouraged more realizations of what would otherwise have remained *unrealized.*

If the top capital gains tax had still been 28 percent in 2003-2008, as it was in 1992, the evidence in my testimony (as well as the rising share of top 400 incomes coming from realized gains) suggests that only about half as many gains would have been realized and taxed. The missing capital gains would have made average top 400 incomes *appear* much smaller. And their average tax rate would be higher because fewer capital gains would then have been included in

the average. Yet there would have been *substantially less tax collected* from the top 400 in 2007 if the 1992 tax rates had still been in effect.

While the capital gains tax rate was 28 percent, and realized capital gains were a smaller fraction of top 400 incomes, the average tax rate on such incomes was 28.2 percent from 1992 to 1996. The effective tax fell to 22.7 percent from 1997 to 2002, and to 18 percent from 2003 to 2008, because nearly two-thirds of reported top 400 incomes then consisted of (greatly enlarged) capital gains taxed at 20 percent and then 15 percent.

A one-time windfall from the sale of property – such as sale of a successful business, farm, winery, hotel or apartment building – is the most common reason for appearing among the top 400 tax returns in any given year. Because decisions to sell or not sell property are known to be strongly affected by the tax rate on any resulting gain, the unprecedented realizations of $90.6 billion by the top 400 in 2007 would likely have been cut in half if realized gains had still faced a 1992-style transactions tax of 28 percent. When fewer assets are sold, fewer taxes are paid.

If the objective is to persuade the top 400 to report lower incomes to the IRS, a higher capital gains tax will definitely accomplish that result. If the objective is to raise more revenues from top taxpayers with the least possible damage to the economy, a higher capital gains tax always fails to do that.

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[13] Canadian Department of Finance, "The Elasticity of Taxable Income" in *Tax Expenditures and Evaluations 2010*. p.50.

[14] Chetty, Raj, "Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss? The Implications of Evasion and Avoidance" *American Economic Journal: Economic Policy*. Jul 2009, Vol. 1, No. 2: p. 33.

[15] Giertz, op. cit., p. 31.

[16] House, Christopher L. and Shapiro, Matthew D., "Phased-In Tax Cuts and Economic Activity," *The American Economic Review*, Vol. 95, No. 5, pp. 1837-48.

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Testimony of Daniel N. Shaviro
Wayne Perry Professor of Taxation, NYU Law School
Before the Committee on Finance, U.S. Senate
May 3, 2011

Mister Chairman, Ranking Member Hatch, and Members of the Committee, I would like to thank you for the opportunity to appear today to discuss the fairness issues posed by the distribution of tax burdens between people at different income levels. I will address three specific topics. The first is how income distribution has changed in our country since the passage of the landmark Tax Reform Act of 1986, and why this might matter to the design of tax reform. The second is how tax expenditures, as opposed to tax rates, affect the distribution of tax burdens. The third is whether economic concern about imposing excessive tax burdens would imply that the budgetary gain from tax expenditure repeal should be offset by reducing tax rates.

Distributional Changes Since 1986

In 1986, Congress enacted comprehensive income tax reform through the cooperation of leaders in both parties. The core feature of the 1986 Act was that it combined tax rate cuts with base-broadening, in a manner intended to be both budget-neutral and distribution-neutral. Since 1986, however, not only have our long-term budgetary problems grown far more serious, but income distribution in the U.S. has significantly changed.

To appreciate the extent to which things have changed since 1986, I believe it is useful to consider the following two tables, both derived by me from research that was conducted by leading economists. The first shows rising income distribution at the top since 1986 without regard to capital gains (which can be misleading when taxpayers realize a big gain that actually accrued over many years), while the second includes capital gains (since ignoring them altogether would also be misleading).

TABLE 1

TOP DECILE (AND ABOVE) INCOME SHARES WITHOUT CAPITAL GAINS[1]

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	34.57	22.59	9.13	2.87	1.00
2008	45.60	33.36	17.67	7.77	3.34
% Increase in Share Since 1986	31.9	47.7	93.5	205.6	234

TABLE 2

TOP DECILE (AND ABOVE) INCOME SHARES WITH CAPITAL GAINS[2]

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	40.63	29.49	15.92	7.40	3.34
2008	48.23	36.52	20.95	10.40	5.03
% Increase in Share Since 1986	18.7	23.8	31.6	40.5	50.6

A theoretically better income measure than either of these would measure economic gain without regard to whether it was realized or not. Such a measure would show, for example, that Steve Jobs is economically well-off, despite his $1 annual salary, given that he owns close to $2 billion worth of Apple stock.[3] Nonetheless, the tables offer powerful evidence of a substantial increase in high-end U.S. income inequality since 1986.[4]

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[1] From Shaviro (forthcoming), using data from Facundo Alvaredo, Tony Atkinson, Thomas Piketty and Emmanuel Saez, *The Top Incomes Database* (data for U.S.), http://g-mond.parisschoolofeconomics.eu/topincomes/

[2] *Id.*

[3] See, e.g., Castillo (2011). If Apple pays tax at a suitable effective rate, one could argue that this results in adequate "proxy taxation" of Jobs' economic gain as an Apple shareholder.

[4] Alan Reynolds, who is also a witness at today's hearing, has written skeptically about this data. See, e.g., Reynolds (2006). His criticisms have been convincingly rebutted, however. For example, (1) Reynolds' treatment of Census Bureau survey data as more reliable than reported taxable income data is misplaced, (2) his effort to show that the data is upward-biased by reason of its excluding a significant component of "personal income" from the National Income and Product Accounts reflects his ignoring that the latter measure includes government transfers

The substantially greater concentration depicted by Table 1 (which excludes capital gains) as compared to Table 2 helps to demonstrate a further point. As Emmanuel Saez notes, the key change has been "an explosion of top wages and salaries .... [T]op income earners today are not 'rentiers' deriving their incomes from past wealth but rather are 'working rich,' highly paid employees or new entrepreneurs who have not yet accumulated fortunes comparable to those accumulated during the Gilded Age."[5] He adds that the "dramatic increase in top wage incomes has not been mitigated by an increase in mobility at the top of the wage distribution ... [Instead], the probability of staying in the top 1 percent wage income group from one year to the next has remained remarkably stable since the 1970s."[6]

Millions of Americans have noticed these changes, which affect broader social and political attitudes. In illustration, a recent survey of more than one thousand millionaires (defined as people with at least $1 million in investable assets, *excluding* real estate and retirement accounts) found that a full 42 percent did not regard themselves as wealthy, largely because they were comparing themselves to people who were wealthier still.[7] In a society where the median cash income for a full-time adult worker barely exceeds $40,000 per year,[8] evidence such as this helps to show that rising high-end income concentration, whether or not one regards it as a problem, is inescapably an important social fact in people's minds.[9]

Views will inevitably differ regarding whether, and if so how, Congress should use tax policy to address rising high-end income concentration. One point worth noting, however, relates to the still-powerful influence of the 1986 Act as a tax reform model. A fundamental aim

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but not taxes, and (3) in emphasizing taxpayer responses to changing marginal tax rates, Reynolds conflates mere timing shifts from one year to another with permanent shifts. See Piketty and Saez (2006).

[5] Saez (2011) at 4 (footnote omitted).

[6] Id. at 4 n. 4.

[7] See Reuters (2011).

[8] See Scheve (2010) at 13, noting that, in 2007, the median cash income for an adult who worked full time was $41,425.

[9] For other similar evidence, see Shaviro (forthcoming)

that was shared by both the Reagan Administration and the Congressional leaders from both parties who spearheaded enactment of the 1986 tax reform was to ensure that the Act would be roughly distribution-neutral over the five-year period following enactment. Tax rate cuts were therefore considered necessary to offset the distributional effects on high-income taxpayers of tax expenditure repeal (as well as the budgetary effects).

The changed circumstances of 2011 might lead one both to question whether tax reform should still be distribution-neutral, and to examine its distributional effects with a finer comb than was thought necessary in 1986. During the 1986 process, the use of two top income groups in measuring tax reform's distributional effects – those earning from $100,000 to $200,000, and those earning $200,000 or more – was widely accepted, without any evident concern about the difference between those who were barely in the top group and those who were millionaires or the super-rich.[10] In 2011, by contrast, the Report of the President's Fiscal Commission (henceforth, the "Fiscal Commission Report"), proposing dramatic tax and other budgetary changes to assure long-term U.S. fiscal solvency, addressed its main proposal's distributional effects on each of the following high-income groups: the 80th to 90th percentile, the 90th to 95th percentile, the 95th to 99th percentile, the top 1 percent, and the top 0.1 percent.[11]

In a similar spirit of concern about high-end income concentration, Congress could consider adding new income tax rate brackets, beginning at higher levels than any under present law, at which marginal rates above 35 percent would apply. The 2010 debate concerning extension of the expiring marginal tax rate cuts from 2001 revealed widespread sentiment that people at the very top of the U.S. income distribution face very different circumstances than those earning, say, "only" $379,150 (the income level at which the 35 percent top rate for

[10] See, e.g., Treasury Department Report to the President (1984) at 47-49.
[11] See National Commission on Fiscal Responsibility and Reform (2010) at 32.

individuals starts in 2011). Higher rates and added rate graduation do indeed raise efficiency issues that require careful consideration, but there are significant arguments in their favor as well as against them.[12]

Distributional Effects of Tax Expenditures, as Compared to Tax Rates

In evaluating how the U.S. income tax system distributes tax burdens, tax rates are only one of the two important variables. The other is the tax base, and in particular the distributional consequences of departures from taxing economic income.[13] While some departures (such as not taxing unrealized appreciation) are primarily administratively motivated and would be difficult to address even if there were a consensus that this ought to be done, for the most part no such problem exists with respect to tax expenditures, which narrow the tax base by targeting favored activities for generous treatment. Among the most important items that unambiguously are tax expenditures are home mortgage interest deductions and the exclusion from income of the value of employer-provided health insurance.[14]

In assessing such items' distributional effects, two main points are clear. First, the benefits that they provide rise sharply with income as one goes from the bottom of the income distribution to roughly the 99th percentile. Thus, consider the itemized deduction for home mortgage interest. As income rises, one is more likely to be a homeowner, and the value of one's home (as well as of the mortgage debt that it can secure) rises. One also is more likely to

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[12] See Shaviro (forthcoming) for discussion of how the academic debate concerning high rates and rate graduation has changed in the years since the passage of the Tax Reform Act of 1986.

[13] Given the subject matter of today's hearing, I ignore the question of whether income is the best tax base. In Shaviro (2004a), I sympathetically explored the case for replacing the existing income tax with a progressive consumption tax.

[14] See Joint Committee on Taxation (2010). A number of other items that regularly appear on official tax expenditure lists arguably should not be so classified. For example, tax benefits for retirement saving address the bias of the income tax against saving, and would not be classified as tax expenditures if one applied a consumption tax baseline. Taxing dividends at a lower rate than other income may reduce the otherwise existing tax bias against equity-financed corporate income. I have also argued elsewhere that a proper definition of tax expenditures, based on their serving primarily allocative rather than distributional objectives, would exclude such items as child tax credits and the earned income tax credit. See Shaviro (2004b).

claim itemized deductions, and one's marginal tax rate, which determines the tax saving per dollar of deductions, gradually rises. A similar analysis applies to the employer-provided health insurance exclusion (except that one need not itemize deductions in order to claim it). For these reasons, both items raise after-tax income more for higher-income than for lower-income taxpayers.[15]

Second, however, individuals at the very top of the income distribution typically gain less from tax expenditures, relative to income, than those immediately below them.[16] This reflects two main factors. First, at very high income levels, expenditures on the subsidized activities tend to decline as a share of income. For example, someone who is earning $10 million per year is unlikely to own a home ten times as expensive (or with a mortgage ten times as high) as that owned by someone earning $1 million per year. Second, in some cases the tax law places relevant dollar ceilings on the amount of benefit that a given taxpayer can claim. For example, Internal Revenue Code section 163(h)(3) places a $1.1 million limit on the mortgage loan principal that can generate deductible interest expense.

Given the decline at the very top of the income distribution in relative utilization of tax preferences, tax reform legislation that combined (i) tax expenditure repeal with (ii) marginal rate reduction, with an eye to achieving general distributional neutrality, could not easily avoid redistributing after-tax income towards those at the very top of the distribution. As it happens, the main plan discussed in the Fiscal Commission Report avoided this effect, and imposed a greater negative percentage change in after-tax income on the top 0.1 percent of the income distribution than on any other group.[17] This, however, reflected such changes as its eliminating the lower tax rates that currently apply to dividends and capital gains (including on corporate

[15] See Toder, Harris, and Lim 22 (2009).
[16] See id.
[17] See National Commission on Fiscal Responsibility and Reform (2010) at 31-32.

stock), which arguably are not true tax expenditures insofar as they reduce the tax bias against equity-financed corporate investment. Moreover, the Fiscal Commission proposal probably would redistribute after-tax income to people at the very top of the distribution who primarily earn salaries, rather than receiving dividends and capital gains.

There are means available by which Congress could, if it chose, reduce the regressivity of tax expenditures up to the 99th percentile without repealing them altogether. For example, it could reduce the $1.1 million cap on home mortgage loan principal that generates deductible expense, and/or (as proposed in the President's budget) convert the deduction into a percentage credit at a fixed rate that is lower than the top marginal rate. Likewise, it could cap the value of employer-provided health insurance that is excludable from income, and/or require its inclusion with the offsetting allowance of a fixed-rate credit. Such ideas are worth considering on multiple grounds: to increase economic efficiency, to reduce the disproportionate benefit that high-income taxpayers currently derive from these items, and to reduce the budget deficit.

Would Repealing Tax Expenditures Suggest That Tax Rates Need to Be Reduced?

Proponents of tax expenditure repeal often propose accompanying such repeal with a second, distinct proposal: that of simultaneously lowering marginal tax rates. The aim is to prevent overall tax revenues, as officially measured, from rising as sharply as they would from stand-alone tax expenditure repeal. This combination of base-broadening with tax rate reduction was, of course, a hallmark feature of the Tax Reform Act of 1986, which was designed to be budget-neutral (and ostensibly revenue-neutral, although, as I explain below, this was a fallacy), in addition to distribution-neutral.

It should be obvious that packaging tax expenditure repeal with tax rate reduction, so that the overall set of changes enacted is merely budget-neutral, loses considerable appeal when we

face massive budget deficits with no end in sight, and thus the prospect of an unsustainable rise in our public debt that could trigger a disastrous fiscal collapse.[18] Proponents of such packages argue, however, that the offsetting tax rate cuts are necessary to prevent undue tax increases.

In so arguing, they forget the very point that often motivates calls for tax expenditure repeal, which is that items actually are actually "spending through the Tax Code," as the Fiscal Commission Report puts it.[19] Likewise, in the words of the House Committee on the Budget's Fiscal Year 2012 Budget Resolution, tax expenditures "are similar to government spending – instead of markets directing economic resources to their most efficient uses, the government directs resources to politically favored uses, creating a drag on growth."[20]

A simple hypothetical example, made famous by the late, great economist David F. Bradford (who served in two Republican Administrations) can help make clear the fundamental equivalence between tax expenditures and overt government spending. To illustrate this point, Bradford described a pretended "secret plan" to eliminate the budget deficit by formally cutting spending rather than taxes. In Step 1, all defense spending on weapons procurement would be eliminated. Suppose this saved $50 billion, but would deprive the military of vitally needed items if nothing else were done. In Step 2, therefore, a new $50 billion "weapons supplier tax credit" (WSTC) would be enacted. "To qualify for the WSTC, manufacturers will sign appropriate documents prescribed by the Secretary of Defense (looking much like today's procurement contracts) and deliver to appropriate depots weapons systems of prescribed characteristics. The

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[18] See, e.g., Burman, Rohaly, Rosenberg, and Lim (2010).
[19] National Commission on Fiscal Responsibility and Reform (2010) at 15.
[20] House Committee on the Budget (2011) at 51. See also Feldstein, Feenberg, and MacGuineas (2011) at 10, noting that tax expenditures are a "substitute for direct government outlays."

WSTC, which may be transferred to other taxpayers without limit, may only be used in payment of income tax. Step 2 is, apparently obviously, a [$50 billion] tax cut."[21]

Steps 1 and 2 would leave absolutely everything unchanged. The military would have the same weapons as previously, and the companies that supplied the weapons would have exactly as much money as previously. As officially measured, however, both "tax revenues" and "spending" would have declined by $50 billion. Thus, the accompanying enactment of a $50 billion tax increase, such as via higher rates, would mean that deficit reduction – officially, but not in economic substance – had been accomplished purely by cutting "spending" in the amount of $50 billion.

If tax expenditures are equivalent to government spending – as the WSTC example makes clear, and as seems unmistakable with respect to items such as the home mortgage interest deduction and the exclusion for employer-provided health insurance[22] – then repealing them is in economic substance a spending cut, not a tax increase. Indeed, the House Committee on the Budget's Fiscal Year 2012 Budget Resolution, although a bit circumspect in its tax expenditure discussion, clearly recognizes this. It describes tax expenditure repeal as good in itself, despite the fact that it would increase total tax revenues as officially measured, and argues that simultaneously lowering income tax rates would provide a second and distinct benefit by increasing "incentives for economic growth."[23] The only claimed relationship in the Budget Resolution between the two proposed changes is that tax expenditure repeal would help make the rate cuts affordable – a point that would equally hold if direct spending were being further reduced instead.

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[21] Bradford (2003).
[22] As noted above, however, the "disguised spending" label may be inapt as to other items commonly listed as tax expenditures.
[23] See House Committee on the Budget (2011) at 51-52.

In sum, while stand-alone tax expenditure repeal would increase officially measured tax revenues, it would not make the government "larger" in any meaningful economic sense. Indeed, to exactly the same extent as cutting direct spending, it would both reduce government intervention in the economy and make our long-term fiscal path more sustainable, thus easing economic uncertainty and lowering the risk of a future fiscal catastrophe. Given the economic equivalence between tax expenditures and direct spending, it is simply nonsense to say that reducing the former, as compared to the latter, should have any effect on whether one simultaneously chooses to reduce income tax rates.

The fundamental point about form versus economic substance that tax expenditure analysis helps to make clear shows that, when Congress enacts simultaneous tax base and tax rate changes, as it did in 1986, "revenue neutrality" is merely a semantic goal, having no definite relationship to the economic substance of what has been done. Thus, suppose for simplicity that all Congress did in 1986 had been to (a) repeal unambiguous tax expenditures and (b) reduce tax rates, with the overall package being budget-neutral since the budgetary gain from (a) equaled the budgetary loss from (b). Calling these changes "revenue-neutral" as well as "budget-neutral" would be literally correct, in terms of the effect on officially measured post-enactment revenues. However, it would not be an economically meaningful description, given that, if the eliminated tax expenditures had instead been structured as identical direct spending rules, the 1986 changes, while still budget-neutral, would instead have been described as substantially *reducing* both taxes and spending. The latter description would be economically more accurate, however, since "spending," in this context appears really to mean rules that, as in the case of tax benefits for

home ownership or health insurance, primarily address resource allocation (i.e., the economic quantity of alternative activities and assets) rather than income measurement.[24]

One could still argue for rate cuts, on the view that they are sufficiently desirable to be worth the potentially substantial budgetary loss relative to stand-alone tax preference repeal. However, in assessing such arguments, the following points should be kept in mind:

(1) Base-broadening, such as through the repeal of tax expenditures, generally weakens, rather than strengthens, the efficiency case for lowering tax rates. This reflects that a more comprehensive tax base is generally less avoidable. In the income tax setting, as base-broadening increasingly eliminates devices for reducing one's taxable income *other* than by actually working or saving less, empirical evidence strongly confirms that avoidance responses significantly decline.[25] To put the point more generally, from a strict economic efficiency standpoint, a higher rate and a broader base function as complements, whereas 1986-style tax reform treats them as if they were substitutes.[26]

(2) No serious analyst today believes that cutting individual income tax rates, given their present levels, has any chance whatsoever of raising net revenue. While the well-known Laffer curve correctly posits that any given tax base is likely to have a revenue-maximizing rate below

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[24] See generally Shaviro (2004b). In illustration, consider the income tax expenditure for municipal bond interest, which is excluded from taxable income. While, from a consumption tax standpoint, *neither* municipal bond interest nor other interest income should be included in the tax base, no sane person could argue that municipal bond interest isn't "income," whereas other interest *is* income. Thus, only an allocative goal of favoring state and local government borrowing relative to other borrowing could be used to rationalize excluding municipal bond interest from income in an income tax framework, or distinguishing between the two types of interest receipts in *any* reasonable tax framework.

[25] See, e.g., Kopczuk 2005 (empirical study of the aftermath of passage of the Tax Reform Act of 1986). Kopczuk finds that the 1986 Act significantly "reduced the marginal cost of collecting a dollar of tax revenue, with roughly half of this reduction due to the base broadening and the other half due to the tax rate reduction," and concludes more generally that "behavioral elasticity is not an immutable parameter but rather ... [is] to some extent controlled by policy makers. One implication is that base broadening reduces the marginal efficiency cost of taxation."

[26] However, as I discuss in Shaviro (forthcoming), this is not to deny that enactment of a package in which base-broadening accompanied rate reduction both (a) made considerable political sense in 1986, though much less so today, and (b) can be a huge policy improvement where one has fixed revenue needs, and has been using a higher rate than would otherwise have been needed to offset the budgetary effects of an unduly narrow tax base.

100 percent, there is no serious dispute that the U.S. individual income tax is currently well below any such rate.[27] Again, base-broadening through the repeal of tax expenditures would make this even more clearly true.

(3) Relatedly, there is considerable consensus among economists that taxpayers' labor supply elasticity (i.e., work decisions' responsiveness to the tax rate) is generally extremely low. To be sure, there are specific groups whose labor supply can be highly tax-responsive – for example, married women, and people who still work at age 70 or above. However, the economics "profession has settled on a value for this elasticity that is close to zero for prime-age males."[28] This makes it hard to argue that raising current income tax rates at the top of the distribution, whether or not good policy all things considered, would make people below the top rate bracket worse-off by reason of any indirect effects on them of reduced high-end labor supply.

(4) There is strong evidence in the economic literature that enacting tax rate cuts, even when fully financed by the repeal of tax expenditures or direct government spending, generally does not lead to a substantial increase in the rate of economic growth.[29] To be sure, well-executed and fully financed tax cuts can have small positive effects, reflecting the improvement in taxpayers' incentives.[30] However, unfinanced tax cuts that increase long-term budget deficits can actually reduce economic growth, due to the drag imposed by public debt issuance and the

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[27] See, e.g., Saez, Slemrod, and Giertz (2009), reviewing the literature on the elasticity of taxable income. One of the best-regarded recent studies found that the revenue-maximizing tax rate would be as high as 80 percent if the income tax base were broadened. Gruber and Saez (2002).

[28] Saez, Slemrod, and Giertz (2010) at 1.

[29] See Gale and Orszag (2004) at 1193-1206 for a comprehensive literature review and discussion of theoretical issues.

[30] See, e.g., Auerbach (2002), finding that a tax cut that was immediately financed by reducing government consumption could induce a long-term 0.5 percent increase in the capital stock; Dennis et al (2004), reaching similar results in a similar scenario.

fact that economic actors generally are not stupid, and can see that future adverse changes are likely to be in the offing.[31]

More generally, U.S. "historical data show huge shifts in taxes with no observable shifts in growth rates."[32] For example, the extremely low-tax era of 1870 to 1912 had the same 3 percent annual growth rate as the relatively high-tax era from 1947 through 1999. Likewise, event studies of particular episodes when tax rates sharply increased within a short time generally fail to find any significant effect on the rate of economic growth. This lack of empirical verification is of course consistent with there being (as one would expect) *some* tendency of taxation to reduce economic growth, that merely has been drowned out by other "noise" in the comparisons that are being made. Nonetheless, "if taxes were as crucial to growth as is sometimes claimed, the large and permanent historical increases in tax burdens and marginal tax rates might be expected to appear in the aggregate growth statistics."[33]

Conclusion

My testimony has emphasized three main points. First, high-end income concentration has greatly increased since the passage of the Tax Reform Act of 1986. If one considers this trend undesirable, it could influence one's views about tax rates at the high end of the income distribution. Second, tax expenditures often benefit higher-income relative to lower-income taxpayers, although, at the very top of the income distribution, usage tends to decline as a percentage of income. Thus, 1986-style reform, in which tax rate reduction accompanies tax expenditure repeal, has a tendency to redistribute after-tax income to the very wealthiest individuals. Third, tax expenditure repeal (if it occurs) should not be viewed as strengthening the case for tax rate reduction, even if one wants to limit the size of government. From an

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[31] See, e.g., Auerbach (2004), Dennis et al (2004); Elmendorf and Reifschneider (2002).
[32] Gale and Orszag (2004) at 1206.
[33] Id.

economic standpoint, tax expenditures are spending through the tax code, even though they are scored as reducing "revenues." Moreover, while tax rate reduction (if fully financed) can have efficiency benefits, base-broadening tends to reduce these benefits. The claim that Congress could raise revenue by cutting current income tax rates is clearly wrong, and the economic growth dividend that such a policy change would yield is probably modest at best.

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Senate Finance Committee Hearing
"Is the Distribution of Tax Burdens and Tax Benefits Equitable?"
May 3, 2011
Responses to Questions for Mr. Daniel Shaviro

Questions from Senator Orrin Hatch

1. Mr. Shaviro, in your written testimony, you state that "One of the best-regarded recent studies found that the revenue-maximizing tax rate would be as high as 80 percent if the income tax base were broadened." Elsewhere in your testimony you say that "a higher rate and a broader base function as complements." In terms of the study you cite, who is it well-regarded by? Do you expect that subjecting everyone, regardless of their income, to an 80 percent tax rate and eliminating tax expenditures would maximize income to the government? Should it be the objective of government to maximize revenue in this manner? What impact would this have on economic growth and productivity? Why would someone choose to live someplace with an 80 percent rate when they could move someplace else?

   The study on taxable income elasticity that I referred to as "one of the best-regarded recent studies" was written by Emmanuel Saez and Jonathan Gruber, two of the most prominent and highly respected public finance economists in the country. Saez won the American Economic Association's John Bates Clark Medal, which is second in prestige only to the Nobel Prize, and Gruber is a leading figure in both healthcare economics and public finance, whose achievements his being considered the intellectual father of then-Governor Mitt Romney's Massachusetts healthcare plan. As an example of this article's stature in the literature, see, for example, an article by Andrew Balls in the National Bureau of Economic Research Digest, available on-line at http://www.nber.org/digest/ju100/w7512.html, which views it as an improvement on prior literature in numerous respects, including its better separation between distinct groups and controls for extraneous factors. Balls notes that the Gruber-Saez estimates are "roughly at the midpoint of the subsequent literature," rather than being in any respect an outlier.

   In designing tax rates, it is important to know the revenue-maximizing rate because anything above that would be highly counter-productive. However, such a rate is highly unlikely to be the socially optimal one. Thus, I fully agree with the tenor of your question that (a) revenue maximization is not the right objective for government finance and (b) imposing such a rate would likely do unacceptable harm to economic growth and productivity. The point my testimony makes is that the fact that the revenue-maximizing rate is so high helps to show that rates within the much lower range that are being debated in Washington are not likely to be similarly harmful.

Questions from Senator John Kerry

1. During the hearing, a statistic from the Joint Committee was repeatedly referenced. For 2009, the Joint Committee on Taxation estimated 51 percent of all households, which includes filers and non-filers, had either zero, or negative income tax liability for tax year 2009. The Committee also found that 30 percent of tax units received a refundable tax credit. Can you explain how the 51 percent that do not pay income taxes contribute their fair share in taxes? In addition, can you explain the type of refundable tax credits received by 30 percent of tax units?

   I noted at the hearing that the 51 percent rate that was being widely quoted at the hearing ignored both other taxes and other years. In other words, many households that did not pay federal income tax in 2009 likely did pay it (or will) in many other years, and even in 2009 many of them paid federal payroll and/or excise taxes, as well as income, sales, or property taxes (among others) levied by state and local governments. Refundable tax credits, such as the earned income tax credit, generally go to low-income households, often with dependent children, in which the parents are working but are earning very little.

2. Did the economic downturn impact tax liability for 2009?

   The economic downturn in 2009 had a huge impact on the above 51 percent figure. It likely would have been in the range of 35 to 40 percent under pre-recession circumstances.

3. What role do you think temporary tax credits such as the Make Work Pay Tax Credit enacted to help working families during the economic downturn had an impact on tax liability for 2009?

   Temporary items such as the Making Work Pay credit also had a significant impact on the 2009 numbers. The Making Work Pay credit both aided needy households and helped to stave off an even deeper recession.

4. Do you think refundable credits such as the Make Work Pay Tax Credit, the Earned Income Tax Credit, and the Child Tax Credit help stimulate the economy during an economic downturn? If so, do you think tax cuts to the top 1 percent have the same impact on the economy during a downturn?

   It is completely accepted among mainstream economists that a tax credit's stimulative impact depends, among other things, on the recipient's marginal propensity to consume. Items such as the Making Work Pay credit, the earned income tax credit, and the child tax credit that go to low-income households are likely to have a much stimulative effect than tax cuts for the top 1 percent in the income distribution, due to poorer households' much greater marginal propensity to spend an extra dollar that federal tax policy makes available to them.

Question from Senator Robert Menendez

1. I'm sure you have seen the IRS data which shows the wealthiest 400 taxpayers in America have seen their effective tax rates plummet in recent years even as their annual incomes have soared past $300 million dollars. Between 1992 and 2007, while most middle class families have seen almost no bump in their salaries, the average adjusted gross income of the richest 400 families has increased by over 400 percent, after adjusting for inflation: from $68 million to $345 million (in 2007 dollars). In 2007, IRS statistics showed that these families who brought in an average of $350 million dollars that year paid an effective tax rate of 16.6 percent, down from 25 percent in 1992.

   Could it be the case for the richest 400 families that despite the fact that their effective tax rates have been going down, because they have seen such enormous gains in income relative to most other families in America, they would actually be paying a higher percentage of the tax burden?

   The point of your question is entirely correct. If people at the very top of the income distribution enjoy a sufficient gain in relative income, their relative tax payments will go up as a percentage of the whole even if their effective tax rates decline.

Question from Senator Ron Wyden

1. In an effort to broaden the tax base and lower tax rates, the bipartisan tax-reform bill I've introduced with Sen. Coats of Indiana – The Bipartisan Tax Fairness and Simplification Act of 2011 (S. 727) – would change the federal subsidy for state and local tax-exempt bonds from a exemption to a tax credit.

   Tax-credit bonds can be more cost effective for the federal government according to both the Congressional Budget Office and the Congressional Research Service, because it costs the federal government less to direct development funds to state and local governments through tax credits than through tax exemptions.

   In addition, this change would make the tax code more equitable, because the value of tax credits is the same for all taxpayers, whereas the value of tax exemptions rises with a taxpayer's income.

   It's true is it not that the value of tax credits are the same for all taxpayers (whatever their income) whereas the value of tax exemptions rise in line with a taxpayer's income and don't you agree that changing tax-exempt bonds as they now exist into tax-credit bonds would make the tax code more equitable?

   I agree that converting the federal tax subsidy for state and local tax-exempt bonds from an exclusion to a tax credit would have the virtue of providing the same value per dollar of interest income to all taxpayers, rather than providing a benefit that rises with marginal tax rates. This not only may be appealing on equity grounds, but increases the efficiency of the tax incentive, by assuring that state and local governments will capture the benefit in full, rather than potentially sharing it with high-bracket taxpayers who pay tax at a higher marginal rate than the marginal investor in the marketplace for bonds.

COMMUNICATIONS

Is the Distribution of Tax Burdens and Tax Benefits Equitable?

United States Senate Committee on Finance
Tuesday, May 3, 2011, 10:00 AM
215 Dirksen Senate Office Building

Submitted by:

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Chairman Baucus and Ranking Member Hatch

Thank you for this opportunity to provide comments to the Committee.

I will leave it to the other witnesses and to the Brookings Urban Tax Policy Center to describe the current distribution of tax burdens and tax benefits and will instead address what is possible through tax reform.

Much of the thrust of public debate on tax burden reflects the fact that 51% of filers pay no Federal Income Tax. That figure is still entirely too low, since for most people the filing of personal income taxes duplicates efforts already put in by their employers, who do most of the paperwork, often at great cost, and write the checks to the U.S. Treasury. Of the 51% who file and get all of their withholding back, a significant majority require the help of professional tax preparers. Apparently, paying no taxes is not easy, although it is quite profitable for tax preparers, especially if refund anticipation loans are part of the picture. Such loans are usually quite predatory, but because the payees consider this "free money" they willingly pay up.

This money, of course, is not free. Indeed, it is not at all adequate for the main purpose for which it is designed for lower income tax payers, the provision of adequate income for low income families.

While one must look askance at any programs which transfer the responsibility for providing adequate wages from the employer and the consumer to the taxpayer, such programs make both economic and social sense in the area of family income maintenance, since in the free market, employers naturally prefer lower cost employees, all things being equal, forcing families to work harder for the same level of well being from work.

The recently expired Making Work Pay tax credit subsidized low wage labor where the preferred option would be a higher minimum wage, forcing employers and ultimately consumers to pay for the services they receive. Minimum wage laws are necessary because they level the playing field so that employers cannot initiate a "race to the bottom" by allowing workers to compete against each other to offer ever lower wages, often leaving families in the impossible position of having to bid well below what would otherwise be a reasonable standard of living in order to survive.

Income support for families, however, addresses real market failure in the employment market. It is entirely appropriate to use tax benefits to assure that all families receive a decent wage.

The United States Department of Agriculture estimates that it should cost $1,000 per month per child to provide a decent level of subsistence. The federal government could easily guarantee half of this amount using tax reform, with states providing the other half with coordinated tax benefits.

This credit would replace the earned income tax credit, the exemption for children, the current child tax credit, the mortgage interest deduction and the property tax deduction. This will lead employers to decrease base wages generally so that the average family with children and at an average income level would see no change in wage, while wages would go up for lower income families with more children and down for high income earners without children.

This shift in tax benefits is entirely paid for and it would not decrease the support provided in the tax code to the housing sector -- although it would change the mix of support provided because the need for larger housing is the largest expense faced by growing families. Indeed, this reform will likely increase support for the housing sector, as there is some doubt in the community of tax analysts as to whether the home mortgage deduction impacted the purchase of housing, including second homes, by wealthier taxpayers.

An enhanced Child Tax Credit could be used to end most income maintenance programs for poor families as well. Parents could be employed at the minimum wage to become functionally literate rather than undertake training for a job with no long term future and receive the child tax credit to supplement their incomes. No other subsistence would be required, with the training provider paying all benefits rather than relying on large, yet underfunded, social welfare bureaucracies at the state level.

The net effect of these reforms will be to end the culture of poverty. Individuals will be trained, either at public or employer expense (in lieu of taxes) to rise to the full measure of their potential. Both parents should be eligible for such benefits and occupational training without literacy training should be abolished. All too often, the fiscal, welfare and immigration policy of the United States seems designed to provide a pool of low wage workers for the food service industry – from the field to the fast food counter. While these jobs may provide some degree of upward mobility, at times they are akin to slavery. In the 21st Century, we can do better than that. If some products cannot be produced without what amounts to subsistence wages, than perhaps those products should not be produced at all, either at home or abroad. It should not, indeed it must not, be the policy of the United States Government to shield consumers from paying decent wages to those who feed us.

Tax reform can be the tool to change this, from VAT on imported goods to a decent sized child tax credit to a livable minimum wage. I urge the Congress to do so.

This proposal will also reduce the need for poor families to resort to abortion services in the event of an unplanned pregnancy. Indeed, if state governments were to follow suit in increasing child tax benefits as part of coordinated tax reform, most family planning activities would be to increase, rather than prevent, pregnancy. It is my hope that this fact is not lost on the Pro-Life Community, who should score support for this plan as an essential vote in maintaining a perfect pro-life voter rating.

Obviously, this proposal would remove both the mortgage interest deduction and the property tax deduction from the mix of proposals for decreasing tax rates while reducing the deficit. This effectively ends the notion that deficit finance can be attained in the short and medium term through tax reforms where the base is broadened and rates are reduced. The only alternatives left are a generalized tax increase (which is probably necessary to finance future health care needs) and allowing tax rates for high income individuals to return to the levels already programmed in the law as of January 1, 2013. In this regard, gridlock is the friend of deficit reduction. Should the President show a willingness to let all rates rise to these levels, there is literally no way to force him to accept anything other than higher rates for the wealthy.

Ultimately, tax rates need to rise for wealthier individuals, heirs and families. There is a natural limit on how much taxes can be increased across the board without lowering consumer spending. Tax increases to higher income individuals are not so limited, since they take from savings and returns from investment. Incentives to work less hard simply do not apply to the taxation of dividend streams, since even off-shoring these investments still requires the funds to re-enter the United States in order for them to be spent.

In the long run, continuing the tax cuts to the highest 20% of taxpayers, which includes the upper middle class, simply delays their payment to the children of the same taxpayers. As wealth becomes more stratified, it is the children of privilege rather than the entire next generation who will inherit the responsibility for repaying the national debt. Once wealthier taxpayers appreciate this fact, they will welcome higher income taxes so as not to unduly burden their own grandchildren with higher taxes in the future.

The distribution of tax benefits and burdens relates directly to the question of the distribution of the national debt, both among individuals and between the several states. I am including a separate paper on this topic as a supplement to my statement.

Again, thank you for the opportunity to submit these comments for the record.

Liability for the National Debt by State

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A common theme in discussions of the national debt is the liability of individuals or families for its repayment, usually based on per capita figures, although none of these calculations are "official." There is no place in the budget where individual liability for the debt is assigned. It is an obligation collectively held. This allows individual policy advocates to generate their own numbers, based on dividing either the total debt or the debt held by the public by the size of the population. While the amount of the national debt is fixed between auctions, debt clocks are in vogue which calculate the buildup of the debt on a constant rate based on the deficit. While this provides great dramatic effect, it is still incorrect. Population figures are also derived from estimated values based on the birth and death rates. Big brother is not watching that closely in real life.

The main value of the per capita debt figure is not public policy but public relations. This public relations campaign has sensitized many Americans to activism on this issue, often in ways that go against their individual interests, particularly in the area of entitlement spending. For example, the proposed budget advanced by the House Budget Committee suggests deep Medicare and Medicaid cuts, the former impacting anyone under 55 years of age and the former impacting the poor and state taxpayers – all in the name of reducing the debt without raising taxes – particularly taxes on the wealthy. The remainder of this essay examines whether the per capita debt figure is at all appropriate.

The size of the national debt and the federal budget as a whole began to balloon with the passage of the Sixteenth Amendment authorizing the taxation of income, with the largest growth periods occurring with World War Two and the passage of the tax legislation of Presidents Reagan and George W. Bush. Prior to this amendment, the direct taxation provisions in the United States Constitution, which apportion direct tax liability between the several states based on population enumeration, were never used because they would fall more heavily on poorer states and give less heavily on richer states. With the exception of the funding for the Civil War, which was funded by an income tax, revenue was raised from excise taxes and tariffs and government remained small.

The ability to incur debt is tied directly to the ability to repay it. As such, the appropriate way to measure individual indebtedness is in terms of individual tax liability. For the fiscal year just ended, individual income tax liability was $898 billion, while the national debt subject to limit was $15 trillion. This means that every dollar of tax liability produced seventeen dollars, twenty cents of liability for the national debt. Individuals owing no income tax liability owe no debt. Individuals with a million dollars in annual income tax liability owe more than seventeen million dollars in debt. Even if progressive income taxes were replaced with flat income taxes,

the ration would remain the same, although the distribution would change (although most flat tax schemes still exempt tens of thousands of dollars of income at the low end of the scale).

The alternative to linking debt liability to tax liability is to distribute it among the states based on population enumeration – either on a per capita basis or as a function of the number of legislators apportioned. At the end of 2010, per capita liability was $50,000 per resident, not counting the residents of the District of Columbia, who have no representation and therefore cannot be taxed on a state based levy. The debt liability allocated among the 435 voting House members is $35.5 Billion per district. The attached table compares the tax liability for citizens in each state based on income tax liability with per capita and House district liability.

This allocation illustrates why a direct tax based on census enumeration was never implemented. Richer states tend to owe less, and in the case of Connecticut, quite a bit less, on a per capita basis than on an income tax liability allocation of the debt. Meanwhile, the poorest states, like Alabama, Mississippi and Arkansas, owe much more on a per capita basis than on an allocation based on income tax liability. It is ironic that those states where the populace is most against income taxation benefit the most from an income tax liability basis for allocating the debt, even though such an allocation is clearly in their interests.

Most individuals are also better off when debt liability is a function of income tax liability. Those who pay no taxes have no liability. Filers between $50,000 and $75,000 have an average tax liability of $5,590, yielding a debt liability of $96,151. For a couple or an individual with one child, that is roughly equal to the $100,000 in debt liability calculated on a per capita basis. However a family with the same tax liability and two parents with two children owes twice as much on a per capita basis. Adding children with an income tax based liability actually lowers or eliminates liability as exemptions and credits add up too, however on a per capita basis, liability for the debt increases with more children. While in the long term, more children will mean more liability on an income tax basis that is only realized when the children begin earning money on their own, not in the current year.

In the long run, both the national debt and our obligations for retiree income support and health care are easier to meet with more children now who will become tax payers later, so perhaps the real solution to this crisis is to give families more money while taking tax subsidies from the wealthy, most especially the home mortgage and property tax deductions. Ending these deductions could buy enough tax revenue to fund a $500 per child per month credit, which would inevitably raise the birth rate while increasing the demand for housing, although the mix will be changed somewhat.

State	Total Tax Liability 2008 in thousands	Tax Liability Estimate 2010 in millions	Population (2010)	House Seats 2010 Census	State Debt Liability by Tax Burden In Billions	State Debt Liability based on population in Billions	State Debt Liability based on Delegation Size in Billions	Change in liability if based on population rather than income tax	Change in liability if based on delegation size rather than income tax
Alabama	$11,560,328	$9,586	4,802,982	7	$164.9	$240.1	$248.8	46%	51%
Alaska	$2,874,802	$2,384	721,523	1	$41.0	$36.1	$35.5	-12%	-13%
Arizona	$16,906,652	$14,020	6,412,700	9	$241.2	$320.6	$319.8	33%	33%
Arkansas	$6,259,233	$5,190	2,926,229	4	$89.3	$146.3	$142.2	64%	59%
California	$142,099,857	$117,835	37,341,989	53	$2,027.3	$1,867.1	$1,883.5	-8%	-7%
Colorado	$19,013,866	$15,767	5,044,930	7	$271.3	$252.2	$248.8	-7%	-8%
Connecticut	$24,551,029	$20,359	3,581,628	5	$350.3	$179.1	$177.7	-49%	-49%
Delaware	$2,977,399	$2,469	900,877	1	$42.5	$45.0	$35.5	6%	-16%
District of Columbia	$3,797,268	$3,149	n/a	0	$54.2	$0.0	$0.0	n/a	n/a
Florida	$65,197,018	$54,064	18,900,773	27	$930.2	$945.0	$959.5	2%	3%
Georgia	$26,048,208	$21,600	9,727,566	14	$371.6	$486.4	$497.5	31%	34%
Hawaii	$3,953,974	$3,279	1,366,862	2	$56.4	$68.3	$71.1	21%	26%
Idaho	$3,359,839	$2,786	1,573,499	2	$47.9	$78.7	$71.1	64%	48%
Illinois	$52,797,528	$43,782	12,864,380	18	$753.3	$643.2	$639.7	-15%	-15%
Indiana	$16,522,894	$13,701	6,501,582	9	$235.7	$325.1	$319.8	38%	36%
Iowa	$8,187,450	$6,789	3,053,787	4	$116.8	$152.7	$142.2	31%	22%
Kansas	$8,902,107	$7,382	2,863,813	4	$127.0	$143.2	$142.2	13%	12%
Kentucky	$9,487,898	$7,868	4,350,606	6	$135.4	$217.5	$213.2	61%	58%
Louisiana	$14,619,104	$12,123	4,553,962	6	$208.6	$227.7	$213.2	9%	2%
Maine	$3,262,066	$2,705	1,333,074	2	$46.5	$66.7	$71.1	43%	53%
Maryland	$24,260,215	$20,118	5,789,929	8	$346.1	$289.5	$284.3	-16%	-18%
Massachusetts	$34,224,437	$28,380	6,559,644	9	$488.3	$328.0	$319.8	-33%	-34%
Michigan	$27,570,424	$22,862	9,911,626	14	$393.3	$495.6	$497.5	26%	26%
Minnesota	$19,439,227	$16,120	5,314,879	8	$277.3	$265.7	$284.3	-4%	3%
Mississippi	$5,661,145	$4,694	2,978,240	4	$80.8	$148.9	$142.2	84%	76%
Missouri	$17,066,740	$14,152	6,011,478	8	$243.5	$300.6	$284.3	23%	17%
Montana	$2,475,970	$2,053	994,416	1	$35.3	$49.7	$35.5	41%	1%
Nebraska	$5,198,821	$4,311	1,831,825	3	$74.2	$91.6	$106.6	23%	44%
Nevada	$9,167,324	$7,602	2,709,432	4	$130.8	$135.5	$142.2	4%	9%
New Hampshire	$5,365,477	$4,449	1,321,445	2	$76.5	$66.1	$71.1	-14%	-7%
New Jersey	$47,774,734	$39,617	8,807,501	12	$681.6	$440.4	$426.5	-35%	-37%
New Mexico	$4,829,902	$4,005	2,067,273	3	$68.9	$103.4	$106.6	50%	55%
New York	$99,939,134	$82,873	19,421,055	27	$1,425.8	$971.1	$959.5	-32%	-33%
North Carolina	$23,996,989	$19,899	9,565,781	13	$342.4	$478.3	$462.0	40%	35%
North Dakota	$2,181,457	$1,809	675,905	1	$31.1	$33.8	$35.5	9%	14%
Ohio	$31,762,030	$26,338	11,568,495	16	$453.1	$578.4	$568.6	28%	25%
Oklahoma	$10,508,085	$8,714	3,764,882	5	$149.9	$188.2	$177.7	26%	19%
Oregon	$10,255,726	$8,504	3,848,606	5	$146.3	$192.4	$177.7	32%	21%
Pennsylvania	$43,566,765	$36,127	12,734,905	18	$621.6	$636.7	$639.7	2%	3%
Rhode Island	$3,572,181	$2,962	1,055,247	2	$51.0	$52.8	$71.1	4%	39%
South Carolina	$10,133,407	$8,403	4,645,975	7	$144.6	$232.3	$248.8	61%	72%
South Dakota	$2,480,573	$2,057	819,761	1	$35.4	$41.0	$35.5	16%	0%
Tennessee	$16,724,497	$13,869	6,375,431	9	$238.6	$318.8	$319.8	34%	34%
Texas	$93,631,621	$77,643	25,268,418	36	$1,335.8	$1,263.4	$1,279.4	-5%	-4%
Utah	$6,481,722	$5,375	2,770,765	4	$92.5	$138.5	$142.2	50%	54%
Vermont	$1,891,833	$1,569	630,337	1	$27.0	$31.5	$35.5	17%	32%
Virginia	$31,539,817	$26,154	8,037,736	11	$450.0	$401.9	$390.9	-11%	-13%
Washington	$25,800,013	$21,394	6,753,369	10	$368.1	$337.7	$355.4	-8%	-3%
West Virginia	$3,923,908	$3,254	1,859,815	3	$56.0	$93.0	$106.6	66%	90%
Wisconsin	$17,040,598	$14,131	5,698,230	8	$243.1	$284.9	$284.3	17%	17%
Wyoming	$2,739,420	$2,272	568,300	1	$39.1	$28.4	$35.5	-27%	-9%

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Statement of Max Richtman, Executive Vice President and Acting CEO
National Committee to Preserve Social Security and Medicare
Senate Committee on Finance
Hearing on Budget Enforcement Mechanisms
May 3, 2011

As Executive Vice President and Acting CEO of the National Committee to Preserve Social Security and Medicare, I appreciate the opportunity to submit this statement for the record. With millions of members and supporters across America, the National Committee is a grassroots advocacy and education organization devoted to the retirement security of all citizens.

In an effort to address the nation's current debt and deficit problem, policymakers are considering a number of budget enforcement mechanisms. These mechanisms would enact budgetary procedures that set limits on the amount of spending by the federal government. Whether through a balanced budget amendment, specific dollar caps on discretionary or direct spending, or caps based on spending as a percentage of GDP, these enforcement mechanisms pose a dangerous threat for retirees both today and in the future.

If enacted and applied to Social Security and Medicare, these mechanisms would require across-the-board spending cuts ("a sequester") to close the gap between projected spending and the level at which the cap has been set, if the cap were to be exceeded. Never before have Social Security or Medicare been included in similar sequestrations. They were exempt from automatic cuts under Gramm-Rudman-Hollings and are exempt under today's Pay-As-You-Go sequestration rules.

Unfortunately, the nation's debt problems cannot be solved by simply establishing spending caps and declaring the crisis over. They require difficult policy decisions weighing which programs would be reduced or eliminated and how beneficiaries of those programs would be affected. More importantly, spending caps do nothing to address the appropriate level of federal revenue, or the $1 trillion in tax expenditures that add to our deficit.

How would sequestration of Social Security and Medicare affect seniors? Policymakers could avoid across-the-board cuts by making specific reductions to programs to meet established targets before a sequester would occur. However, depending on when the caps are initiated and the level at which they are set, the impact could be immediate, affecting even current beneficiaries. And even if Congress does act and adjust the programs, the reductions would be dramatic if some of the cap levels currently under consideration are enacted.

If a budget enforcement mechanism including Social Security and Medicare is enacted and Congress does not act to avoid sequestration, our nation's seniors may open their mail to find they are being notified of a percentage reduction in their monthly Social Security check.

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Many of these same seniors rely on Social Security benefits for all or most of their income in retirement, and are already facing the erosion of their primary means of financial support through Cost-of-Living Adjustments that do not fully keep up with inflation, or are not provided at all, as has been the case for the past two years. Cutting their modest benefits through automatic sequestration tied to spending in the rest of government could create significant hardship to millions of seniors who rely on fixed incomes in retirement.

Seniors paid their Social Security taxes during their working years so that they would have a safe, reliable source of income in their retirement. Subjecting them to the vagaries of sequestration, not knowing from one year to the next how much their Social Security benefits might be reduced, all in the name of meeting an arbitrary spending cap level, is a violation of our country's compact with its citizens. Social Security did not the cause the nation's debt problems and Social Security beneficiaries, who worked all their lives and paid into the system, should not be expected to pay for our fiscal mistakes.

We believe it would be equally unacceptable to subject Medicare to sequesters tied to arbitrary global spending caps. If spending is projected to exceed the caps, the reductions necessary to bring spending under the caps would no doubt be dramatic, almost certainly affecting current beneficiaries and the health care providers who serve them. If Congress fails to act and a sequester ensues, what would happen? Payments to doctors and hospitals would have to be reduced by the percentage necessary to bring spending under the cap levels. Seniors may be asked to pay out-of-pocket for these expenses while many providers, no longer able to tolerate the additional uncertainty in their reimbursement rates, would likely stop treating Medicare patients, potentially leaving millions of seniors foregoing the care that they need.

Although all businesses are subjected to some uncertainty by virtue of the nature of the business cycle, cuts triggered by sequestration would only apply to providers willing to accept Medicare patients. This would place an unreasonable burden on those providing health care services to the elderly and disabled, and could well create a crisis as providers increasingly close their practices to Medicare patients.

Additionally, one can only imagine the bureaucracy that would be required to inform beneficiaries, hospitals and physicians of these unanticipated changes in their payments and respond to their questions and concerns.

We all agree that the nation's debt problems must be addressed, Social Security's long-term financing issues must be solved and health care costs must be brought under control. These problems can be solved by policymakers developing thoughtful solutions to specific problems, not by simply passing laws that mandate across-the-board cuts. These solutions should be developed without placing undue burdens on today's seniors and future retirees.