NATIONAL CENTER FOR POLICY ANALYSIS

Congressional Brief: Tax Reform

In 2011, the rate relief, new 10-percent tax bracket, death tax repeal, marriage penalty relief and all the remaining tax cuts enacted in 2001 and 2003 will sunset, resulting in substantial tax increases for every American who pays income taxes. The deficit and public debt has grown because of greatly increased spending rather than tax cuts.

Key Facts about the U.S. Tax System

- The top U.S. corporate income tax of 39.25 percent (including average state taxes) is the second-highest in the world, after Japan's 39.54 percent. The average was 27.6 percent among countries in the Organization for Economic Cooperation and Development (OECD) in 2007.
- The current 45 percent estate tax is the third-highest in the developed world; if it returns to a 55 percent rate in 2011, it will be the highest in the world.
- The income tax system has become more progressive in recent years, with the share paid by the top 1 percent of earners growing from 25.8 percent in 1986 to 36.9 percent in 2004, whereas the share paid by the bottom 50 percent fell from 6.5 percent to 3.3 percent.
- Nearly half of U.S. taxpayers who reported dividend income in 2003 earned less than $50,000 annually.
- Nearly half of tax returns reporting capital gains in 2005 were from households with incomes below $50,000 (79 percent were for households earning less than $100,000).
- Although originally aimed at wealthy households with high deductions, the Alternative Minimum Tax (AMT) will affect more than one-third of taxpayers (39 million) by 2017.

Progressive Taxes

The income tax system has become more progressive in recent years — meaning higher income taxpayers pay a larger share of income tax revenues and a larger share of their incomes in taxes.

- For instance, between 2001 and 2004, the income share of the top 1 percent of earners rose 8.6 percent, but their tax burden over the same period rose 8.9 percent.
- In contrast, the income share of the bottom 50 percent of earners fell 2.8 percent, but their tax burden fell almost 17 percent.

Regressive Taxes

Due to the complicated U.S. tax system and benefit programs, low- and middle-income families can face higher effective tax rates than Bill Gates or Warren Buffett on the next dollar earned or saved.

- For 30-year-old couples earning $20,000 a year, economist Laurence Kotlikoff estimates that the effective marginal tax rate on an additional dollar earned is 42.5 percent, whereas those earning $50,000 face a marginal tax rate of only 24.4 percent.
- A 30-year-old single parent earning $10,000 a year faces an effective 72.3 percent tax on an additional dollar earned due to his or her loss of welfare benefits, higher than the 36.9 percent tax on a single parent earning $200,000.
- Similarly, a 30-year-old single parent earning $15,000 a year faces an effective marginal tax on saving of 260 percent, whereas a parent earning $250,000 faces a tax on saving of only 31 percent.
- The estates of the middle class lose a greater percentage of their value to the estate tax than those of the super-rich.
- The 12.4 percent Social Security payroll tax (half of which is paid directly by the employee) is levied only

www.ncpa.org
Dallas Headquarters: 12770 Coit Road, Suite 800, Dallas, TX 75251
Washington Office: 601 Pennsylvania Avenue NW, Suite 900, South Building, Washington, D.C. 20004
NCPA NATIONAL CENTER FOR POLICY ANALYSIS

on the first $106,800 of income (in 2009), thus higher wage workers can face a lower marginal tax on additional work than low-income workers.

- Excise taxes on alcohol, tobacco, utilities and gasoline are especially regressive, with the lowest fifth of income earners spending nearly one-third of their income, on the average, on these products, whereas the highest earners spend just 6 percent of their income on these items.

Tax Cuts that Raise Revenues and Incomes

Official revenue forecasts from tax rate increases or cuts are static — they do not account for the effects of tax changes on the economy or individual behavior. But experience has shown that some tax cuts can increase revenues, create jobs and raise the rate of economic growth.

- The Joint Economic Committee of Congress estimated that the pre-2001 estate tax reduced the capital stock by about $500 billion; thus, repeal of the estate tax would increase the stock of capital that fuels growth.
- Revenues from capital gains — which are taxed when an asset is sold — doubled when rates were cut from 20 percent and 10 percent (depending on income) to 15 percent and 5 percent, respectively.
- Whereas the Congressional Budget Office (CBO) projected capital gains revenues under the old rates would expand from $50 billion in 2003 to $68 billion in 2006, revenues more than doubled to $103 billion.
- After the top tax rate for stock dividends was cut from 35 percent to 15 percent in 2003, net individual dividend income from Standard & Poor's 500 firms increased 50 percent over the previous year.

Key Facts about Spending & the Deficit

- From 1993 to 2000, federal revenues increased 75.4 percent, whereas spending increased slightly less than 27 percent.
- From 2001 to 2007, federal revenues increased nearly 29 percent, whereas spending increased 46.5 percent.
- As a result, the U.S. public debt rose from $5.7 trillion in 2000 to $10.6 trillion as of January 2009.
- Even without new economic stimulus spending, the CBO projects a federal deficit of $1.2 trillion in 2009, 8.3 percent of gross domestic product (GDP).
- Add in the economic stimulus package and the federal deficit could reach $1.8 trillion (12.5 percent of GDP) or more for 2009.

NCPA Policy Recommendations

- **Make Income Tax Cuts Permanent**. Lower tax rates, especially at the margin, encourage work, investment and reduce tax avoidance.
- **Repeal the AMT**. On the grounds of tax efficiency, simplicity and fairness, the AMT should be repealed immediately and not replaced with some other, massive tax hike. At the very least it should be indexed to inflation so that it does not fall on more middle-class taxpayers.
- **Repeal the Estate Tax**. The estate tax generates little revenue for the federal government, but negatively affects every American. It reduces capital formation, and thereby lowers productivity, wages, employment and federal revenues from payroll and income taxes.
- **Make Dividends Tax Cuts Permanent**. Dividends represent part of a company's cost of capital. When dividends taxes fall, the cost of capital falls, and business managers tend to increase their firms' investment in equipment and buildings. These investments usually result in new job creation and higher incomes for employees.
- **Make the Capital Gains Cuts Permanent**. Keeping capital gains taxes low would help relieve federal budget deficits by increasing government revenue and encouraging greater capital investment. The value of taxable gains should be indexed for inflation, which accounts for 20 to 25 percent of total gains reported.