INTRODUCTION
What is the Briefing Book?

When policymakers testify before Congress or get grilled on Sunday morning interview programs, they carry with them a briefing book, a binder full of questions and answers prepared by their staff covering (they hope) every topic that might come up. The document on your screen is page one of your briefing book on tax and budget policy, a compendium of information on a host of questions likely to be addressed during the 2012 presidential election debate and beyond. This briefing book is intended as a resource for the public, the press, and even the presidential campaigns—in short, for anyone who wants to be well informed about current tax and budget matters.

Many of these questions deserve to come up—and be vigorously debated—in the 2012 campaign, for tax policy today is at a critical juncture. Most of the individual income tax cuts enacted since 2001 are scheduled to expire at the end of 2012. Congress faces a decision about whether to extend some or all of the tax cuts, or modify some while keeping others intact, or start with a clean slate and overhaul the tax system entirely. Adding to the pressure is the individual alternative minimum tax (AMT), which Congress has repeatedly "patched" to prevent tens of millions of middle-income taxpayers from being swept into its net. All of these issues are cast against a background of federal budget deficits that will soon grow dramatically if nothing is done. In 2013 a new president and a new Congress, whatever its composition, will have to confront the daunting scope and nature of tax changes needed to address these challenges.

The candidates in the 2012 presidential race have offered voters markedly different proposals to change the federal tax system; these range from extending the recent tax cuts only for low- and middle-income households to replacing all federal taxes with a consumption tax. Evaluating these proposals requires a clear understanding of the complexities, inequities, and inefficiencies of the current tax system and the implications of the changes proposed. Beyond the election, that same knowledge will be needed to enlighten the debate about how to deal with the upcoming sunset of the 2001-10 tax cuts.

This Tax Policy Briefing Book offers a broad array of short explanations of important tax issues. Some simply provide background on the current state of tax and budgetary affairs: How much revenue does the federal government raise from which sources? How do Congress and the president decide on a budget? Others explain the key elements of the tax system: What taxes are now on the books? How do they affect individuals, families, and businesses? How do those effects change over time? Still others look forward, evaluating various proposals to improve the federal tax system: What incremental reforms would make the system work better? What impacts would more fundamental reforms have? Finally, a set of entries examines how state and local governments raise funds and how their taxes interact with the federal tax system.
How is the Briefing Book Organized?

The briefing book is organized into four topic areas: background, key elements of the U.S. tax system, ways to reform it, and taxes at the state and local level. Links at the end of each entry take you to related entries, references containing additional information, and revenue and distributional tables. The Glossary link on the left side of each page takes you to a chapter containing definitions of many technical terms related to taxation and budgeting.

- **Some Background**: discusses general aspects of the tax system.
- **Key Elements of the US Tax System**: discusses specific aspects of our tax system and how they affect taxpayers.
- **How Could We Improve the Federal Tax System**: addresses changes that could make the current tax system simpler, fairer, and more efficient.
- **The State of State (and Local) Tax Policy**: looks at how state and local governments raise funds to finance government services and other activities.
- **Glossary**: defines a broad range of terms used in the briefing book.
- **Appendix: TPC's Greatest Tables**: brings together a collection of often-requested revenue and distributional tables, covering a broad range of tax laws and proposals.
How Should the Use the Briefing Book Be Used?

The Tax Policy Briefing Book is not like other books; few if any readers will start with the first brief and read straight through to the conclusion. Instead you can pick a topic, read the basic information on it, and then follow the links to related entries in the briefing book or to supporting data tables and publications.

"Print" buttons on every entry allow you to print out that entry. Of course, we plan to continually expand and update the online book, so you may want to check online for new material from time to time. For example, we plan to add a new chapter devoted to the tax proposals offered by the presidential candidates. And we will be adding more topics and features to the book after the 2008 election, when the contours of the tax policy debate become clearer.
THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the
2012 Election and Beyond

THE NUMBERS

What are the federal government’s sources of revenue? .............................................................. I-1-1
How does the federal government spend its money? ................................................................. I-1-4
What is the breakdown of revenue among federal, state, and local governments? .................. I-1-6
How do U.S. taxes compare internationally? ........................................................................... I-1-7
The Numbers: What are the federal government’s sources of revenue?

Individual income taxes and payroll taxes accounted for 82 percent of all federal revenues in fiscal year 2010. Corporate income taxes contributed another 9 percent. Excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts (earnings of the Federal Reserve System and various fees and charges) made up the balance. The composition of tax revenue has changed markedly over the past half century. The share coming from individual income taxes has remained roughly constant, while payroll taxes have accounted for a larger share and corporate income and excise taxes smaller shares.

- In 2010 the federal government collected $2.2 trillion, an amount equal to 14.9 percent of GDP. Federal revenue has ranged from 14.4 of GDP in 1950 to 20.6 percent in 2000 over the past five decades, averaging 17.9 percent.

- The individual income tax has been the largest single source of federal revenue since 1950, averaging 8 percent of GDP.

- Payroll taxes swelled following the creation of Medicare in 1965. Taxes for Medicare, combined with periodic increases in Social Security taxes, caused payroll tax revenue to grow from
1.6 percent of GDP in 1950 to 6 percent or more since 1980. Payroll taxes also include railroad retirement, unemployment insurance, and federal workers’ pension contributions.

- Revenue from the corporate income tax fell from between 5 and 6 percent of GDP in the early 1950s to 1.3 percent of GDP in 2010.

- Excise taxes fell steadily throughout the same period, from nearly 3 percent of GDP in 1950 to 0.5 percent in recent years.

- The remaining sources of revenue have fluctuated less, together claiming between 0.5 and 1.0 percent of GDP since 1950 and standing near the bottom of that range in 2010.

Changes in the shares of the various taxes in total federal revenue reflect these historical shifts. The individual income tax has consistently provided nearly half of total federal revenue since 1950, while other revenue sources have waxed and waned. Excise taxes brought in 19 percent of total revenue in 1950 but only about 3 percent in recent years. The share of revenue coming from the corporate income tax dropped from about one-third in the early 1950s to less than a tenth in 2010. In contrast, payroll taxes provided two-fifths of revenue in 2010, four times its one-tenth share in the early 1950s.
See Also

The Numbers: How does the federal government spend its money?

The Numbers: What is the breakdown of tax revenues between federal, state, and local governments?

The Numbers: How do U.S. taxes compare internationally?

Data Sources

Budget of the United States Government, Fiscal Year 2012, Historical Tables, Table 2.1, Receipts by Source: 1934-2016

Budget of the United States Government, Fiscal Year 2012, Historical Tables, Table 10.1, Gross Domestic Product and Deflators Used in the Historical Tables: 1940-2016

Further Reading


Author: Roberton Williams
Last Updated: September 13, 2011
The Numbers: How does the federal government spend its money?

About 55 percent of federal government spending in fiscal 2010 was mandatory, covering all expenditures that are controlled by laws other than appropriations acts (see figure 1). Almost all such spending is for entitlements, expenditures for which depend on individual eligibility and participation, and which are funded at whatever level is needed to cover the resulting costs. Just under 40 percent of spending in fiscal 2010 was discretionary, covering activities that Congress must reauthorize each year. The remainder went to pay interest on the national debt.

- Mandatory spending has claimed a much larger share of the federal budget over the past four decades, more than doubling from about one-fourth of federal spending in 1962 to just over half today (see figure 2). In contrast, the share of the budget going for discretionary spending has fallen from two-thirds in 1962 to about two-fifths now. Interest on the national debt has fluctuated over the period: it climbed from 6 percent in 1962 to more than 15 percent in the mid-1990s, fell to about 7 percent in the early 2000s, and has fluctuated more recently as interest rates have fallen to historically low levels. Debt service accounted for just 5 percent of federal spending in 2010, the lowest level in nearly 50 years.
About half of fiscal 2010 discretionary spending paid for defense, and most of the rest went for domestic programs such as agricultural subsidies, highway construction, and the federal courts (see figure 3). Only 3 percent of discretionary spending funded international activities, such as foreign aid.

Social Security claimed one-third of mandatory spending in fiscal 2010 (see figure 4). Medicare and Medicaid took up 25 percent and 13 percent, respectively. The remaining 29 percent covered income security programs (such as food stamps), retirement and disability programs (including pensions for federal retirees), and other programs.
Figure 3. Composition of Discretionary Spending, Fiscal 2010

Source: Budget of the United States Government, Fiscal Year 2012, Historical Tables: Table 8.7; http://www.whitehouse.gov/omb/budget/Historicals

Figure 4. Composition of Mandatory Spending, Fiscal 2008

Source: Congressional Budget Office, Budget and Economic Outlook, Fiscal Years 2011 through 2021, Historical Budget Data, Table E-9.
See Also

The Numbers: What are the federal government’s sources of revenue?

The Numbers: What is the breakdown of tax revenues between federal, state, and local governments

The Numbers: How do U.S. taxes compare internationally?

Author: Roberton Williams
Last Updated: September 13, 2011

Data Sources


The Numbers: What is the breakdown of revenue among federal, state, and local governments?

Federal, state, and local revenues totaled nearly $4 trillion in 2009. Federal revenue made up over 60 percent of the total, states collected about 22 percent, and local governments brought in about 17 percent. Transfers from the federal government to state and local governments and from state governments to local governments shifted the balance of resources among the three groups.

- The federal government transferred over one-fifth of its revenue (nearly one-seventh of total government revenue) to state and local governments, leaving it with 48 percent of total revenue, about $2 trillion.

- Almost all of the federal transfer went to the states, which in turn passed the equivalent of about 100 percent of this revenue to local governments.

- States collected 22 percent of total revenue from their own sources, about $900 billion.
Local governments received transfers from both the federal and state governments equal to about one-seventh of total revenue; from their own sources, they collected about $700 billion, or 17 percent of all government revenue.

See Also

- The Numbers: What are the federal government’s sources of revenue?
- The Numbers: How does the federal government spend its money?
- The Numbers: How do U.S. taxes compare internationally?

Author: Roberton Williams
Last Updated: January 24, 2012

Data Sources

- Bureau of Economic Analysis, National Income and Product Accounts. Federal Receipts: Table 3.2; State Receipts: Table 3.20; Local Receipts: Table 3.21.
The Numbers: How do U.S. taxes compare internationally?

U.S. taxes are low relative to those in other developed countries. In 2008 U.S. taxes at all levels of government claimed 26 percent of GDP, compared with an average of 35 percent of GDP for the 33 member countries of the Organization for Economic Co-operation and Development (OECD).

- Among OECD countries only Mexico, Chile and Turkey had lower taxes than the United States as a percentage of GDP. In many European countries taxes exceeded 40 percent of GDP, but those countries generally provide much more extensive government services to their citizens than the United States does.

- The United States relies less on consumption taxes—18 percent of total 2008 tax receipts—than any other OECD country. Revenue from such taxes averaged 32 percent of total taxes among the 33 OECD countries. Mexico, in contrast, collected 60 percent of its 2008 tax revenue from consumption taxes.
• Personal income taxes made up 38 percent of U.S. tax revenue in 2008, more than in most other OECD countries, where such taxes averaged 26 percent of the total. However, individual taxpayers paid a larger share of tax revenue in Denmark (52 percent) and New Zealand (41 percent).

• Corporate income taxes accounted for a slightly larger share of U.S. tax revenue, 7 percent in 2008, than the OECD average of 10 percent.

• U.S. employees, on average, contributed more in taxes for retirement and disability insurance—10 percent of total tax receipts—than many of their OECD counterparts, where such taxes accounted for 9 percent of total receipts on average. U.S. employers, however, contributed less: 12 percent of the total compared with OECD employers’ average of 15 percent.

See Also

The Numbers: What are the federal government’s sources of revenue?

The Numbers: How does the federal government spend its money?

The Numbers: What is the breakdown of tax revenues between federal, state, and local governments?

Further Reading


Data Sources

• Personal income taxes made up 35 percent of U.S. tax revenue in 2005, more than in most other OECD countries, where such taxes averaged 25 percent of the total. However, individual taxpayers paid a larger share of tax revenue in Denmark (49 percent), New Zealand (41 percent), Australia (40 percent), Switzerland (36 percent) and Canada (36 percent).

• Corporate income taxes accounted for a slightly larger smaller share of U.S. tax revenue, 11 percent in 2005, than the OECD average of 10 percent.

• U.S. employees, on average, contributed more in taxes for retirement and disability insurance-11 percent of total tax receipts-than most of their OECD counterparts, where such taxes accounted for 8 percent of total receipts on average. U.S. employers, however, contributed less: 13 percent of the total compared with OECD employers’ average of 16 percent.

See Also
The Numbers: What are the federal government’s sources of revenue?
The Numbers: How does the federal government spend its money?
The Numbers: What is the breakdown of tax revenues between federal, state, and local governments?

Data Sources
Organization for Economic Co-operation and Development, OECD in Figures, 2008 Edition

Author: Roberton Williams
Last Updated: February 26, 2009

Further Reading
THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the
2008 Election and Beyond

THE BUDGET PROCESS

The Budget Process: How does it work? ................................................................. I-2-1
The Budget Process: What is the history? ............................................................. I-2-2
The Budget Process: What is the schedule? ....................................................... I-2-3
The Budget Process: What is reconciliation? ..................................................... I-2-4
The Budget Process: How is it enforced? ........................................................... I-2-5
The Budget Process: What is PAYGO? .............................................................. I-2-6
The Budget Process: How does it work?

Each year, the Congress is supposed to pass a concurrent budget resolution setting out aggregate spending, revenue, and deficit targets for at least the next five years. "Concurrent" means that the resolution lacks the force of law and does not require the president’s signature—which, of course, implies that the president cannot veto it either.

- The budget resolution divides total spending among the main functions of government, such as defense, transportation, and health. Spending allocations are provided to individual Congressional committees and the House and Senate appropriations committees further divide their spending allocation among their subcommittees.

- The budget resolution leaves it up to individual congressional committees to decide the details of the budget, program by program, consistent with the aggregate targets. In practice, however, the general debate over the budget resolution often ends up discussing the budgets for individual programs and their implications.

- The Congressional Budget Office (CBO) was created to provide technical advice to the Congress on budget matters in a nonpartisan manner. Every bill reported to the floor by the Senate and House committees must attach a CBO cost estimate that covers at least five years, to show that the proposed spending is consistent with the budget resolution’s targets.

See Also

Budget Process: What is the history?
Budget Process: What is the schedule?
Budget Process: What is reconciliation?
Budget Process: How is it enforced?
Budget Process: What is PAYGO?

Further Reading


The Budget Process: What is the history?

Today’s congressional budget process has its origins in the Congressional Budget and Impoundment Control Act of 1974. That law sought to create a coherent process for Congress’ revenue and spending decisions and to constrain a president’s ability to impound funds appropriated by Congress.

- In 1972, newly reelected President Richard M. Nixon refused to spend funds appropriated by Congress for various social programs. Although the Constitution provides that a president may not spend money without a congressional appropriation, it was less clear whether he had to spend every dollar that Congress appropriated.

- Nixon’s impoundments were quickly challenged in court, and he lost every case at the appellate level except one. Before the Supreme Court could consider the issue, Congress moved explicitly to limit the president’s power to impound funds.

- But Nixon had an effective counterargument. He pointed out that Congress had no formal, orderly process of its own for adding up individual spending and revenue decisions and for relating total spending to total revenue. Nixon argued that if the president lacked the power to impound spending, total spending might expand without limit.

- Congress realized that Nixon had won the substantive argument and that it could not limit the president’s impoundment powers unless it created a formal budget process of its own. It responded by passing the Congressional Budget and Impoundment Control Act of 1974.

See Also

Budget Process: How does it work?
Budget Process: What is the schedule?
Budget Process: What is reconciliation?
Budget Process: How is it enforced?
Budget Process: What is PAYGO?

Further Reading


Author: Rudy Penner
Last Updated: September 3, 2007
The Budget Process: What is the schedule?

The budget process begins each year with the submission of the president’s budget for the following fiscal year, usually no later than the first Monday in February. The process is slated for completion by June 30, but that almost never happens.

- Within six weeks following submission of the president’s budget, the various congressional committees are expected to submit reports to the House and Senate budget committees outlining how their spending and revenue proposals will differ from those of the president’s budget.

- After compiling this information, the budget committees are expected to formulate a concurrent budget resolution by April 15, after which the House Appropriations Committee may begin the appropriations process. If the budget resolution is not passed by May 15, the House Appropriations Committee may begin the appropriations process in its absence.

- All necessary appropriations bills are supposed to be passed by June 30, but they seldom are. Reconciliation bills that alter tax and entitlement laws are supposed to be completed by June 15.

- If appropriations are not completed by October 1 - and that is common - federal agencies are funded under continuing resolutions that typically cover spending for only part of a year, but may sometimes be extended to cover the whole fiscal year. These resolutions typically limit spending to last year’s level or to the lower of House or Senate approved spending levels if legislative action has not yet been completed by the whole Congress.

- Congress successfully passed budget resolutions each year from the first effective year of the process in fiscal 1976 through 1998. The failure to pass a budget resolution has become more common in recent years, as the whole Congress was not able to pass resolutions for fiscal 1999, 2003, 2005, and 2007.

See Also

Budget Process: How does it work?
Budget Process: What is the history?
Budget Process: What is reconciliation?
Budget Process: How is it enforced?
Budget Process: What is PAYGO?

Further Reading


Author: Rudy Penner
Last Updated: September 2, 2007
The Budget Process: What is reconciliation?

Congress uses the reconciliation process when it wants to legislate policy changes in mandatory or other direct spending or tax laws to achieve the budget resolution’s goals.

- Budget resolutions may contain "reconciliation instructions" that tell the relevant committees how much they should alter revenue or entitlement outlays to make them consistent with the resolution’s targets.

- The committees’ actions responding to these instructions are then bundled into a reconciliation law. Assuming they are free of points of order, reconciliation laws can be passed in the Senate by a simple majority; they do not require the sixty votes necessary to shut off a filibuster.

- The content of reconciliation laws is limited by the Senate’s Byrd rule, which, in general, disallows items that do not affect outlays or revenue. The Byrd rule also prohibits initiatives that would increase the deficit beyond the time horizon used for the budget resolution. This is the main reason that the tax cuts of the early 2000s and certain other tax initiatives are temporary.

See Also

Budget Process: How does it work?
Budget Process: What is the history?
Budget Process: What is the schedule?
Budget Process: How is it enforced?
Budget Process: What is PAYGO?

Further Reading


Author: Rudy Penner
Last Updated: September 2, 2007
The Budget Process: How is it enforced?

Spending and revenue targets set in the annual budget resolution are enforced by points of order, which any member of Congress may raise against legislation that is inconsistent with those targets.

- The House and Senate budget committees are responsible for providing estimates and calculations that track whether the targets are being met.

- In the House, the Rules Committee often reports so-called special rules that set aside one or more points of order. The House then votes on the adoption of the special rule, which needs only a simple majority to pass.

- In the Senate, if a point of order is lodged against a bill or an amendment, it takes a supermajority vote of sixty senators to overcome it.

- The chairperson of the House or the Senate budget committee, often with the concurrence of the ranking member, may threaten to lodge a point of order against a legislative initiative that seriously violates the budget resolution or an established budget rule, but this step may just start a bargaining process. Eventually, the member pushing the initiative may settle for a less egregious violation in return for passage.

See Also

- Budget Process: How does it work?
- Budget Process: What is the history?
- Budget Process: What is the schedule?
- Budget Process: What is reconciliation?
- Budget Process: What is PAYGO?

Further Reading


Author: Rudy Penner
Last Updated: September 2, 2007
The Budget Process: What is PAYGO?

PAYGO, which stands for “pay-as-you-go,” is a budget rule requiring that, relative to current law, any tax cuts or entitlement and other mandatory spending increases must be paid for by a tax increase or a cut in mandatory spending. The legislation must be paid for over two time periods: 1) the period of the current year, the budget year and the ensuing four fiscal years, and 2) the period of the current year, the budget year and the ensuing nine fiscal years.

- The original PAYGO was part of the Budget Enforcement Act of 1990. In that year, President George H. W. Bush and the leadership of the Congress painfully negotiated a very large deficit reduction package of spending cuts and tax increases. Having accomplished so much, the Congress was concerned that the package would eventually erode, because future Congresses would reverse the spending cuts and tax increases bit by bit. PAYGO helped to prevent this and was supplemented by caps on appropriations and outlays for discretionary programs.


- After Democrats won control of the Congress in 2006, the House of Representatives quickly re-instituted PAYGO and the Senate adopted a similar rule with the Budget Resolution for fiscal year 2008. Unlike the version passed in 1990, the new PAYGO is not a law. It is simply a procedural rule. If legislative changes were not fully paid for, the earlier law required a sequester of spending to make up the difference. The new rule does not.

- Violations of the PAYGO rule are subject to points of order in the House and Senate. In the Senate, points of order against PAYGO violations can be overcome by 60 votes, and when considering particular bills, the House can adopt a rule prohibiting such points of order with a simple majority.

See Also

Budget Process: How does it work?
Budget Process: What is the history?
Budget Process: What is the schedule?
Budget Process: What is reconciliation?
Budget Process: How is it enforced?

Further Reading


Author: Rudolph G. Penner
Last Updated: July 12, 2007
TAXES AND THE BUDGET

Taxes and the Budget: What is the short-term budget scenario? .......................................................... I-3-1
Taxes and the Budget: What is the long-term budget scenario? ............................................................. I-3-3
Taxes and the Budget: What is the short-term budget scenario?

The Congressional Budget Office (CBO) and, within the executive branch, the Office of Management and Budget (OMB) both produce short-term budget scenarios. CBO’s scenarios set the budget baseline: the starting point for congressional deliberations on budget policy. The baseline looks forward ten years and assumes that all policies continue as under current law. In contrast, OMB’s main scenario assumes implementation of all of the president’s proposals and covers only five years.

- CBO’s current baseline projections, published in March 2008 (see figure), show a unified budget deficit (that is, including the balance in the Social Security trust fund) of $357 billion in fiscal 2008, a surplus of $105 billion in 2012, and a surplus of $202 billion in 2018. CBO’s projections do not, however, consider the impact of extending any portion of President Bush’s tax cuts of 2001 and 2003, providing relief from the alternative minimum tax (AMT), or extending any of the many “temporary” tax cuts that are routinely renewed. The baseline also considers only a portion of the likely costs of the wars in Iraq and Afghanistan. Including these items could easily convert the small (0.6 percent of GDP) surplus projected for 2012 into a deficit well in excess of $200 billion.
• OMB’s current five-year projections, published in February 2008, also show a small surplus for 2012, and unlike the CBO projections they assume that the tax cuts of 2001 and 2003 are made permanent. (As estimated by CBO separately from its baseline projections, the revenue loss from extending the tax cuts is $250 billion in 2012.) The president makes a number of other tax proposals that are roughly revenue neutral in the aggregate. The most important—a reform of the tax treatment of employer-provided health insurance—would raise $24 billion in 2012. The president does not request appropriations for the wars in Iraq and Afghanistan beyond 2009, and he requests only one year’s relief from the AMT. Moreover, the president’s budget assumes that the Congress will cut nonsecurity discretionary spending by $56 billion below CBO’s baseline by 2012. This implies an absolute cut in such spending after adjusting for inflation.

See Also
Taxes and the Budget: What is the long-term budget scenario?
Taxes and the Budget: How accurate are short-term and long-term budget scenarios?

Data Sources
Congressional Budget Office, An Analysis of the President’s Budgetary Proposals for Fiscal Year 2009 (Washington, March 2008), Table 1.2, p. 4.


Further Reading
Congressional Budget Office, An Analysis of the President’s Budgetary Proposals for Fiscal Year 2009 (Washington, March 2008).


_________, "Preliminary Analysis of the President’s Budget Request for 2009" (Washington, March 3, 2008).

Taxes and the Budget: What is the long-term budget scenario?

The Office of Management and Budget (OMB), the Congressional Budget Office (CBO), the Government Accountability Office (GAO), and a variety of private groups compile long-run federal budget scenarios. Those scenarios differ one from another because the economic and policy assumptions underlying them differ, but all conclude with the same sad tale: current budget policy is not sustainable.

- Social Security, Medicare, and Medicaid are all affected by the aging of the population as the baby-boom generation reaches retirement age and life expectancy continues to increase. Medicare and Medicaid are also afflicted by soaring health costs as their expenditures per capita grow much faster than income per capita. Consequently, expenditures on these three programs will grow much faster than the economy. The budget pressures from these sources are made worse by an additional fact: low birth rates since the 1960s imply that the labor force and hence the number of taxpayers will grow at a slowing rate.

- CBO and GAO each produce two long-run budget paths, one more optimistic than the other, which they call "scenarios" rather than projections because they are not intended as forecasts but simply illustrate the likely implications of current policy. The huge deficits that emerge in all of their long-run paths could not possibly be financed domestically or internationally; this means that current policy is unsustainable. This analysis focuses on the less optimistic scenarios because their policy assumptions seem more reasonable.

- CBO’s more pessimistic scenario (see figure) assumes that Congress makes permanent the Bush tax cuts of 2001 and 2003 and extends all other temporary tax cuts. This scenario assumes that taxes claim 18.9 percent of GDP in 2030, compared with 18.8 percent in 2007 and an average (and relatively constant) tax burden over the past forty years of 18.3 percent. Spending for Social Security, Medicare, and Medicaid is meanwhile projected to grow from 8.4 percent of GDP in 2007 to 14.5 percent in 2030; the total federal tax burden would have to rise by about one-third to finance that increase entirely with higher taxes. Other noninterest spending is assumed to remain roughly constant relative to GDP, but because this budget scenario implies a rapidly growing public debt, the government’s interest bill rises from 1.7 percent to 4.8 percent of GDP. The problem feeds on itself as larger deficits impose higher interest bills, which in turn cause still larger deficits. The public debt eventually explodes, climbing from 37 percent of GDP at the end of fiscal 2007 to more than 100 percent in 2030.
GAO assumes a slightly lower tax burden than CBO and slightly more rapid growth in Social Security, Medicare, and Medicaid. As a result, the debt exceeds GDP in 2027—three years earlier than in the CBO scenario.

OMB has developed only one projection but uses sensitivity analysis to show the implications of alternative assumptions. The projection assumes that Congress adopts the president’s recommendations for reducing Medicare reimbursements and other savings, so that Medicare costs grow much more slowly than in the CBO and GAO scenarios. Consequently, the debt does not exceed GDP until well after 2040.

All these long-run budget projections assume that the growth of health spending eventually slows, because it is implausible that such spending will be allowed to absorb an ever-growing share of GDP and eventually squeeze out non-health-related consumption. But all of the projections may be too optimistic about the timing and the extent of the slowdown. Any squeeze on non-health-related consumption can be postponed for a very long time if foreigners continue to finance our budget deficits, and even if they do not, it may be investment rather than consumption that is squeezed out. If projections of health costs prove too optimistic, a budget crisis will arrive sooner than the scenarios anticipate.
See Also

Taxes and the Budget: What is the short-term budget scenario?

Taxes and the Budget: How accurate are the short-term and long-term budget scenarios?

Further Reading


Taxes and the Budget: How accurate are short-run and long-run budget scenarios?

Short-run budget projections tend to be highly inaccurate, because of unforeseen changes in economic activity, changes in technical assumptions, and changes in economic and other policies. Typically, the first two types of changes alter projections much more than do changes in policies. Surprisingly, longer-run projections may be more accurate than shorter-run projections.

- Over the period 1983-2005, the average absolute error in the five-year revenue projection of the Congressional Budget Office (CBO) caused by changes in the economic and technical assumptions was 1.6 percent of GDP, which would be $219 billion at the 2007 level of GDP. Between the earliest official projection of the 2007 budget balance (in the ten-year projection of 1997) and the actual outcome, the projected balance varied over a range of $844 billion because of changes in economic and technical assumptions.

- If the CBO projection is too pessimistic in one period, it is extremely probable that it will be too pessimistic in the next period as well. Similarly, too much optimism in one period is likely to be repeated in the next. Thus one observes long streaks of overly pessimistic or overly optimistic projections.

- Especially large errors tend to occur after the fifth year of CBO’s ten-year projection period, and so one might question the prominence that CBO publications give to the second half of their projection periods. However, these projections serve an important role in estimating the longer-run effects of changes in tax and spending policies. Errors in the underlying economic and technical assumptions shift projections of aggregate revenue and outlays but usually have little effect on estimates of the effects of policy changes. Even so, it might be better to confine those longer-run assumptions to appendices in CBO reports, to avoid giving the appearance of false precision.

- If short-run projections have such huge inaccuracies, can very long budget projections have any credibility? Ironically, such projections may actually be more accurate. One reason is that policy assumptions (as opposed to economic and technical assumptions) made for the long run may be more realistic - for a while at least - than those made for the shorter run. When making its short-run projections, CBO is required to assume the continuation of current law, even if doing so implies unlikely outcomes, such as sharply rising tax burdens or declining nondefense spending relative to GDP. CBO does not face the same constraint when making its long-run projections, but instead may assume that tax burdens will remain roughly constant in the long run and that the ratio of spending to GDP, outside of Social Security, Medicare, and Medicaid, will change little. Such assumptions are much more consistent with past policies than is the assumption of unchanging law.
However, the whole point of long-run projections is to see whether policies are sustainable over time, and recent analyses indicate that they are not—certainly not much beyond 2030, if even that long. The kind of errors that make short-term projections inaccurate have little effect on the main purpose of long-term analysis.

Shorter-run revenue projections (after adjusting for policy changes) have incurred large errors over recent periods, because tax revenue has grown faster than GDP over some extended periods and more slowly over others. The effects of such cycles tend to even out over the very long run.

The main reason for making very long run budget projections is to show how rapidly spending on Social Security, Medicare, and Medicaid will grow if these programs are not reformed. Long-run projections of Social Security outlays relative to GDP tend to be extremely accurate compared with revenue projections. One reason is that Social Security outlays depend heavily on demographic trends, which tend to be easier to project over several decades than economic trends, which are more important in determining revenue. Also, the indexing of initial Social Security benefits to wages and the important role of wages in GDP mean that variations in Social Security outlays and variations in GDP tend to move together. Therefore the long-run projection of the ratio of Social Security outlays to GDP can be quite accurate even when the forecast of GDP goes astray. Unfortunately, it is much more difficult to forecast Medicare and Medicaid outlays, and if long-run budget projections turn out to be misleading, it is very likely because large errors were made in forecasting health expenditure.

The fiscal disaster portrayed by long-run budget projections is so overwhelming that it is likely to occur eventually in the absence of significant program reforms, even if today’s projections turn out to be far too pessimistic. And those projections could easily turn out to be not too pessimistic at all, but rather too optimistic.

See Also

Taxes and the Budget: What is the long-term budget scenario?
Taxes and the Budget: What is the short-term budget scenario?

Author: Rudolph G. Penner
Last Updated: April 22, 2008

Further Reading

Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2008 to 2018 (Washington, January 2008), Chapter 1, especially Figure 1-3.

Penner, Rudolph G., Errors in Budget Forecasting (Washington: The Urban Institute, 2001).

Taxes and the Budget: How much spending is uncontrollable?

Certain types of government spending are often described as "uncontrollable." In the case of entitlements, this uncontrollability is more a political matter than based on any legal or real constraints. Total "uncontrollable" spending—entitlements, other mandatory spending, and net interest on the public debt—has been growing much more rapidly than total spending in recent decades and thus accounts for an ever-larger share of the total.

- Whereas discretionary programs are funded by specific appropriations that generally last only one year, entitlement spending, such as for Social Security and Medicare, is ongoing. The laws establishing entitlements specify who is eligible for benefits and describe the nature of the benefit. The government then pays the cost of the benefits for as many eligible individuals as show up to claim them. Thus total entitlement spending cannot be predicted with precision from year to year and is in this sense "uncontrollable."

- As a matter of law, entitlement spending can be curbed by changing eligibility criteria or the nature of the benefit. But this requires Congress to actively intervene to change the law, and the resulting cuts in spending growth are usually highly unpopular. In contrast, unless renewed, a discretionary program will automatically go out of existence when its funding expires. To cut discretionary spending, then, Congress need simply not renew the program. It is therefore often assumed that it is easier to control discretionary than entitlement spending. But the difference should not be exaggerated. Cuts in appropriations from year to year can also be highly unpopular and politically difficult.

- There is another sense in which entitlements are "uncontrollable." The cost of the three largest—Social Security, Medicare, and Medicaid—is rising much more rapidly than tax revenue and than GDP, because of the aging of our society and the explosion of health care costs. But, again, this excess growth is not inevitable. If Social Security were indexed less generously, and if Medicare and Medicaid were placed on a fixed budget like the universal health care systems of Canada and the United Kingdom, they would instantly become more controllable. Other major entitlements, such as the earned income credit, food stamps, and civilian and military pensions are not projected to grow faster than GDP.

- Other forms of mandatory spending usually arise because of contractual obligations, for example for the procurement of goods and services. In addition, the government may have to pay damages when it loses lawsuits.

- In fiscal 1962 mandatory spending (including entitlements) and net interest constituted only 26.1 percent of total spending. By fiscal 2006 they had grown to 61.7 percent. Nevertheless, the overall tax burden has remained relatively constant because defense spending fell over the same period from 49.2 percent of total spending to 19.6 percent. The percentage of total spending devoted to nondefense discretionary programs is about the same in 2006 as it was in 1962, but there have been significant ups and downs over the period.
See Also

Taxes and the Budget: What is generational accounting?

Taxes and the Budget: What does it mean for a government program to be off-budget?

Taxes and the Budget: Are the Social Security trust funds real?

Author: Rudolph G. Penner
Last Updated: August 29, 2007
Taxes and the Budget: What is Generational Accounting?

Almost all public policy decisions have some impact on generations yet unborn. We leave them official debt when we run budget deficits, and we expect them to pay for some of the government benefits that we and our predecessors have promised to the elderly and others. On the other side of the ledger, current taxpayers leave future generations with both tangible assets and a body of government-financed technological knowledge with which to generate additional wealth. And we bequeath a benefit structure that will provide them with social insurance and a public safety net, but they will have to figure out a way to either pay for it, reform it, or pass the bill along to still later generations. Generational accounting—a concept originally developed by Laurence J. Kotlikoff, Alan J. Auerbach, and Jagadeesh Gokhale—attempts to quantify the value of these net assets or liabilities transferred from generation to generation.

- The net tax rate faced by future generations is then calculated by dividing the present value of the net tax burden (taxes minus transfer payments) by the present value of expected future earnings from labor. The calculation can be made either for particular birth cohorts or for all those to be born in the future. A basic assumption is that there is no default and no free lunch—all net liabilities transferred forward must be paid for eventually.

- The present value of the burden passed forward consists of official government debt, net of assets, plus the present value of all future government purchases, plus the present value of all government payments to individuals (such as Social Security benefits) promised to those now alive, minus the present value of all the taxes that will be paid by those now alive. The calculations usually include all levels of government: federal, state, and local.

- The implied tax burden passed to the future is huge, mainly because current generations will not come close to paying for the present value of government purchases plus the benefits that they are promised, most of which go to the elderly. Medicare and Medicaid, the main public health insurance programs, pose a special problem because health care costs are growing so much faster than tax revenue.

- When the present value of the burden being passed to future generations is compared with the present value of their future labor income to arrive at a net tax rate, the calculation suggests that unborn generations will face twice the lifetime tax burden faced by those alive today.

- Generational accounting is often criticized because its calculations are based on numerous assumptions regarding a highly uncertain future. For example, health care costs must be projected to infinity. Historically, these costs have been rising 2 percentage points a year faster than incomes. That cannot continue indefinitely, or else they will eventually exceed total income. But when will their growth slow down? Medicare trustees assume that cost growth in the Hospital Insurance program (Medicare Part A) will begin to slow in about twenty-five years, eventually falling to the GDP growth rate in the early 2080s. But this assumption is completely arbitrary.
• If growth in health care costs does not slow, the rate of growth of Medicare and Medicaid may exceed the discount rate used to compute their present value. Their present value would then be infinite. That would make generational accounting meaningless. Similarly, the discount rate used to calculate the present value of earnings must exceed the growth rate of earnings to avoid infinite values. But that implies that the present value of earnings in, say, 2050 will be lower than today’s earnings. That forces the estimate of future tax rates upward.

• The choice of a discount rate to use in computing present values is itself contentious. The arithmetic results are extremely sensitive to this choice. The calculations discussed above assume a real rate of 3.9 percent, approximately the historical rate on long-term government bonds. If we care deeply about the welfare of future generations, we may wish to use a lower discount rate. If instead we reflect on the likelihood that they will be considerably richer than us, we may wish to use a higher rate.

• Another criticism of generational accounting is that it counts only what is easily countable. In particular, it assumes that no benefits accrue to present or future generations from government purchases. Thus, for example, the "greatest generation"-the generation that won World War II-gets no credit for its contribution to the welfare of future generations. At a more mundane level, the long-run benefits of expenditures on education or research are not recorded.

• But these criticisms do not invalidate the basic point, which is that the current generation is leaving a gigantic burden to unborn generations. Whether net taxes will have to increase by 50 percent, 100 percent, or 200 percent is almost beside the point. The results are frightening no matter how one does the calculations, and they suggest that current fiscal policy is not sustainable.

**See Also**

Taxes and the Budget: How much spending is uncontrollable?

Taxes and the Budget: What does it mean for a government program to be off-budget?

Taxes and the Budget: Are the Social Security trust funds real?

**Further Reading**


Taxes and the Budget: What are extenders?

Tax "extenders" are tax laws that will expire after a certain date. The Congressional Budget Office (CBO) must assume that these laws will be permanently terminated as scheduled when it compiles the budget baseline that serves as a starting point for congressional budget deliberations. This makes the baseline unrealistic, since temporary tax laws very often are extended. Because the vast majority of extenders involve tax cuts, the assumption that these provisions will be terminated tends to make CBO project a healthier budget balance than is likely to occur. There is one exception to the rule: temporary taxes whose revenue is deposited in trust funds are assumed to continue.

- The most important temporary tax cuts are the Bush tax cuts of 2001 and 2003. They will expire at the end of 2010 unless Congress extends them. If all were extended permanently, the budget surplus that CBO projects for the period 2011-18 would be reduced by a cumulative $3.2 trillion.

- Congress has recently provided a series of one-year reductions in the burden that would otherwise be imposed by the alternative minimum tax. If the exemption amount of the tax were permanently indexed for inflation, the cumulative budget balance projected by CBO for the period 2009-18 would be worsened by over $900 billion.

- There are eighty-seven other temporary tax provisions. All but three are temporary tax cuts.

- The most important of the eighty-seven is the research and experimentation tax credit. It has been enacted for one year at a time and has been extended for eleven straight years.

- Why does Congress enact so many temporary provisions? It would be nice to think that it was to force the periodic reevaluation of certain tax subsidies. However, it is more likely that Congress wishes to avoid actions that force it to show a significant deterioration in the long-term budget balance. This tendency is strengthened by the Senate’s Byrd rule. It is difficult to pass any legislation in the Senate unless one has the sixty votes necessary to cut off a filibuster. However, that is not true of legislation contained in a reconciliation bill adopted as part of the budget process. This procedure limits debate and allows legislation to be passed with a simple majority of fifty-one votes. But reconciliation may only be used for bills that do not increase the budget deficit beyond the time horizon of the budget resolution. The Bush tax cuts were passed using reconciliation procedures, and that is a major reason that they are temporary.

- There is a curious asymmetry in the rules that specify how the budget baseline should be constructed. Temporary tax provisions are assumed to be ended on schedule, but entitlements that must be reauthorized periodically, such as farm subsidies, are assumed to continue throughout the ten-year projection period.

- Pay-as-you-go rules say that any increase in an entitlement or cut in taxes compared with the baseline must be paid for with some other tax increase or entitlement cut. The asymmetric rules used in designing the baseline thus imply that Congress must pay for a routine extension of a temporary tax cut but can avoid paying for an extension of an entitlement. That would seem to create a strong bias in favor of higher entitlements and higher taxes.
• It is also assumed that appropriations for discretionary programs, most of which last for only one year, are renewed and adjusted for inflation.

• The asymmetry between the spending and tax sides of the budget could be cured by assuming either that all temporary entitlement, appropriation, and tax laws expire as specified by the law, or that all temporary provisions are continued. Because most temporary provisions are renewed routinely on both sides of the budget, the second option would provide a more accurate view of the future size of government and the path of the budget balance. Such a reform, however, would be strongly resisted by those who dislike the controversial Bush tax cuts, because it would make it easier to extend them.

See Also

Budget Process: What is reconciliation?

Budget Process: What is PAYGO?

Further Reading


Horney, James R., and Richard Kogan, "Key Argument Against Applying Pay-As-You-Go to Tax Cuts Does Not Withstand Scrutiny" (Washington: Center on Budget and Policy Priorities, March 22, 2007)
Taxes and the Budget: What does it mean for a government program to be "off-budget"?

In the late 1960s the federal government adopted a unified budget that included trust fund operations along with budgets for almost all other federal activities. Since then various agencies have attempted to escape budget discipline by moving off-budget, but most have been brought back under pressure from advocates for fiscal responsibility. Today there are only two off-budget entities that were once on-budget: the Social Security system and the U.S. Postal Service. In the case of Social Security, only the trust funds (for Old-Age and Survivors Insurance and for Disability Insurance) are off-budget; administrative costs are on-budget. The Federal Reserve System and the various government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, have always been off-budget.

- Social Security was temporarily taken off-budget by the Gramm-Rudman-Hollings Act of 1985, and its off-budget status was made permanent by the Budget Enforcement Act of 1990. There were a number of reasons for taking Social Security off-budget:
  
  o Social Security’s off-budget status would protect benefits from being reduced by the reconciliation procedures that are an important part of the budget process. Although Social Security’s off-budget status thus provides considerable protection against benefit reductions, the Congress did not want to encourage benefit increases or payroll tax cuts either. The House of Representatives therefore created a point of order against legislation that would increase Social Security’s seventy-five-year actuarial deficit by more than 0.02 percent of payroll or reduce the five-year cash flow balance of the system by more than $250,000. The Senate established a point of order against legislation that would reduce the Social Security surplus during the period covered by the budget resolution (generally five years).
  
  o Since 1983, Social Security trust funds have accumulated large surpluses that will eventually be needed to pay promised benefits. Indeed, they are not sufficient for that purpose. It was therefore argued that the Social Security surplus was not a true surplus, but rather an advance payment for future benefits that should be separated from the surplus or deficit of the rest of government. It was hoped that this separation would induce greater fiscal discipline in the rest of the government, ideally leading to a balanced budget in the activities of government outside of Social Security.
  
  o Those goals have not been fulfilled. Despite the formal separation of Social Security from the rest of the budget, budget debates in Congress and the media focus mainly on the unified budget balance, that is, the combined balance of Social Security and the rest of government. Many argue that the Social Security surplus consequently masks the true deficit of the federal government. In the more than two decades that Social Security has been off-budget, the rest of government has run a surplus in only two years: 1999 and 2000.
  
  o Because the rest of the federal government is, in effect, borrowing from Social Security to finance part of its deficit, some accuse the rest of government of "stealing" from Social Security. In fact, Social Security trust funds invest their surplus in Treasury securities bearing the full faith and credit of the United States. The interest rate on these securities is determined by a formula that reflects market interest rates. The rest of government is no
more stealing from Social Security than it is from an individual who invests some of his or her pension fund in U.S. Treasury securities.

- The U.S. Postal Service was taken off-budget to make it free to adopt efficient business practices, but this is not a sufficient excuse, since many business-type activities of the government, such as selling mortgage insurance, are on-budget. GSEs are off-budget because they are owned by private shareholders, and their debt does not bear the full faith and credit of the U.S. government. However, most observers believe that their close ties to government would lead to a government bailout if they get into financial trouble. It is therefore argued that they should be subjected to controls over their budgets. This is not done within the formal budget process, but strict regulatory controls have been imposed on Fannie Mae and Freddie Mac.

- The central banks of most democratic countries are off-budget. This helps to preserve their independence from the other branches of government. If the Federal Reserve were on-budget and its expenditures had to be appropriated, the Congress might conceivably make its appropriation contingent on lowering interest rates or making some other change in monetary policy.

- Various small agencies have successfully escaped the unified budget for short periods. The special interests that back these agencies believe, probably rightly, that lawmakers will treat them more generously if doing so does not increase the official budget deficit. Advocates of fiscal discipline work hard to bring off-budget agencies back into the fold and to prevent new agencies from going off-budget. With the help of the Gramm-Rudman-Hollings Act of 1985, this effort has been largely successful. The Rural Development Bank, the Export-Import Bank, the Strategic Petroleum Reserve, and the Pension Benefit Guarantee Corporation all were moved off-budget for varying periods in the past but are now on-budget.

See Also

Budget Process: What is reconciliation?

Taxes and the Budget: How much spending is uncontrollable?

Taxes and the Budget: What is generational accounting?

Taxes and the Budget: Are the Social Security trust funds real?

Further Reading


Taxes and the Budget: Are the Social Security trust funds real?

Payroll tax and certain other revenues dedicated to the Social Security system today exceed the cost of paying current benefits. This surplus is used to buy special U.S. Treasury bonds that are then deposited in the system’s two trust funds, one dedicated to Old Age and Survivors Insurance and the other to Disability Insurance. The Treasury pays the trust funds interest on these bonds, using a formula that reflects market interest rates. Four questions are commonly raised about the trust funds: Are their assets "real," or are they just worthless pieces of paper? Do the surpluses deposited in the trust funds represent an addition to national saving? Does the existence of the trust funds alter the amount that the U.S. government must borrow from the public? And if the answer to these questions is no, why have trust funds in the first place?

- The trust funds’ "pieces of paper" are U.S. Treasury bonds that bear the full faith and credit of the U.S. government. They are just as valuable as the Treasury securities in the hands of a business or an individual. In that sense the trust fund assets are very real.

- The Social Security system can redeem these bonds for cash at any time. That means that after the system starts to run a cash flow deficit in about ten years, Social Security will be able to redeem the bonds to pay scheduled benefits, without additional congressional action. It is now expected that the combined trust funds will have redeemed all their Treasury bonds by sometime in the early 2040s. At that point revenue dedicated to the system from the payroll tax and other sources will cover only about three-quarters of scheduled benefits.

- Whether the trust funds represent an addition to national saving is harder to answer. If the federal government balanced the budget for non-Social Security programs every year, the Social Security surplus would add to national saving, unless the surplus somehow affected business or personal saving or the budget decisions of state and local governments. However, the federal government has balanced the non-Social Security budget only three times in the past fifty years.

- The Social Security surplus might still add to national saving if it reduced the unified budget deficit, that is, the sum of the Social Security surplus and the non-Social Security deficit. That would happen if the two were determined independently. But it is unrealistic to say that the non-Social Security deficit is completely independent of the Social Security surplus. Although the annual congressional budget resolution establishes separate goals for the two balances, political rhetoric and media reports focus on the unified budget deficit. If the unified deficit is really the primary target of fiscal policy, then an increase in the Social Security surplus allows the rest of government to run a bigger deficit. This negates the effect of the larger Social Security surplus on national saving.

- To understand how the existence of the trust funds affects the federal government’s borrowing from the public, imagine a situation in which the non-Social Security operations of government run a deficit of $100 billion while Social Security runs a surplus of $10 billion. The unified budget deficit is then $90 billion. The Treasury must borrow $100 billion to finance the non-Social Security part of government. The Social Security surplus enables it to borrow $10 billion of that amount from Social Security. It must then borrow the other $90 billion from the public. (The amount borrowed from the public does not necessarily exactly equal the budget deficit,
because the deficit can be financed by means other than borrowing, for example by drawing down cash balances or issuing currency.) Now imagine that Social Security is operated without any trust funds and that payroll and other dedicated taxes are pooled with all other government revenue, while Social Security and other outlays are also combined. The taxes dedicated to Social Security may still exceed Social Security outlays by $10 billion, but this surplus need not be separately identified in the budget accounts. If the rest of government is still running a deficit of $100 billion, the net deficit will be $90 billion. That is the amount that has to be borrowed from the public - the same with the trust funds as without.

- Why, then, should we have Social Security trust funds if they don’t affect national saving or alter the amounts that government must borrow from the public? The answer is that the trust funds are an accounting device that tracks whether the taxes dedicated to Social Security are sufficient to fund its benefits and other costs. With dedicated revenue today more than paying total costs, the system is, in effect, paying for tomorrow’s benefits in advance, while receiving interest from the Treasury on the accumulated surpluses. Advocates for Social Security see the trust fund balances as the system’s property and effectively argue that they should not be used for any purpose other than Social Security. Thus, although the existence of the trust funds may not be important economically, it is extremely important politically in giving Social Security benefits some protection against budget cuts.

**See Also**

- Taxes and the Budget: How much spending is uncontrollable?
- Taxes and the Budget: What is generational accounting?
- Taxes and the Budget: What does it mean for a government program to be off-budget?

**Further Reading**

ECONOMIC STIMULUS

What is the Economic Stimulus Act of 2008? ................................................................. I-5-2
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What fiscal stimulus options are of questionable effectiveness? ................................... I-5-27
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Background: Economic Stimulus

This section looks at the tools available to the government to help reverse economic downturns and evaluates their likely effectiveness.

- What is the Economic Stimulus Act of 2008
- What does the 2008 stimulus act do for individuals?
- What does the 2008 stimulus act do for businesses?
- What is the role of monetary policy?
- How do automatic stabilizers work?
- When is fiscal stimulus appropriate?
- What characteristics make fiscal stimulus most effective?
- What fiscal stimulus options would be most effective?
- What fiscal stimulus options would have questionable effectiveness?
- What fiscal stimulus options should be avoided?
Economic Stimulus: What is the Economic Stimulus Act of 2008?

The Economic Stimulus Act of 2008 has three main parts: an individual tax rebate that the Internal Revenue Service will send out starting in mid-2008 and two business provisions that encourage investment during 2008 by increasing limits on expensing investment costs and accelerating depreciation of qualifying investments. The congressional Joint Committee on Taxation estimates that the three provisions together will reduce federal revenue by $152 billion in fiscal 2008 and by another $16 billion in fiscal 2009. In subsequent years, revenue will actually rise as firms will claim less depreciation for investments made in 2008 than they otherwise would have. As a result, revenue losses from 2008 through 2018 will total $125 billion.

See Also

Economic Stimulus: What does the 2008 stimulus act do for individuals?
Economic Stimulus: What does the 2008 stimulus act do for businesses?
Economic Stimulus: When is fiscal stimulus appropriate?
Economic Stimulus: What characteristics make fiscal stimulus most effective?
Economic Stimulus: What fiscal stimulus options would be most effective?

Further Reading

U.S. Congress, Joint Committee on Taxation, "Distributional Effects of a Provision to Provide Tax Credits for Individual Taxpayers as Contained in the ‘Economic Stimulus Act of 2008,’ as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).


Data Sources


Author: Roberton Williams
Last Updated: March 13, 2008
Economic Stimulus: What does the 2008 stimulus act do for individuals?

People who file tax returns for either 2007 or 2008 may qualify to receive "recovery rebates." In total, the rebates will lower federal taxes by about 5 percent in 2008 and reduce the average effective federal tax rate (individual income, payroll, and excise taxes only) from 19.6 percent to 18.6 percent. The rebates will reduce federal revenue by an estimated $107 billion in fiscal 2008 and by another $10 billion in fiscal 2009.

- Tax filers who are neither dependents nor nonresident aliens receive a basic credit that is the larger of either:
  - $600 ($1,200 for joint filers), but not more than the tax filer’s income tax liability before subtracting child and earned income credits, or
  - $300 ($600 for joint filers) if the tax filer has either (a) at least $3,000 of earnings, Social Security benefits, and veteran’s payments or (b) net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction and one personal exemption (two personal exemptions for a joint return). That value is $8,750 in 2007 ($17,500 for joint filers and $11,250 for heads of household) and $8,950 in 2008 ($17,900 for joint filers and $11,500 for heads of household).

- People who qualify for a basic credit may also receive a $300 credit for each child eligible for the regular child credit (typically a related child under age 17 at the end of the year). This is in addition to the regular child credit.

- The sum of the basic and child credits is reduced by 5 percent of the tax filer’s adjusted gross income over $75,000 ($150,000 for joint filers). See figures 1 and 2.

- Beginning in mid-2008, individuals who file 2007 tax returns will receive advance recovery rebates based on the information in their returns. They, along with others who receive no advance rebate, will complete a worksheet for their 2008 tax return to recalculate the rebate based on 2008 information. If that recalculation yields a larger rebate than the original calculation, the difference will be credited as a 2008 tax payment. If the recalculation yields a smaller value, the taxpayer does not have to repay the difference.
Figure 1. Stimulus Rebate for Single People by Number of Children and Income

Dollars

Rebate starts at $3,000

Two children

One child

No children

Phaseout begins at $75,000

2007 Income

0 20,000 40,000 60,000 80,000 100,000

Notes:
(a) Rebate starts at $3,000 of 2007 income from earnings, Social Security benefits, and veteran's payments or when total 2007 income exceeds $9,750 ($11,250 for heads of household) and tax unit has net income tax liability of at least $1.

(b) Phaseout is based on adjusted gross income.

Figure 2. Stimulus Rebate for Married Couples by Number of Children and Income

Notes:
(a) Rebate starts at $3,000 of 2007 income from earnings, Social Security benefits, and veteran's payments or when total 2007 income exceeds $8,750 ($11,250 for heads of household) and tax unit has net income tax liability of at least $1).

(b) Phaseout is based on adjusted gross income.

See Also

Economic Stimulus: What is the Economic Stimulus Act of 2008?

Economic Stimulus: What does the 2008 stimulus act do for businesses?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

Data Sources


Author: Roberton Williams
Last Updated: March 13, 2008

Further Reading

U.S. Congress, Joint Committee on Taxation, "Distributional Effects of a Provision to Provide Tax Credits for Individual Taxpayers as Contained in the ‘Economic Stimulus Act of 2008,’ as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

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<tr>
<td>Amount A to Amount A + $3,000</td>
<td>$300 + $300 per child + 10% of AGI &gt; Amount A</td>
</tr>
<tr>
<td>Amount A + $3,000 to $74,999</td>
<td>$600 + $300 per child</td>
</tr>
<tr>
<td>$75,000 to Amount B (^{c})</td>
<td>$600 + $300 per child – 5% of AGI &gt; $75,000</td>
</tr>
<tr>
<td>More than Amount B</td>
<td>No rebate</td>
</tr>
</tbody>
</table>


a. Calculations assume that all income comes from earnings, Social Security, and veteran’s payments and that all filers claim the standard deduction and only the regular personal and dependent exemptions. Income is adjusted gross income (AGI) as shown on filer’s 2007 tax return.
b. Amount A = $14,250 plus $3,400 for each child.
c. Amount B = $87,000 plus $6,000 for each child.
Table 2. Advance Rebate Calculations for Married Taxpayers

<table>
<thead>
<tr>
<th>Parental status and income</th>
<th>Rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Childless couple</td>
<td></td>
</tr>
<tr>
<td>Less than $3,000</td>
<td>No rebate</td>
</tr>
<tr>
<td>$3,000 to $23,499</td>
<td>$600</td>
</tr>
<tr>
<td>$23,500 to $29,499</td>
<td>$600 + 10% of AGI &gt; $23,500</td>
</tr>
<tr>
<td>$29,500 to $149,999</td>
<td>$1,200</td>
</tr>
<tr>
<td>$150,000 to $173,999</td>
<td>$1,200 – 5% of AGI &gt; $150,000</td>
</tr>
<tr>
<td>$174,000 or more</td>
<td>No rebate</td>
</tr>
<tr>
<td>Married couple with one child</td>
<td></td>
</tr>
<tr>
<td>Less than $3,000</td>
<td>No rebate</td>
</tr>
<tr>
<td>$3,000 to $26,899</td>
<td>$900</td>
</tr>
<tr>
<td>$26,900 to $32,899</td>
<td>$900 + 10% of AGI &gt; $26,900</td>
</tr>
<tr>
<td>$32,900 to $149,999</td>
<td>$1,500</td>
</tr>
<tr>
<td>$150,000 to $179,999</td>
<td>$1,500 – 5% of AGI &gt; $150,000</td>
</tr>
<tr>
<td>$180,000 or more</td>
<td>No rebate</td>
</tr>
<tr>
<td>Married couple with two children</td>
<td></td>
</tr>
<tr>
<td>Less than $3,000</td>
<td>No rebate</td>
</tr>
<tr>
<td>$3,000 to $30,299</td>
<td>$1,200</td>
</tr>
<tr>
<td>$30,300 to $36,299</td>
<td>$1,200 + 10% of AGI &gt; $30,300</td>
</tr>
<tr>
<td>$36,300 to $149,999</td>
<td>$1,800</td>
</tr>
<tr>
<td>$150,000 to $185,999</td>
<td>$1,800 – 5% of AGI &gt; $150,000</td>
</tr>
<tr>
<td>$186,000 or more</td>
<td>No rebate</td>
</tr>
<tr>
<td>Married couple with more than two children</td>
<td></td>
</tr>
<tr>
<td>Less than $3,000</td>
<td>No rebate</td>
</tr>
<tr>
<td>$3,000 to Amount A</td>
<td>$600 + $300 per child</td>
</tr>
<tr>
<td>Amount A to Amount A + $6,000</td>
<td>$600 + $300 per child + 10% of AGI &gt; Amount A</td>
</tr>
<tr>
<td>Amount A + $6,000 to $149,999</td>
<td>$1,200 + $300 per child</td>
</tr>
<tr>
<td>$150,000 to Amount B</td>
<td>$1,200 + $300 per child – 5% of AGI &gt; $150,000</td>
</tr>
<tr>
<td>More than Amount B</td>
<td>No rebate</td>
</tr>
</tbody>
</table>


a. Calculations assume that all income comes from earnings, Social Security, and veteran's payments and that all filers claim the standard deduction and only the regular personal and dependent exemptions. Income is adjusted gross income (AGI) as shown on filer's 2007 tax return.
b. Amount A = $23,500 plus $3,400 for each child.
c. Amount B = $174,000 plus $6,000 for each child.
Examples of 2008 Recovery Rebates for Single Taxpayers

Single mother with two children and $22,050 of earnings: rebate equals $600 (limited to her income tax liability before child and earned income credits) plus $300 for each child. Her taxable income equals her earnings of $22,050 minus a standard deduction of $7,850 minus three exemptions of $3,400 each, or $4,000. Her tax is 10 percent of that amount, or $400. Her rebate is thus $400 (the $600 maximum reduced to her $400 tax liability) plus $600 ($300 for each child), or $1,000.

Single elderly individual whose only income is $20,000 of Social Security benefits: rebate equals $300 because the individual has more than $3,000 of income from Social Security. She does not qualify for the basic $600 benefit because she has no income tax liability.

Single individual with $2,500 of veteran’s payments and $5,000 of investment income: the individual qualifies for no rebate. His income from earnings, Social Security, and veteran’s payments is less than $3,000 and he has no income tax liability.

Single father with two children and adjusted gross income of $85,000: her rebate of $1,200 ($600 for her plus $300 for each child) is reduced by 5 percent of the amount by which her AGI exceeds $75,000. That excess equals $10,000, 5 percent of which is $500. Her rebate is thus $1,200 minus $500, or $700.

Single mother with two children and adjusted gross income of $100,000: her rebate of $1,200 ($600 for her plus $300 for each child) is reduced by 5 percent of the amount by which her AGI exceeds $75,000. That excess equals $25,000, 5 percent of which is $1,250. She gets no rebate because the $1,250 reduction exceeds her maximum benefit of $1,200.

Examples of 2008 Recovery Rebates for Married Couples

*Married couple with two children and $30,000 of earnings*: rebate equals $1,200 (limited to their income tax liability before child and earned income credits) plus $300 for each child. Taxable income equals earnings of $30,000 minus a standard deduction of $10,700 minus four exemptions of $3,400 each, or $5,700. Their tax is 10 percent of that amount, or $570. Their rebate is thus $570 (the $1,200 maximum reduced to their $570 tax liability) plus $600 ($300 for each child), or $1,170.

*Married couple whose only income is $30,000 of Social Security benefits*: rebate equals $600 because the couple has more than $3,000 of income from Social Security. They do not qualify for the basic $1,200 benefit because they have no income tax liability.

*Married couple with $2,500 of Social Security benefits and $10,000 of investment income* the couple qualifies for no rebate. Their income from earnings, Social Security, and veteran’s payments is less than $3,000 and they have no income tax liability.

*Married couple with two children and adjusted gross income of $175,000*: their rebate of $1,800 ($600 for each spouse plus $300 for each child) is reduced by 5 percent of the amount by which their AGI exceeds $150,000. That excess equals $25,000, 5 percent of which is $1,250. Their rebate is thus $1,800 minus $1,250, or $550.

*Married couple with two children and adjusted gross income of $200,000*: their rebate of $1,800 ($600 for each spouse plus $300 for each child) is reduced by 5 percent of the amount by which their AGI exceeds $150,000. That excess equals $50,000, 5 percent of which is $2,500. They get no rebate because the $2,500 reduction exceeds their maximum benefit of $1,800.

Economic Stimulus: What does the 2008 stimulus act do for businesses?

The Economic Stimulus Act of 2008 contains two provisions that help businesses by increasing limits on expensing investment costs and accelerating depreciation of some investments. The congressional Joint Committee on Taxation estimates that the two provisions will reduce federal revenue by $51 billion in fiscal 2008 and 2009. Revenue will rise by $43.5 billion in subsequent years as firms will claim less depreciation for investments made in 2008 than they otherwise would have. As a result, revenue losses from the investment provisions will net $7.5 billion from 2008 through 2018.

- **Temporary Increase in Limitations on Expensing of Depreciable Business Assets.** Businesses may expense (that is, deduct the full cost of) qualifying investment undertaken in 2008, subject to limitations. The stimulus bill doubles for one year the maximum amount of investment that firms may expense. "Qualifying investment" is generally defined as "depreciable tangible personal property that is purchased for use in the active conduct of a trade or business."

  - Firms may expense up to $250,000, but this limit is reduced by the amount by which qualifying investment exceeds $800,000. Thus, for example, a firm that invests $750,000 may expense $250,000. But a firm that invests $900,000 may expense only $150,000, because the $250,000 limit is reduced by the $100,000 of investment over the $800,000 limit. Firms that invest $1,050,000 or more may not expense any of their investment.

  - After 2008 the limit on expensing reverts to $125,000 (indexed from 1997), with the reduction beginning when investment exceeds $500,000 (also indexed from 1997).

  - This provision will reduce federal revenue by an estimated $1.5 billion in fiscal 2008 and 2009, but that cost will be offset by about $1.4 billion of additional revenue in subsequent years, because firms will be unable to claim as much depreciation in those years on investments made in 2008. The net revenue cost from 2008 through 2018 will thus be about $100 million.

- **Special Depreciation Allowance for Certain Property.** On top of the amount of investment that they may expense, firms may also claim an additional first-year depreciation of 50 percent of the cost of qualifying investments contracted for and placed in service during 2008. The Joint Committee on Taxation estimates that this provision will reduce federal revenue by about $49.5 billion in fiscal 2008 and 2009, but that cost will be offset by about $42.1 billion of additional revenue in subsequent years, because claiming the additional first year depreciation will reduce the amount firms may depreciate in the future. The net revenue cost from 2008 through 2018 will thus be about $7.4 billion.
See Also

Economic Stimulus: What is the Economic Stimulus Act of 2008?

Economic Stimulus: What does the 2008 stimulus act do for individuals?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

Author: Roberton Williams
Last Updated: March 13, 2008

Data Sources


Further Reading

Economic Stimulus: What is the role of monetary policy?

Economists view monetary policy as the first line of defense against economic slowdowns. Compared with fiscal policy, monetary policy has the advantages of the Federal Reserve’s ability to act faster than the administration or Congress and to better judge the appropriate timing and magnitude of a stimulus. Further, unless well crafted, fiscal stimulus may impose long-run costs on the economy without providing much short-run gain.

- The Federal Reserve can adjust monetary policy more quickly than the administration and Congress can adjust fiscal policy. Because most contractions in economic activity last for only a few quarters, the timeliness of the policy response is crucial. Fiscal policy in practice responds to changes in economic conditions with a considerable lag: it takes time first to enact a stimulus bill and then to implement it, and time for the spending increases or tax reductions to reach the pockets of consumers. As a result, the effect of fiscal stimulus on household and business spending may come too late.

- Whether and how much stimulus is needed depends on economic conditions today, on projections of likely future conditions, and on assessments of the risks to both economic activity and inflation going forward. Forecasting economic conditions—or even determining the current state of the economy—is inherently very difficult, given limitations in the available data and in economists’ understanding of the world. But the Federal Reserve’s large and sophisticated team of analysts is better positioned to accomplish this task than any other agency of the federal government. In addition, the Federal Reserve staff carries out this work independent of political considerations.

- Economists worry that poorly crafted fiscal stimulus would have little short-run economic benefit and could do long-run harm. For example, permanent tax cuts unaccompanied by permanent spending reductions would increase the long-run budget deficit. And a permanent increase in the deficit—especially now, when the budget is already so far out of long-run balance—would reduce economic growth over time. Moreover, because higher expected government borrowing is likely to push up current long-term interest rates, the short-run stimulative effect would be muted as well. In fact, under plausible assumptions about economic behavior, the response of forward-looking financial markets to a sustained reduction in personal income taxes would offset about half of the incipient stimulative effect of the tax cut.
See Also

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

Economic Stimulus: What fiscal stimulus options would have questionable effectiveness?

Economic Stimulus: What fiscal stimulus options should be avoided?

Author: Douglas Elmendorf
Last Updated: February 7, 2008

Further Reading


Economic Stimulus: How do automatic stabilizers work?

Automatic stabilizers are features of the tax and transfer systems that tend by their design to offset fluctuations in economic activity without direct intervention by policymakers. When incomes are high, tax liabilities rise and eligibility for government benefits falls, without any change in the tax code or other legislation. Conversely, when incomes slip, tax liabilities drop and more families become eligible for government transfer programs, such as food stamps and unemployment insurance, that help buttress their income.

- Automatic stabilizers are quantitatively important at the federal level. A 2000 study estimated that reduced income and payroll tax collection offsets about 8 percent of any decline in GDP. Additional stabilization from unemployment insurance, although smaller in total magnitude than that from the tax system, is estimated to be eight times as effective per dollar of lost revenue because more of the money is spent rather than saved.

- Automatic stabilizers also arise in the tax and transfer systems of state and local governments. However, state constitutions generally require balanced budgets, which can force countervailing changes in outlays and tax rules. These requirements do not force complete balance on an annual basis: they generally focus on budget projections rather than realizations, so deficits can still occur when economic conditions are unexpectedly weak. In addition, many governments have "rainy day" funds that they can draw down during periods of budget stringency. Even so, most state and local governments respond to an economic slowdown by legislating lower spending or higher taxes. These actions are contractionary, working at cross-purposes with the automatic stabilizers.
See Also

Economic Stimulus: What is the role of monetary policy?
Economic Stimulus: What characteristics make fiscal stimulus most effective?
Economic Stimulus: What fiscal stimulus options are most effective?
Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?
Economic Stimulus: What fiscal stimulus options should be avoided?
Economic Stimulus: When is fiscal stimulus appropriate?

Author: Douglas Elmendorf
Last Updated February 7, 2008

Further Reading


Economic Stimulus: When is fiscal stimulus appropriate?

Economists’ concerns about discretionary fiscal stimulus are centered on political and administrative limitations, in particular the long lags in enacting and implementing stimulus programs and the potential for politically motivated measures that are ineffective or even counterproductive at increasing short-run economic activity. However, fiscal policy has strengths as well as weaknesses.

- Fiscal stimulus, once implemented, can affect the economy more quickly than monetary stimulus implemented at the same time—an especially important consideration if economic conditions are deteriorating rapidly. The Federal Reserve’s large-scale econometric model suggests that a 1-percentage-point drop in the federal funds rate enacted this quarter adds nothing to the level of GDP in the current quarter, 0.1 percent in the next quarter, 0.2 percent in the third quarter, and 0.4 percent in the fourth quarter. In contrast, a fiscal stimulus that distributes funds even by mid-year could have a much larger effect in the second half of the year. For example, the model finds that a temporary $70 billion tax cut, if distributed in the third quarter to households that are likely to spend much of their extra income, would boost the level of GDP by 0.5 percent during the third quarter and 0.6 percent in the fourth quarter.
Fiscal stimulus combined with monetary stimulus can reduce uncertainty about the total amount of thrust provided to the economy. All of the main types of stimulus-tax cuts, increases in government spending, and reductions in interest rates by the Federal Reserve-have very uncertain effects. But any surprises in the effects of these different instruments will not be perfectly correlated and will therefore cancel out to at least some extent, thus reducing the overall uncertainty.

Fiscal stimulus could become essential in a situation where the Federal Reserve has already lowered the federal funds rate close to zero. Although adjusting the funds rate is not its only means of stimulating the economy, the Federal Reserve has scant experience with alternatives, so their effectiveness is even more uncertain. That said, the federal funds rate today is still well above zero, so this concern has little bearing currently.

Fiscal stimulus would also become critical if monetary policy proves ineffective—if reducing the federal funds rate fails to lower other interest rates, or if wary lenders refuse to lend money, or if cautious consumers and businesses refuse to borrow. Consumer and business spending would then fail to rise in response to the monetary stimulus. None of those scenarios appears to apply now, however. Monetary expansions still appear to cause a wide range of interest rates to fall, and despite the credit crisis, banks appear able to lend money. Nor is there any evidence that households and businesses are unwilling to borrow more or that more borrowing would not spur more spending.

Fiscal stimulus is appropriate if policymakers want to achieve full employment with higher rather than lower interest rates. Monetary policy increases output by lowering interest rates; fiscal policy increases output while increasing the budget deficit, thus resulting in higher interest rates. Policymakers may fear that lower interest rates could fuel another asset price bubble or lead investors to flee U.S. assets, causing the dollar to weaken. Although those concerns have merit, other factors may mitigate against them. First, some depreciation of the dollar may be necessary to correct current trade and capital imbalances. Second, lower interest rates might also help deal with the ongoing problems in housing and mortgage markets—and in financial markets more generally—by supporting housing demand, easing mortgage refinancing, and boosting asset values. Finally, lower interest rates help to spur investment and thus long-term economic growth.
See Also

Economic Stimulus: What is the role of monetary policy?

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options are most effective?

Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Economic Stimulus: What fiscal stimulus options should be avoided?

Further Reading


Blinder, Alan S., "The Case Against the Case Against Discretionary Fiscal Policy" (Princeton University, 2004).


Economic Stimulus: What characteristics make fiscal stimulus most effective?

Fiscal stimulus can raise output and incomes in the short run when the economy is operating below its potential. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted. It should be timely so that its effects are felt while economic activity is still below potential; when the economy has recovered, stimulus becomes counterproductive. It should be temporary to avoid raising inflation and to minimize the adverse long-term effects of a larger budget deficit. And it should be well targeted to provide resources to people who most need them and will spend them: for fiscal stimulus to work, it is essential that the funds be spent, not saved.

- Making fiscal stimulus timely is especially challenging because it involves not just enacting tax cuts or spending increases but also implementing them. In the worst case, poorly timed fiscal policy adds instability to the economy, intensifying rather than damping the business cycle. If fiscal stimulus is enacted too slowly, not only might it fail to prevent a drop in output and incomes, but the stimulus might arrive after recovery has begun, leading to overexpansion and higher inflation.

- Fiscal stimulus should be temporary because, in the long run, the Federal Reserve generally keeps the economy operating close to full employment and full capacity. This means that, most of the time, fiscal stimulus would not increase output but instead simply raise inflation or induce the Federal Reserve to run tighter monetary policy in order to keep inflation down.

- Over the long run, permanent tax cuts or increases in government spending that are not matched by changes on the other side of the ledger reduce national saving, resulting in lower investment or more foreign borrowing. This, in turn, diminishes economic growth and future national income. Also, larger expected budget deficits tend to push up long-run interest rates, which restrain investment and weaken net exports by pushing up the value of the dollar—effects that will undo part or all of the direct stimulative effects of lower taxes or higher government spending. Therefore, a temporary stimulus is likely to be more effective than a permanent policy change at a much lower long-run cost. Temporary stimulus will be even more effective if it is actually paid for over five or ten years, to avoid raising the long-run path of federal debt.

- Fiscal stimulus should be well targeted in two ways. First, it should go to those households or businesses most likely to raise spending in response to the stimulus and thus increase GDP in the short run. Second, it should provide the greatest benefit to those people most adversely affected by the slowdown. These two aspects of targeting are complementary. Higher-income households can generally smooth their consumption over the business cycle by drawing down their savings or borrowing. Therefore directing resources to them will likely have little effect on consumer spending. In contrast, lower-income families are more likely to have to cut back their consumption in hard times. These families are likely to spend any additional money they receive from tax cuts or transfer payments, which thus help protect them from the downturn while also boosting the overall economy.

- Research has found that tax rebates to households rapidly increase consumer spending and hence short-run economic activity (see tables 1 and 2). An across-the-board rate reduction is much less effective than a flat tax cut per household, and capital-oriented tax cuts (such as re-
ductions in the tax rate on dividends or capital gains) provide little short-run stimulus. Policies that target the people most affected by an economic slowdown, such as the long-term unemployed, have the biggest bang for the buck—the largest increase in GDP for a given cut in taxes or increase in outlays. In contrast, few firms appear to respond to bonus depreciation for business investment, and the maximum effect on investment occurs after three years, well after fiscal stimulus would be most helpful.

Table 1. Estimates of the Effect of Alternative Fiscal Policies

<table>
<thead>
<tr>
<th>Policy Option</th>
<th>Increase in real GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008:Q3</td>
</tr>
<tr>
<td><strong>Policies costing 1 percent of GDP annually on a permanent basis</strong></td>
<td></td>
</tr>
<tr>
<td>Proportional cut in personal income taxes</td>
<td>0.2</td>
</tr>
<tr>
<td>10 percent investment tax credit</td>
<td>0.2</td>
</tr>
<tr>
<td>Increase in federal purchases</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Policies costing 1 percent of GDP on a one-time basis</strong></td>
<td></td>
</tr>
<tr>
<td>Temporary tax rebate (assuming 20 percent spent)</td>
<td>0.3</td>
</tr>
<tr>
<td>Temporary tax rebate (assuming 50 percent spent)</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Memorandum:</strong></td>
<td></td>
</tr>
<tr>
<td>One-percentage-point reduction in federal funds rate</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Notes:
(a) The figures for the effects of fiscal policy apply the dynamic responses reported in the Elmendorf and Reifschneider paper to a hypothetical fiscal stimulus implemented in 2008:Q3.
(b) Tax and spending changes cannot literally be permanent without offsetting changes on the other side of the government ledger or government debt would spiral upward as a share of output. Therefore, the analysis assumes that changes would be sustained for ten years before budget balance was gradually restored. The permanent 10 percent investment tax credit was not calibrated to cost exactly 1 percent of GDP, but its budget implications turned out to be very similar to those of the other policies shown.
(c) The simulations assume that half of all subsequent increases in income would be consumed as well. If instead only one-fifth of subsequent multiplier increases in pre-tax income is spent by households, the results here would require that the tax cut be targeted so that somewhat more than half of it is spent.
(d) Figures apply the dynamic responses reported in the personal communication by Reifschneider to a hypothetical monetary stimulus implemented in 2008:Q1.

Source: TPC calculations based on Elmendorf and Reifschneider (2002); David Reifschneider, Federal Reserve Board, personal communication.
## Table 2. Impact of Various Fiscal Options

<table>
<thead>
<tr>
<th>Policy option</th>
<th>Congressional Budget Office</th>
<th>Moody's Economy.com</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cost-effectiveness</td>
<td>Time from enactment to impact</td>
</tr>
<tr>
<td>Tax cuts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonrefundable lump-sum rebate</td>
<td>Large</td>
<td>Medium</td>
</tr>
<tr>
<td>Refundable lump-sum rebate</td>
<td>Large</td>
<td>Medium</td>
</tr>
<tr>
<td>Payroll tax holiday</td>
<td>Large</td>
<td>Medium</td>
</tr>
<tr>
<td>Temporary across-the-board cut</td>
<td>Small</td>
<td>Short</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Extend AMT patch permanently</td>
<td>Medium</td>
<td>Long</td>
</tr>
<tr>
<td>Make Bush tax cuts permanent</td>
<td>Small</td>
<td>Long</td>
</tr>
<tr>
<td>Make dividend and capital gains cuts permanent</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Cut corporate tax rate</td>
<td>Small</td>
<td>Long</td>
</tr>
<tr>
<td>Spending increases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extend unemployment insurance benefits</td>
<td>Large</td>
<td>Short</td>
</tr>
<tr>
<td>Increase food stamps temporarily</td>
<td>Large</td>
<td>Short</td>
</tr>
<tr>
<td>Provide aid to state governments</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Increase infrastructure spending</td>
<td>Small</td>
<td>Long</td>
</tr>
</tbody>
</table>

Notes:

(a) One-year dollar change in real GDP for a given dollar reduction in federal tax revenue or increase in spending. Estimates are for the year the spending or tax change takes effect, which is not necessarily the year in which it is enacted.

(b) TPC’s assessments are based on the discussion in Moody’s Economy.com (2008).

(c) The CBO table does not distinguish between refundable and nonrefundable rebates, but its text states, “Making the rebate refundable would further boost the cost effectiveness of the stimulus.” n.a., not available; the source does not provide an assessment of the indicated policy option.

Source: Congressional Budget Office (CBO, 2008) and Moody’s Economy.com (2008).
See Also

Economic Stimulus: What is the role of monetary policy?

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Economic Stimulus: What fiscal stimulus options should be avoided?

Economic Stimulus: When is fiscal stimulus appropriate?

Author: Douglas Elmendorf
Last Updated: February 7, 2008

Further Reading


Congressional Budget Office, "Options for Responding to Short-term Economic Weakness" (Washington, January 2008).


House, Christopher, and Matthew D. Shapiro, "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation," Working


Economic Stimulus: What fiscal stimulus options are most effective?

The most effective fiscal policy options to stimulate the economy are those that would increase spending quickly and be short-lived. Those criteria can be met by policies that temporarily boost the purchasing power of households who are most likely to increase their spending quickly in response. Extending unemployment insurance beyond its normal twenty-six-week limit, raising food stamp benefits, or issuing refundable tax credits, all on a temporary basis, would likely provide the greatest fiscal stimulus in the shortest time.

- **Extend unemployment insurance benefits temporarily.** Unemployment insurance protects workers against hardship due to job loss but weakens the incentive to find a new job. For that reason unemployment insurance benefits are generally limited to twenty-six weeks. But policymakers also recognize the need to extend benefits during economic slowdowns, when new jobs are harder to find. Such action could be even more important now, because the long-term unemployment rate (the share of the labor force out of work for more than six months) was nearly twice as high in the last quarter of 2007 as it was immediately before the 2001 recession. Because the funds would go to people whose income has fallen, nearly all would be spent rather than saved. Thus a policy of extending unemployment benefits offers a very high bang for the buck in terms of macroeconomic stimulus.

- **Increase food stamps temporarily.** Another option would temporarily increase food stamp benefits, for example by 20 percent for each recipient for six months. This change could be implemented quickly just by raising the value of the electronic benefit cards issued to food stamp beneficiaries. This change, too, would be well targeted to families most hurt by an economic slowdown, who would spend essentially all of the extra income.

- **Issue refundable tax credits temporarily.** Extended unemployment benefits and higher food stamp allotments would affect only a fraction of the population. Thus even the two combined would not provide adequate stimulus to offset a generalized downturn. Refundable tax credits, however, could move funds to virtually all households filing tax returns, and do so within a few months of enactment. For example, tax rebates enacted in February and based on 2007 tax returns could reach households over a five- to six-week period beginning in May or June. A refundable credit (one that can exceed taxes owed) would reach even the lowest-income households. This would maximize the share of the total outlay that would be spent rather than saved while providing assistance to those households most vulnerable to a weak economy. In contrast, a nonrefundable income tax rebate, like the one enacted in 2001, would exclude more than 25 million working households with no income tax liability; the result would not only be less fair but would also provide less stimulus bang for the buck. Making the credits temporary would ensure that they do not worsen the long-run budget outlook.
See Also

- Economic Stimulus: What is the role of monetary policy?
- Economic Stimulus: How do automatic stabilizers work?
- Economic Stimulus: What characteristics make fiscal stimulus most effective?
- Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?
- Economic Stimulus: What fiscal stimulus options should be avoided?
- Economic Stimulus: When is fiscal stimulus appropriate?

Further Reading

- Congressional Budget Office, "Options for Responding to Short-term Economic Weakness" (Washington, January 2008).
- U.S. Congress, Joint Committee on Taxation, "Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals" (Washington, January 2008).

Author: Douglas Elmendorf
Last Updated: February 7, 2008
Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Policies that boost investment, such as direct spending on public infrastructure or tax incentives for businesses, are likely to have a smaller impact on the economy than policies designed to increase consumer spending. In particular, the available evidence suggests that the stimulus they provide would be small, not well-timed, or both.

- **Increase infrastructure investment.** Although additional investments in physical and technological infrastructure might provide an important boost to long-term growth, they are difficult to design in a manner that generates significant short-term stimulus. In the past, infrastructure projects that were launched as the economy started to weaken added little to total spending until after the economy had recovered. However, declining revenue during a downturn may force state and local governments to cut previously planned infrastructure spending (such as road repair), and such reductions can actually intensify the downturn. If policies could be designed to effectively prevent such cuts, economic stimulus could be delivered more quickly.

- **Create temporary investment tax incentives.** Temporary tax incentives for business investment, such as the bonus depreciation provision enacted in 2003, could stimulate the economy in the short run by inducing businesses to undertake investment immediately that they would otherwise have pursued in some future year. But research has found that this effect is small at best, and it appears to work more slowly than measures aimed at boosting household consumption. In addition, temporary investment tax incentives provide no direct help for families coping with a temporary downturn.
See Also

Economic Stimulus: What is the role of monetary policy?

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options are most effective?

Economic Stimulus: What fiscal stimulus options should be avoided?

Economic Stimulus: When is fiscal stimulus appropriate?

Author: Douglas Elmendorf
Last Updated: February 7, 2008

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Congressional Budget Office, "Options for Responding to Short-term Economic Weakness" (Washington, January 2008).


U.S. Congress, Joint Committee on Taxation, "Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals" (Washington, January 2008)
Economic Stimulus: What fiscal stimulus options should be avoided?

Some fiscal measures would do very little to boost economic activity during a downturn, either because they would take too long to have any effect or because they would give additional spending power to households who are less likely than others to increase their spending. Such policies might even make the economy worse off in the long run if they increase the long-run government deficit, causing interest rates to rise and so reducing investment.

- **Reduce tax rates.** Permanently reducing tax rates would generate less than half as much economic stimulus as a flat, refundable tax credit of the same size. It would also give disproportionate benefits to high-income households, the least likely to be hurt by a downturn. A permanent tax reduction could also raise long-term interest rates and crowd out some of the modest direct stimulus.

- **Make the 2001 and 2003 tax cuts permanent.** The tax cuts enacted in 2001 and 2003 expire at the end of 2010. Making those cuts permanent would violate all three principles of effective fiscal stimulus—they would be neither timely, nor temporary, nor well targeted—and might even hurt the economy in the short run, for several reasons. First, a reduction in income taxes starting in 2011 would provide little boost to consumer spending in 2008. Second, the 2001 and 2003 tax reductions offered the largest dollar benefits to the highest-income families, so extending them would provide little stimulus bang for the buck even in 2011, because those families tend to save more of an unexpected increase in income. Third, a permanent tax change would increase the long-run budget deficit, likely reducing long-run economic growth. Worse, if the financial markets conclude that the policy will raise the long-run deficit, interest rates would rise today, crowding out investment and reducing GDP in the short run as well.
See Also

Economic Stimulus: What is the role of monetary policy?

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options are most effective?

Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Economic Stimulus: When is fiscal stimulus appropriate?

Author: Douglas Elmendorf
Last Updated: February 7, 2008

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Congressional Budget Office, "Options for Responding to Short-term Economic Weakness" (Washington, January 2008).


U.S. Congress, Joint Committee on Taxation, "Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals" (Washington, January 2008)
THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the
2008 Election and Beyond

DISTRIBUTION AND TAX BURDENS

Are federal taxes progressive? .......................................................... I-6-1
How should progressivity be measured? ....................................... I-6-2
Distribution: Are federal taxes progressive?

Taken as a whole, the federal tax system is progressive: on average, households with higher incomes pay a larger share of their income in federal tax than do those with lower incomes. In other words, the overall average effective tax rate—total tax paid as a percentage of income—rises as income rises. But not all taxes within the federal system are equally progressive. The estate tax is the most progressive federal tax. The individual and corporate income taxes are also progressive. In contrast, payroll taxes for Social Security and Medicare are regressive, claiming a larger share of income from lower-income than from higher-income households.

- We estimate that the average effective individual income tax rate across all tax units in 2008 will be 9.5 percent. About 40 percent of tax units will pay no individual income tax or will receive a net subsidy for 2008; the 1 percent of tax units with the highest incomes will pay an estimated 18.3 percent of their income in individual income tax on average.
  - Individual income tax averages 15.0 percent of income for the top-earning fifth, compared with -8.1 percent for the bottom 20 percent of earners.
  - At very high incomes, the average effective individual income tax rate actually declines, primarily because much of these taxpayers’ income is in the form of capital gains, which are lightly taxed.
The corporate income tax is also progressive. Average effective corporate tax rates are roughly the same for the bottom 80 percent of the income distribution but rise substantially for those at or near the top of the scale.

- The average effective corporate tax rate for the top fifth of households, 5.1 percent, is more than five times the 0.9 percent average for those in the middle fifth of the income spectrum.
- Households in the top 1 percent, who tend to get a much larger share of their income from capital, pay an average effective corporate tax rate of 9.6 percent (using the Tax Policy Center’s method of imputing corporate income tax to households based on their receipt of capital income).

In 2008 about 90 percent of estate tax revenue will come from the top 10 percent of cash income earners.

- The average effective estate tax rate is essentially zero for the bottom 80 percent of the income distribution. The top 20 percent pay an average of 0.4 percent of their income, the top 1 percent pay 0.7 percent, and the top 0.1 percent – the richest 1 in 1,000 -- pay 0.8 percent.
- Many estate taxpayers whose cash incomes appear low actually have substantial unrealized wealth. When taxpayers are categorized by a more comprehensive measure of income that includes this unrealized wealth, the top 10 percent pay virtually all the estate tax.

For 2008 average effective payroll tax rates are estimated at 8.4 percent for the bottom fifth of income earners, and 10.4 percent for the next fifth, but only 5.7 percent for the top fifth. Households in the top 1 percent will pay an estimated average of only 1.5 percent of their income in payroll taxes.

- This regressivity of payroll taxes stems from two factors. First, the Social Security portion of payroll taxes is subject to a cap: in 2008 individuals pay Social Security tax on only their first $102,000 in earnings. Second, higher-income households tend to receive more of their income from sources other than wages, such as capital gains and dividends, which are not subject to the payroll tax.

For the latest on the distribution of federal tax burdens, see http://www.taxpolicycenter.org/taxtopics/currentdistribution.cfm
See Also

Distribution of Tax Burdens: How Should Progressivity Be Measured?

Data Sources


Author: Jeffrey Rohaly
Last Updated: June 19, 2008

Further Reading


Distribution: How should progressivity be measured?

A tax system is considered progressive if, on average, households with higher incomes pay taxes that are a larger share of that income. Thus, in a progressive tax system, the average effective tax rate—tax paid as a percentage of income—rises as income rises. This implies that, under such a system, the ratio of after-tax income to pre-tax income falls as income rises. Hence a natural measure of the impact on progressivity of a change in tax policy is the percentage change in after-tax income. A tax cut that gives all households the same percentage increase in after-tax income is neither progressive nor regressive but distributionally neutral; it leaves the relative distribution of after-tax income unchanged. A tax cut that increases after-tax income proportionately more for lower-income households makes the tax system more progressive. One that increases after-tax income more for higher-income households makes the system less progressive.
Although the percentage change in after-tax income is likely the most informative measure of the distributional impact of a tax change, the Tax Policy Center also reports several other measures in its distribution tables, each of which can be useful but can also be misleading if interpreted incorrectly.

Comparison of the shares of a tax cut received by each income group can be misleading because the individual income tax is highly progressive. High-income households may receive what appears to be a large share of an income tax cut, but the tax system could still end up more progressive if their share of the tax cut is much smaller than their share of overall tax liability.

The average tax cut in dollar terms is another often-used measure of who benefits from a tax cut. For example, in 2010, as a result of the 2001-06 tax cuts, households in the middle of the income distribution will receive an average tax cut of $814 (see table). Those in the top one-tenth of 1 percent will receive an average cut that is almost 400 times larger ($314,150). These numbers alone, however, do not tell us who benefited proportionately more, since those at the top of the income scale have significantly more income—but also pay significantly more tax—than those in the middle.

An alternative distributional measure is the change in tax as a percentage of the household’s total tax liability. This measure can be extremely misleading. Because low-income households pay less tax than high-income households under a progressive tax system, a small tax cut in dollar terms for low-income households can be a large percentage cut, and thus can appear to be a huge reduction in tax liability.

For example, consider a family earning $20,000 that pays $1 in taxes and another family earning $2 million that pays $500,000. Now suppose that legislation provides a $1 tax cut for the low-income family and a $100,000 tax cut for the high-income one. Using the percentage change in tax liability makes it appear that the cut is tilted toward the low-income family: its taxes fall by 100 percent while those of the high-income family fall "only" 20 percent. In fact, the cut increases the after-tax income of the poor family by just 0.005 percent while increasing that of the wealthy family by 5 percent, or 1,000 times more as a percentage of income.

Thus it would be extremely misleading to characterize the 2001-06 tax cuts as benefiting the middle class more than the wealthy simply because the percentage change in tax is, on average, higher for those in the middle quintile. For example, in 2010 federal taxes fall by an average of 11.6 percent for those in the middle quintile and 9.1 percent for those in the top quintile. But in terms of what really matters—economic resources as measured by after-tax income—those in the top quintile benefit proportionately more. They see an increase in after-tax income of 3.6 percent, while those in the middle of the spectrum receive only a 2.3 percent increase.

Another measure of the impact of a tax policy is the change in the share of the overall tax burden paid by different income classes. This concept can also be misleading as a measure of the progressivity of a tax cut if the tax burden is changing at the same time.

Consider the example discussed above. After the tax legislation that provides the low-income family with a $1 tax cut and the high-income family with a $100,000 cut, the high-income family pays 100 percent of the total tax burden, since the other family has had its tax liability completely eliminated. But just because the high-income family now pays a larger share of the tax burden, it does not mean that it did not benefit the most from the tax cut. As already shown, in
percentage terms its after-tax income went up 1,000 times more than did that of the lower-income family.

- The problem with using the change in the share of the tax burden can be seen when examining the 2001-06 tax cuts. As a result of the cuts, the share of the federal tax burden paid by the top income quintile rises by 0.3 percentage point in 2010, whereas the share paid by the middle quintile falls by 0.2 percentage point. But, again, that does not imply that the 2001-06 tax cuts made the tax system more progressive, nor does it mean that those in the middle quintile benefited more than those at the top.

See Also

Distribution of Tax Burdens: Are federal taxes progressive?

Data Sources


Further Reading


Author: Jeffrey Rohaly
Last Updated: June 7, 2007
INCOME TAX ISSUES

How do the standard and itemized deductions compare? .............................................................. I-7-1
What is the difference between tax deductions and tax credits? .............................................. I-7-4
How do phaseouts of tax provisions affect taxpayers? .............................................................. I-7-6
Income Tax Issues: How do the standard and itemized deductions compare?

Tax filers may either claim the standard deduction, whose value varies with filing status, or itemize individual deductible expenses. In either case, taxable income is reduced by the amount of the allowed deduction.

- In 2011 single filers and married persons filing separately may claim a standard deduction of $5,800. The standard deduction for married couples filing jointly is double that amount: $11,600. Heads of household may deduct $8,500. Those values are adjusted each year for inflation as measured by the consumer price index for all urban consumers (CPI-U).

- Individuals who are blind or age 65 or older may deduct additional amounts. Single filers and heads of household may claim an additional $1,450 for each condition (blind or elderly); the additional amount for married filers is $1,150 per condition. Thus, for example, an elderly couple who are both blind may claim a total deduction of $16,200 ($11,600 standard deduction plus four additional $1,150 deductions).

- In 2009 nearly two-thirds of tax units claimed the standard deduction (figure 1). About one in seven of those units claimed an additional deduction because at least one member was elderly or blind.
Alternatively, tax filers may itemize the actual amounts spent on allowed deductible expenses, the most common of which are state and local taxes, mortgage interest, charitable contributions, medical and dental expenses, and casualty and theft losses (figure 2).

In 2011 and 2012, high-income individuals may claim the full value of their itemized deductions. If the 2001-03 tax cuts expire in 2013 as scheduled, however, those taxpayers will have to reduce their itemized deductions by 3 percent of the amount by which adjusted gross income exceeds a threshold—projected to be $174,450 in 2013 ($87,225 for married couples filing separately)—but not more than 80 percent of deductions claimed. The 2001 tax act cut that reduction by one-third for 2006 and 2007, by two-thirds for 2008 and 2009, and completely for 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the temporary repeal through the year 2012.

Itemized deductions averaged about $26,344 in 2009 for tax units claiming them (figure 2). Married couples filing jointly tended to have higher deductions, averaging nearly $32,000; deductions averaged nearly $19,000 for single filers and almost $20,000 for heads of household.

Mortgage interest and state and local taxes each accounted for somewhat over a third of average itemized deductions in 2009, nearly $9,500 each. Charitable contributions made up about half of the remaining deductions, an average of about $3,500.
See Also

Income Tax Issues: What is the difference between tax deductions and tax credits?

Data Sources

Internal Revenue Service, Statistics of Income, "SOI Tax Stats-Individual Income Tax Returns," Table 1.3 All Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Marital Status, Tax Year 2009.

TPC Tax Facts Personal Exemption and Standard Deduction 2001-2011

Author: Roberton Williams
Last Updated: September 26, 2011

Further Reading


________, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code Of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, JCS-3-01, April 2001, especially individual income tax proposals 5, 6, 7, and 10.


President's Advisory Panel on Federal Tax Reform, Final Report, especially chapters 3 and 5.
Income Tax Issues: What is the difference between tax deductions and tax credits?

Tax deductions and tax credits can both reduce an individual’s income tax liability, but they do it in different ways. Tax deductions reduce taxable income; their value thus depends on the taxpayer’s marginal tax rate, which rises with income. Because deductions cannot reduce taxable income below zero, their value is limited to the filer’s tax liability before applying the deduction. In contrast, tax credits directly reduce a person’s tax liability and hence have the same value for all taxpayers with tax liability at least equal to the credit. In addition, some credits are refundable; they are not limited by the taxpayer’s tax liability. As a general rule for policy, tax deductions make most sense for items that represent reductions in ability to pay tax, such as casualty losses. Credits are more appropriate for subsidies provided through the tax system.

- An individual tax filer has the choice of claiming the standard deduction or itemizing deductible expenses for items such as state and local taxes paid, mortgage interest, and charitable contributions. In either case, taxable income is decreased by the amount of the allowed deduction. The deduction reduces tax liability by the amount of the deduction times the filer’s marginal tax rate and is thus worth more to taxpayers in higher tax brackets. For example, a $10,000 deduction reduces taxes $1,500 for people in the 15 percent tax bracket, whereas the same deduction cuts taxes $3,500 for those in the 35 percent tax bracket.

- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allows all taxpayers to claim the full value of their itemized deductions in 2011 and 2012. However, if the relevant provision expires in 2013 as currently scheduled, high-income taxpayers will have to reduce their itemized deductions and thus will not benefit fully from their itemizable expenses. The reduction in 2013 will be 3 percent of the amount which adjusted gross income (AGI) exceeds $174,450 ($87,225 for married couples filing separately), up to 80 percent of total itemized deductions.

- The standard deduction and some itemized deductions are disallowed under the alternative minimum tax (AMT). For example, AMT taxpayers may not deduct state and local tax payments or items in the "miscellaneous" deductions category. The AMT reduces but does not eliminate other deductions. Medical expenses in excess of 7.5 percent of AGI, for example, may be deducted under the regular income tax, but the threshold is 10 percent of AGI under the AMT.

- Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These include deductions for contributions to Individual Retirement Accounts, al-
imony payments, certain moving expenses, and interest on student loans, among others. The personal exemption ($3,700 each for taxpayers and their dependents in 2011) is also, in effect, a deduction, because it reduces taxable income. The value of all of these deductions depends on the taxpayer’s marginal tax rate and tax liability.

- Tax credits are subtracted not from taxable income but directly from a person’s tax liability; they thus reduce taxes dollar for dollar. As a result, credits have the same value for everyone who can claim their full value.

- Most tax credits are nonrefundable; that is, they cannot reduce a person’s tax liability below zero. As a result, low-income tax filers often cannot get the full benefit of the credits for which they qualify. Some tax credits, however, are fully or partially refundable: if their value exceeds a person’s tax liability, the excess is paid to the filer. The earned income tax credit (EITC) is fully refundable; the child tax credit (CTC) is refundable only to the extent that the filer’s earnings exceed a specified threshold—$3,000 in 2011. These two credits accounted for more than 52 percent of the dollar value of all credits claimed in 2009 (see figure).

See Also

Income Tax Issues: How do the standard deduction and itemized deductions compare?

Taxation and the Family: What is the earned income tax credit?

Taxation and the Family: What is the child tax credit?

Taxation and the Poor: Can poor families benefit from the child tax credit?

Further Reading


Data Sources


TPC Tax Facts, Historical Deduction Type

Author: Roberton Williams
Last Updated: September 26, 2011
Income Tax Issues: How do phaseouts of tax provisions affect taxpayers?

- Many provisions in the tax code are phased out (that is, their value is reduced as income rises) for higher-income taxpayers as a way to target tax benefits on middle- and lower-income households and to limit the loss of revenue. Phaseouts not only claw back these benefits but also increase the *marginal tax rate* that affected taxpayers face and thus decrease the after-tax gains of earning more income. Some taxpayers have multiple tax provisions phasing out at the same time, compounding the negative effects on their work incentives. More broadly, phaseouts complicate the tax code and make it more difficult for taxpayers to understand the taxes they pay. The table below describes the main phase-ins and phaseouts in the tax code as of 2011.

Phaseouts are structured in various ways and thus have different impacts. Some reduce *credits* and thus have the same tax effect for all affected taxpayers. Others reduce *deductions*, in which case their effect depends on the taxpayer's marginal tax rate: the higher the rate, the greater the value of the lost deduction.

- Phaseouts reduce tax benefits at different rates depending on their structure and range.
  - Most phaseouts reduce benefits at a constant rate over the full phaseout range; the rate depends on the width of the range. For example, for single tax filers the American Opportunity Tax Credit phases out over a $10,000 range, so its phaseout rate is 1 percent per $100 in additional income. In contrast, the adoption credit phases out over a $40,000 range, so its phaseout rate is one-fourth as fast—just 0.25 percent per $100.
  - Some phaseouts, however, reduce benefits by a certain amount for each fixed increment of income. For example, the child credit decreases by $50 for every $1,000 or part of $1,000 in additional income above the phaseout threshold. Whether income exceeds the threshold by $1 or by $999, the credit falls by the same $50.
  - Some phaseouts have more pronounced "cliffs," so the benefit drops in large increments when income exceeds the threshold. For example, in 2011, the limit on the deduction for higher education tuition and fees drops from $4,000 to $2,000 for a single tax filer as soon as income exceeds $65,000 and then drops to zero when income tops $80,000.
  - Many phaseouts are indexed for inflation so that the phaseout ranges remain fixed in real terms. Phaseouts that are not adjusted for inflation affect more taxpayers over time, as inflation raises nominal incomes and thus lifts more taxpayers above the phaseout thresholds.
  - Many phaseouts create significant marriage penalties—or bonuses—because the phaseout range for married couples is less than twice that for single tax filers. Take the phaseout of personal exemptions for example. It is not in effect for 2011 and 2012 but is scheduled to resume in 2013, when it will begin at a projected $261,650 for married couples filing jointly, which is under twice the projected $174,450 threshold for single filers. Consider a couple in which each spouse had income of $150,000. Each spouse would be unaffected by the phaseout if they were single, but they were worse off as joint filers because they lost some of their personal exemptions. The phaseout of itemized deductions (which also does not apply in 2011...
or 2012 but is scheduled to resume in 2013) is worse: it will begin at the same $174,450 income level for both single and married tax filers.

### Appendix

#### Summary of the 2011 Individual Income Tax Code

- **Selected Provisions and Parameters:**

  - **Effective Date:**
    - 2011 for joint filers, 2012 for single filers.
  - **Phase-Out:**
    - For joint filers, the phase-out begins at $174,450 in 2011, for single filers, the phase-out begins at $87,225 in 2011.

#### Table: Selected Provisions and Parameters

<table>
<thead>
<tr>
<th>Provisions and Parameters</th>
<th>Effective Date</th>
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<td>Single Filers</td>
<td>2011</td>
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#### Notes:

- **References:**
  - Urban-Brookings Tax Policy Center
  - www.taxpolicycenter.org/briefingbook
See Also

Income Tax Issues: What is the difference between tax deductions and tax credits?

Taxation and the Family: What is the earned income tax credit?

Taxation and the Family: What is the child tax credit?

Taxation and the Family: How does the tax system subsidize child care expenses?

Taxation and the Family: What incentives exist to help families pay for college?

Taxation and the Family: What incentives exist to help families save for college?

Taxation and the Family: What are marriage penalties and bonuses?

Author: Roberton Williams
Last Updated: October 5, 2011

Data Sources

Internal Revenue Service, "Your Federal Income Tax," Publication 17 (Washington, various years),


________, "Individual Retirement Arrangements (IRAs)," Publication 590 (Washington, 2010).

Further Reading

THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the 2008 Election and Beyond

TAX EXPENDITURES

What are they and how are they structured? ................................................................. I-8-1
What is the tax expenditure budget? ................................................................. I-8-6
Why are they controversial? ........................................................................... I-8-8
How have they changed over time? ................................................................. I-8-3
What are the largest tax expenditures? ................................................................. I-8-6
Tax Expenditures: What are they and how are they structured?

Tax expenditures are revenue losses attributable to tax provisions that often result from the use of the tax system to promote social goals without incurring direct expenditures. How tax expenditures are structured affects both who will benefit from them and how much they will reduce federal revenues.

- Income tax provisions generally seek to promote one or more of three broad objectives: measuring income accurately, distributing fiscal benefits and burdens based on a household’s ability to pay, and promoting activities or behavior that are considered socially desirable. Tax expenditures are tax provisions that are not structural features of the income tax or necessary to measure income accurately.
  
  o There is some debate about whether distributionally-oriented tax provisions should be considered tax expenditures and, if so, which ones should be. Similarly, commentators debate which provisions should be considered structural features of the income tax.

  o Each year the Office of Tax Analysis at the Treasury Department and the Joint Committee on Taxation publish separate lists of income tax expenditures and their estimated cost on foregone revenue. Some commentators have suggested that this Tax Expenditure Budget should be broadened to include tax expenditures within the payroll, wealth transfer, and excise taxes.

- Tax expenditures can take many forms. Some result from tax provisions that reduce the present value of taxable income through deferral allowances, or special exclusions, exemptions, or deductions from gross income. Others affect a household’s after-tax income more directly through tax credits or preferential rates for specific activities.

  o Individual income tax expenditures are typically structured either as deductions or exclusions, non-refundable tax credits, or refundable tax credits. With non-refundable credits, taxpayers may only use the credit to reduce or eliminate positive income tax liability. In contrast, refundable credits do not have that restriction: if the credit exceeds pre-credit tax liability, the tax filer still receives the excess as a payment.

  o Deductions and exclusions accounted for more than 80 percent of the major individual income tax expenditures in 2008 (see figure 1). However, the use of refundable tax credits has increased over time, primarily because of the growth of the earned income tax credit (EITC) (see figure 2).
The structure of a tax expenditure is important because it determines its value for different families.

- Generally, deductions and exclusions are most valuable for high-income households because their value is the amount deducted or excluded times the taxpayer’s marginal tax rate. Thus, a $100
deduction or exclusion typically saves $35 for someone in the 35 percent top income tax bracket, but only $10 for someone in the 10 percent bracket.

- Most deductions are itemized deductions as opposed to “above-the-line” deductions. Itemized deductions have value only when listed and claimed; they thus are worth nothing for the roughly two-thirds of households that claim the standard deduction.

  - Non-refundable credits generally have the same value for all tax units whose income tax liability exceeds the credit. However, their value is limited to the taxpayer’s positive tax liability so they have no value for households that owe no tax.

  - By contrast, refundable tax credits are the only form of tax expenditure that can provide the same subsidy for all households.

  - All three types of tax expenditures may contain income limits or phase in or out in order to further target their distributional effects.

- Only three tax credits—the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC)—are refundable so households in the bottom half of the income distribution reap relatively little benefit from tax expenditures.

  - More than two-fifths of all households—and over half of those with children—have no federal income tax liability (see figure 3) and thus cannot benefit from deductions, exclusions and non-refundable tax credits.

  - Many such households do, however, pay substantial payroll taxes and would benefit if income tax credits could be used against those levies, or against income taxes paid in the past or future.
example, over a 25 year period, more than 80 percent of tax units with no income tax liability in the current year end up paying a positive amount of income taxes, and more than 99 percent end up paying a positive amount of income and payroll taxes, on net.

- The best way to structure a tax expenditure depends on its purpose.
  - Tax provisions intended to measure taxable income accurately should be exclusions or non-itemized deductions. Such provisions are not generally considered tax expenditures.
  - Tax expenditures designed to redistribute income must take into account which households they aim to benefit. In particular, only refundable tax credits can assist tax units at the bottom of the income distribution.
  - Tax expenditures intended to spur socially-desirable behavior or activities should focus on the relative responsiveness of targeted groups. Unless there is good reason to exclude low-income households, such tax expenditures may be most effective if they are refundable credits.

See Also
- Income Tax Issues: How do the standard and itemized deductions compare?
- Income Tax Issues: What is the difference between tax deductions and tax credits?
- Income Tax Issues: How do phase-outs of tax provisions affect taxpayers?
- Tax Expenditures: What is the tax expenditure budget?
- Tax Expenditures: Why are they controversial?
- Tax Expenditures: How have they changed over time?
- Tax Expenditures: What are the largest tax expenditures?
- Taxes and the Poor: How do refundable and nonrefundable credits differ?

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Author: Lily Batchelder
Last updated: 7/17/09
Tax Expenditures: What is the tax expenditure budget?

The tax expenditure budget comprises the estimated revenue losses attributable to various exclusions, exemptions, deductions, nonrefundable credits, deferrals, and preferential rates in the tax code. These provisions reduce the income tax liabilities of individuals or businesses that undertake certain types of activities. For instance, people who donate to charities often deduct their donations on their tax returns and thus reduce their income tax. The tax expenditure budget estimates the aggregate cost of this and other provisions. The Congressional Budget Act of 1974 requires that the budget include estimates for tax expenditures, but only for those provisions that affect the federal income taxes of individuals and corporations. The government could, but does not, formulate tax expenditure budgets for Social Security and other taxes.

- Both the Office of Tax Analysis in the Treasury Department and the congressional Joint Committee on Taxation (JCT) estimate tax expenditures; the items that each includes and the estimated values are generally similar but do not always match. The Office of Management and Budget (OMB) publishes the Treasury’s estimates in its Analytical Perspectives volume that accompanies each year’s publication of the Budget of the U.S. Government. Each year JCT issues estimates covering the current and four subsequent fiscal years.

- OMB’s tax expenditure budget for fiscal 2008 totaled $878 billion, but the estimates for individual provisions are not strictly additive. Various provisions interact in ways that can make their combined tax expenditure differ from the sum of their individual revenue costs.

- Tax expenditures operate essentially like direct expenditures, even though they appear as tax breaks. They benefit hundreds of different types of activities and individuals and currently account for one-fourth to one-third of all benefits and subsidies granted to the public.

- Like mandatory programs (or entitlements) on the spending side of the budget, most tax expenditures do not go through a direct appropriations process each year. They continue and often expand with no congressional vote; for example, the value of charitable deductions rises with an expanding economy.
See also

Tax Expenditures: What are tax expenditures and how are they structured?

Tax Expenditures: Why are they controversial?

Tax Expenditures: How have they changed over time?

Tax Expenditures: What are the largest tax expenditures?

Data Sources

Budget of the U.S. Government, FY 2010, Analytical Perspectives, Table 19.1

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Author: C. Eugene Steuerle and Gillian Reynolds
Last updated: July 17, 2009
Tax Expenditures: Why are they controversial?

To some, tax expenditures are spending items which do not belong in the tax code. To others, they are merely a way of reducing taxes, and repealing them would amount to a tax increase. In fact, as budget items, tax expenditures perform very much like spending programs, which means they may be bad or good, depending on whether they serve a legitimate public purpose in the best manner possible. Controversy also surrounds the identification and measurement of tax expenditures.

- Both political parties like to provide subsidies and expenditures in the form of tax breaks, because they cause the measure of net tax revenue to fall without increasing the measure of spending. Thus, they give the appearance of reducing government’s size. For this reason, tax subsidies have strong political appeal. In fact, however, tax expenditures can actually expand government’s interference in the economy, partly because they induce changes in taxpayers’ behavior. Also, like direct spending, tax expenditures must also be paid for through higher taxes elsewhere.

- Imagine, for instance, a government that did only two things: it provided tax expenditures for energy equal to 20 percent of national income, and it collected an income tax on workers. Then it would have to assess tax rates high enough to collect 20 percent of national income from workers before it granted back the tax breaks for energy.

- Tax expenditures are based on deviations from a given tax system. Traditionally, they represent reductions in the revenue that would be collected under a comprehensive income tax. If the current income tax were replaced wholly or in part by a consumption tax, some provisions now classified as tax expenditures would no longer be regarded as such. For example, under a comprehensive consumption tax system, the tax-preferred treatment of capital gains and retirement savings would not be considered tax expenditures. In-kind benefits such as food stamps and public housing, however, would be regarded as tax expenditures under either type of system.

- In some cases it is less clear whether a given provision is a tax expenditure so their identification becomes a matter of judgment. For instance, what is the right measure of "normal depreciation" in an inflationary economy? The congressional Joint Committee on Taxation uses a different definition of what would be included in a normal or comprehensive income tax, and therefore it classifies some different items as tax expenditures than does the Treasury Department.

- The value of any single tax expenditure can be measured as the revenue loss due to that tax expenditure alone (or, equivalently, as the amount by which total revenue would rise if that tax expenditure only were repealed). However, tax expenditures may interact with each other, so that the actual effect on revenue of changing several tax expenditures simultaneously could differ from the sum of their individual effects. For example, if several tax expenditures were repealed simultaneously, some individuals might be pushed into higher tax brackets, thereby changing the value of each subsidy and possibly their resulting behavior.

- Tax expenditures can also be reported as outlays equivalents rather than as revenue losses. They then reflect the amount of taxable direct spending that would be required to match the benefit of the tax provision. The difference between outlay equivalent losses and revenue losses usually arise when a tax subsidy itself is nontaxable. For instance, it would take a taxable outlay equivalent of $1,000 (or $1,000 in taxable wages) to give a person in a 50
percent tax bracket the same level of benefit as $500 in tax credits. While the fact that tax benefits are not themselves taxed often adds to their value, the Treasury Department in 2006 stopped reporting outlay equivalents that took this extra value into account. Its main justification was that the criteria “...were often judgmental and hard to apply with consistency.” Of course, this leads itself to inconsistency, as when the tax expenditure budget counts the benefit of not taxing a direct outlay but ignores the parallel benefit for an equivalent tax provision.

See Also

Tax Expenditures: What are tax expenditures and how are they structured?
Tax Expenditures: What is the tax expenditure budget?
Tax Expenditures: What are the largest tax expenditures?
Tax Expenditures: How have tax expenditures changed over time?

Data Sources

Budget of the U.S. Government, FY 2010, Analytical Perspectives, Table 19-1.


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Tax Expenditures: How have they changed over time?

Tax expenditures have shifted dramatically over time. With the important exception of the Tax Reform Act of 1986, recent decades have seen an increase in the number, and sometimes the value, of tax expenditures. At the same time there has been a rise in social tax expenditures and a decline in business tax expenditures, again due mainly to the 1986 act. Tax expenditures also vary in value with tax rates: when rates rise, so do the tax savings associated with many of the deductions and exclusions that make up a large part of the tax expenditure budget.

- Aggregate tax expenditures reported by the Treasury increased between 1976 and 1985 from 5.2 percent to 8.3 percent of GDP. (Because of their interactions, individual tax expenditures do not, strictly speaking, sum to their total cost, but the summation of Treasury numbers still provides a reasonable approximation of their aggregate effect.) They dropped sharply after the tax reform of 1986, falling to near 1976 levels, and rose gradually thereafter, peaking in 2001 at 7.4 percent. (The Treasury first began estimating tax expenditures in 1974; estimates from that year included tax expenditures for 1974-76.) They have stayed within a percentage point of 7 percent of GDP since 1999.
- In the 1970s many tax subsidies were provided as business tax breaks and deductions, which higher-income taxpayers found more valuable. The 1986 tax reform significantly cut back on business preferences, particularly through removal of the investment credit. Only a few social tax expenditures have been removed over time, although their value often fluctuated as tax rates rose or fell.
- Nonbusiness tax expenditures-those reported on individual income tax returns that do not also benefit businesses-are higher in 2006 than in 1976 (see figure).
Underlying Data: Download

- Exclusions that exempt specific kinds of income from tax constitute a substantial share of tax expenditures. Many exclusions benefit a large percentage of the population, including much of the middle class. Between 1948 and 1982 exclusions doubled, from 12 percent of personal income to 24 percent, before falling off to 19 percent in 2004. Employer contributions to health plans, Social Security benefits, and tax breaks associated with homeownership are the largest exclusions from income taxation.
- Tax credits have grown significantly since 1986. The expanded use of the earned income tax credit, child tax credits, and other tax benefits targeted toward lower-income families, especially those with children, drove much of this rise. The earned income tax credit and the child credit are refundable and thus provide benefits for many families who owe no income tax.
- The tax expenditure budget ignores the costs of complexity—the time and money costs of claiming credits and deductions on tax returns and the cost of finding and implementing strategies to minimize taxes. But taxpayers today can use software to prepare their returns, which makes it politically more feasible for Congress to add layers of tax complexity without incurring as much taxpayer wrath.
See Also

Tax Expenditures: What are tax expenditures and how are they structured?

Tax Expenditures: What is the tax expenditure budget?

Tax Expenditures: Why are they controversial?

Tax Expenditures: What are the largest tax expenditures?

Data Sources


Further Reading


Author: Gillian Reynolds and C. Eugene Steuerle
Last Updated: July 20, 2009
Tax Expenditures: What are the largest tax expenditures?

Tax expenditures make up a substantial part of the federal budget. Some of them are larger than the entire budgets of the programs or departments that spend money for the same or related purposes; for example, the value of the tax breaks for homeownership exceeds total spending by the Department of Housing and Urban Development.

The largest tax expenditure is the exclusion of employers’ contributions for their employees’ medical insurance premiums and medical care. Under this provision, contributions are excluded from the employee’s gross income, while the employer may deduct the cost as a business expense.

The next-largest tax expenditure is the combined net exclusion of contributions to and earnings of employer-provided and individual pension plans. These include 401(k) plans, Individual Retirement Accounts (IRAs), the savers’ credit, and Keogh plans. Most of these plans allow taxpayers to exclude employer or individual retirement contributions from their gross income, and to defer taxes on the investment income earned on these savings until the money is withdrawn.

The deductability of mortgage interest on owner-occupied homes is one of the three homeownership subsidies that top the list of tax expenditures. Under this provision the mortgage interest paid by owner-occupants of homes may be taken as a nonbusiness deduction, up to a limit.

One of the largest tax expenditures for businesses is the provision that allows for accelerated depreciation of certain types of machinery and equipment.

The deductability of nonbusiness state and local taxes other than on owner-occupied homes is another large tax expenditure. These taxes are deductible even though they may pay for services received from the state or local government.
• Deductions of charitable contributions to nonprofit educational institutions, nonprofit health institutions, and organizations other than those for education and health are listed as three separate tax expenditures, but deductions for charitable contributions combined would rank as the sixth-largest tax expenditure.

• Another large tax expenditure for businesses is the deferral of income from controlled foreign corporations. Income earned by a U.S. firm through a foreign subsidiary is exempt from taxation by the U.S. until it is returned to the U.S. parent company as dividends or other income.

• Homeowners may exclude up to $250,000 ($500,000 for a couple filing jointly) of capital gains on the sale of their principal residence. This is the second-largest homeownership tax subsidy.

• The third large tax subsidy for homeownership is the deductibility of state and local property tax on owner-occupied homes. Homeowners who itemize may deduct the amount of property taxes they paid, while nonitemizers may take a deduction in addition to the standard deduction of $250 for single filers and $500 for joint filers.

• Taxpayers with one or more children under age 17 qualify for a partially refundable child credit of $1,000 per child. Only the nonrefundable portion of the credit is counted as a tax expenditure; any refundable portion is considered an outlay.

• The reduced tax rate on capital gains is the another large tax expenditure. These gains are taxed at a lower rate than ordinary income, provided they are held for more than one year.

• The step-up in basis of capital gains precludes assets from being taxed on any gains accrued, but not realized, at the death of the owner. If the estate tax remains repealed in 2010, some heirs will no longer benefit from this provision.

See Also
Tax Expenditures: What is the tax expenditure budget?
Tax Expenditures: Why are they controversial?
Tax Expenditures: How have tax expenditures changed over time?

Data Sources


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Author: Gillian Reynolds and C. Eugene Steuerle
Last Updated: July 20, 2009
THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the 2008 Election and Beyond

TAX GAP

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The Tax Gap: What is the tax gap?

The tax gap is the difference between taxes owed and taxes paid. The Internal Revenue Service estimates that over the past thirty years the tax gap has ranged from 16 to 20 percent of total tax liability. For 2001 the IRS estimates the gross tax gap at $345 billion, or slightly over 16 percent of tax liability, of which $55 billion will eventually be recovered through voluntary late payments and enforcement activities, leaving a net tax gap of about $290 billion. Some view the tax gap as a major revenue source that can be used to close the federal budget deficit or to pay for reform of the alternative minimum tax, without raising taxes. In fact, the potential revenue gains from proposals to improve enforcement are quite limited.

- Nonfiling and underpayment of reported taxes account for less than 20 percent of the gross tax gap; underreporting on timely filed tax returns makes up the bulk of the gap. Underreporting on individual income tax returns alone accounted for about 68 percent of the gross tax gap in 2001.

- Over 60 percent of underreported individual tax is for business and self-employment income, which the IRS has no easy way to verify independently.

- Only 10.5 percent of the underreporting gap is attributable to corporate income tax, and only 1.4 percent to the estate tax and excise taxes.

- Individual income taxpayers fail to report about 54 percent of income from sources for which there is no information reporting, such as sole proprietorships. In contrast, less than 5 percent of income from easily verified sources-interest, dividends, and pensions-goes unreported. When income is subject to both information returns and tax withholding, as is the case with wages, just over 1 percent goes unreported.
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The Tax Gap: What is being done now to close the gap?

The Internal Revenue Service conducts a number of enforcement programs, which together raised $49 billion in fiscal 2006. The biggest source of enforcement revenue is collection of taxes reported or assessed but not paid—the so-called collection programs. Other programs include traditional face-to-face audits of taxpayer records, whether at an IRS office or at the taxpayer’s home or business, correspondence audits, and document matching.

- IRS enforcement resources declined sharply in the late 1990s, as funding shifted toward greater emphasis on taxpayer services. Enforcement spending is starting to increase but is still below mid-1990s levels in wage-adjusted dollars, while both the number of tax returns and the complexity of the tax law have increased.

- The IRS promotes voluntary compliance by raising the cost of tax evasion and, through taxpayer services, making it easier for honest taxpayers to fulfill their responsibilities.

- IRS data suggest that about four dollars, on average, is recovered in direct enforcement revenue per additional dollar spent on enforcement.

- Some research findings suggest that increased enforcement produces gains from improved voluntary compliance that far exceed the direct revenue that these programs bring in, but the actual amount is hard to quantify.

![IRS Spending Deflated by Employment Cost Index, 1997-2006](chart.jpg)

| See Also | Further Reading |
|----------|----------------|----------------|----------------|----------------|----------------|
| Author: Eric Toder | Last Updated: January 3, 2008 |
| Last Updated: January 3, 2008 |
The Tax Gap: Can much of it be closed?

The two principal approaches for closing the tax gap are more information reporting and stepped up enforcement by the Internal Revenue Service. Both are worth pursuing, despite some additional costs, but neither promises to reduce the tax gap significantly.

- The president’s 2008 budget includes a number of proposals to expand information reporting. One would require brokers to report to the IRS the cost of assets sold by taxpayers (they currently must report only the gross sale price); another would require banks to report credit card sales by merchants. The Treasury estimates that all their proposals would raise about $29 billion over ten years, less than 1 percent of the tax gap.

- Sustained increases in IRS enforcement funds could lead to more revenue. If, for example, the $11 billion IRS budget proposed for 2008 were permanently raised by 20 percent, with the increase directed to enforcement, the IRS could ultimately raise $9 billion to $10 billion more per year at fiscal 2008 levels. This estimate includes direct receipts from enforcement only and not any increase in voluntary compliance in response to the increased enforcement.

See Also
Tax Gap: What is the tax gap?
Tax Gap: What is being done now to close the gap?

Further Reading


THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the 2008 Election and Beyond

BUSH TAX CUTS

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Background: Bush Tax Cuts

This section quantifies the effects of the many tax cuts enacted since 2001 and whom they have benefited.

Description of the Bush Tax Cuts

• How did they change the tax code?
• How did the 2001 tax cuts change the tax code?
• How did the 2002 tax cuts change the tax code?
• How did the 2003 tax cuts change the tax code?
• How did the 2004 tax cuts change the tax code?
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• How did the 2006 tax cuts change the tax code?

Beneficiaries of the Bush Tax Cuts

• If we account for how the cuts are paid for, who benefits from them?
• If we ignore how the cuts are paid for, who benefits from them?
• Who benefits when their cost and potential economic growth are accounted for?
• How are the distributional effects measured?

Fiscal Effects of the Bush Tax Cuts

• How have they affected tax revenue?
• How big are the cuts?
• How do they compare with the Reagan cuts?
• Did they reduce the size of government?
• Are they justified as part of a "starve the beast" strategy?
• Are tax cuts an effective way to reduce government spending?
• How do the AMT and interest payments affect the cost?
• What is their impact on government borrowing and interest payments?
• What spending and revenue measures would pay for making them permanent?

Economic Effects of the Bush Tax Cuts

• How did they affect corporate investment?
• How did they affect small businesses and entrepreneurs?
• How did they affect incentives to work?
• How did they affect retirement saving?
• Were they well designed to strengthen long-term economic growth?
• Were they well timed to spur economic growth?
• What are the indirect effects on economic growth?
• Did they provide good "bang for the buck"?
• Didn't they help the economy recover from the 2001 recession?
The Bush Tax Cuts: How did they change the tax code?

The tax cuts enacted between 2001 and 2006 contain a host of large and small changes to the tax code that phase in at different rates and expire at different times. The tax cuts of 2001, 2003, 2004, 2005, and 2006 built on one another, with many of the bills passed after 2001 serving to extend provisions in earlier bills. Most provisions are now scheduled to expire at the end of 2010.

- The 2001 tax cut was especially sweeping. Its two most prominent changes were a phased-in reduction in income tax rates and a reduction and eventual repeal (at the beginning of 2010) of the estate tax. It also provided a wide range of tax breaks for education, families with children, married couples, and contributions to certain kinds of savings accounts.

- The 2002 tax cut addressed a different part of the tax code, significantly but temporarily reducing the tax burden on new business investments. Its main provision has already expired.

- The 2003 bill cut taxes on dividends and capital gains and accelerated the schedule for phasing in most of the other tax cuts enacted in 2001.

- The 2004 tax cut extended various provisions from the 2001 and 2003 tax cuts that were scheduled to expire before 2010, so that they remain in force through 2010.

- The 2005 tax cuts indexed the alternative minimum tax for inflation for one year ("patched" it, in tax parlance), eliminated the income restrictions on Roth Individual Retirement Accounts (IRAs) in 2010, and extended the reduced rates on dividend and capital gains income.

- The 2006 tax cuts made certain aspects of the 2001 tax act permanent, including the raised annual contribution limits to IRAs, tax-free withdrawals from qualified tuition savings accounts, and the savers’ credit, and permanently extended rules governing education-based tax credits.
See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2005 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


Tax Policy Center, "Major Legislation by Act, 1981-2006" (Washington)
The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

The 2001 tax cut legislation, titled the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), was the most sweeping of the Bush tax cuts and set the stage for later legislation. Key features were a reduction in the top four income tax rates and the creation of a new 10 percent bracket. EGTRRA also temporarily raised the alternative minimum tax (AMT) exemption, doubled the child tax credit, reduced the estate tax and repealed it in 2010, and reduced taxes on taxpayers filing as married couples.

- Under the 2001 tax cut, the top individual income tax rate was scheduled to decline from 39.6 percent in 2000 to 35 percent by 2006. The 28, 31, and 36 percent rates were scheduled to fall by 3 percentage points each. These reductions were scheduled to occur in stages; the 2003 tax cut bill accelerated these reductions so that the full reductions took place at the start of 2003.

- The 2001 tax act also created a new 10 percent tax bracket, carved out of the 15 percent bracket. The 10 percent bracket applied to the first $12,000 of taxable income (for married couples filing jointly) through 2007. The limit was scheduled to rise to $14,000 in 2008 and to be indexed for inflation starting in 2009; later legislation would accelerate the phase-in of this provision and extend it to 2010.

- The AMT exemption was raised to $49,000 for couples and $35,700 for singles through 2004; this provision is called a “patch,” since it is temporary and does not address the AMT’s more fundamental problems. Later legislation would further patch the AMT, typically in one-year increments.

- The exemption for estates was set to gradually rise to $3.5 million in 2009. The top effective tax brackets for estate and gift taxes were also reduced, from 60 percent to 50 percent in 2002 and then gradually to 45 percent in 2009. The estate tax was repealed as of 2010 for one year only; it would then return to its pre-2001 provisions in 2011.

- The 2001 bill enacted a gradual increase in the maximum value of the child credit, reaching $1,000 in 2010. It also made the credit partly refundable, so that if it reduced a household’s income tax bill below zero, the household could claim a tax refund, at least up to specified levels that depended on the household’s earnings.

- The bill addressed the "marriage penalty" in several ways. Before its enactment, the standard deduction for married couples was 167 percent of the standard deduction for singles. That sometimes created a marriage penalty, because the combined standard deduction for a married couple was less than twice the sum of their individual standard deductions. The 2001 act gradually increased the ratio to 200 percent by 2009, so that two single people who marry can both keep the standard deduction they would have had as single taxpayers. Similarly, the tax brackets were altered so that the maximum taxable income in the 15 percent bracket for married couples rises to double the maximum for singles, again to eliminate this source of the marriage penalty.
The act increased the contribution limits for tax-preferred retirement saving accounts. Contribution limits for both traditional and Roth Individual Retirement Accounts were gradually increased from $2,000 under previous law to $5,000 by 2008 and indexed to inflation after that until 2010, at which point the increases would disappear. These provisions were reformed in later legislation.

See Also

The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

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The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

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The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The primary feature of the 2002 tax cut legislation (the Job Creation and Worker Assistance Act of 2002) was to provide for "bonus depreciation." Bonus depreciation allows firms to claim extra deductions for depreciation of a long-term physical capital investment during the early years, which reduces reported corporate profits, and thus taxes owed, in the present. This provision allowed a first-year deduction of 30 percent of the value of qualified investments made after September 10, 2001, and before September 11, 2004. This temporary provision, intended to boost investment spending during a period of economic weakness, was scheduled to expire at the end of 2004 but was extended in 2003.

See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2005 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

Further Reading

Joint Committee on Taxation, "Estimated Revenue Effects of the ‘Job Creation and Worker Assistance Act of 2002,’" JCX-13-02 (Washington, March 6, 2002).


Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008
The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The 2003 tax cut legislation, titled the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), reduced taxes on dividends and capital gains and accelerated some provisions passed in earlier tax cuts.

- Tax rates on realized capital gains received by individual shareholders were reduced from 10 percent (for taxpayers in tax brackets where the ordinary income tax rate was 15 percent or below) and 20 percent (for all other brackets) to 5 percent and 15 percent, respectively, through 2007 and to 0 and 15 percent in 2008. Tax rates on dividends received by individual shareholders were reduced from the rates that apply to ordinary income to the new capital gains rates.

- The 2001 tax cut had raised the alternative minimum tax exemption to $49,000 for couples and $35,700 for singles through 2004. The 2003 tax cut raised the exemption further, to $58,000 for couples and $40,250 for singles, but still only through 2004.

- The 2003 tax cut also accelerated and expanded many of the provisions of the 2001 tax act, including the expansion of the child tax credit, the reduction in taxes on married couples, and the lower rates and adjusted brackets on individual income. It also expanded the bonus depreciation provision passed in 2002.

See Also

- The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?
- The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?
- The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?
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Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008
The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

Two pieces of tax legislation were passed in 2004: the Working Families Tax Relief Act of 2004 (WFTRA) and the American Jobs Creation Act (AJCA). WFTRA extended certain provisions of the 2001 and 2003 tax cuts to various sunset dates; AJCA primarily involved changes in the taxation of business and corporate income that are largely unrelated to the 2001 and 2003 tax cuts.

- The primary tax change in WFTRA was to extend provisions introduced three years earlier under the 2001 tax legislation. It extended the 10 percent bracket for joint filers through 2010, the higher standard deduction for married filers through 2009, and the doubled child tax credit through 2009.

- WFTRA also extended the higher alternative minimum tax exemption through 2005 and extended certain ongoing tax provisions, the Work Opportunity Tax Credit and the Welfare to Work Tax Credit, aimed at increasing incentives for business to hire more workers from "vulnerable" populations.

- The most significant provision of AJCA was a change in the tax incentives for U.S. businesses involved in exporting, to make the U.S. tax code compliant with international trade guidelines. AJCA also increased tax credits for business investment abroad and temporarily increased the business "expensing" provision.

- AJCA did also change certain provisions of the individual income tax. One notable provision allowed individuals to claim a deduction for state and local sales taxes paid, in lieu of deducting state income taxes. This provision primarily benefited individuals in states that have a sales tax but no state income tax.
See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2005 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 200

Further Reading


Tax Policy Center, "Major Legislation by Act, 1981-2006" (Washington)
The Bush Tax Cuts: How did the 2005 tax cuts change the tax code?

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended lower rates on dividend income and capital gains through 2010, raised the higher exemption amount for the alternative minimum tax for one year, and eliminated income restrictions on high-income taxpayers for converting traditional Individual Retirement Accounts (IRAs) to Roth IRAs. The first two provisions extended provisions of earlier tax legislation, whereas the relaxed restriction on IRA conversions was largely a gimmick used to conform the costs of TIPRA to budgetary rules: taxpayers converting traditional to Roth IRAs pay taxes currently that they otherwise would have paid on withdrawals from their IRAs during retirement; thus the provision raised current revenue at the expense of revenue in later years. This change effectively eliminated the income restriction for participation in a Roth IRA.

See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

Further Reading


The Bush Tax Cuts: How did the 2006 tax cuts change the tax code?

The Pension Protection Act of 2006 (PPA) addressed regulations governing employer-sponsored pensions and included several tax provisions. PPA was the first act to make certain aspects of the 2001 tax law permanent, including the higher annual contribution limits to Individual Retirement Accounts (IRAs) and tax-free withdrawals from qualified tuition savings accounts. PPA also extended certain temporary rules concerning education-based tax credits and added provisions encouraging employer participation in automatic 401(k) pensions.

- Under PPA the limits for contributions to IRAs are $4,000 in 2006 and 2007, $5,000 in 2008, and indexed to inflation thereafter. PPA also makes permanent the higher contribution limits to 401(k) plans, which were initially raised under EGTRRA legislation and previously set to expire in 2010. The saver’s credit, which increases saving incentives for low-income households, was made permanent as well.

- PPA also made it easier for employers to automatically enroll employees in their defined-contribution pension plans and to set default contributions to these plans. Before PPA, certain states had restricted the ability of employers to automatically deduct such contributions from employee paychecks without written consent; PPA made these automatic deductions universally legal. Also, PPA instituted protections for employers concerned about their legal responsibility when they automatically selected investments for employee pensions.
See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

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Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


Tax Policy Center, "Major Legislation by Act, 1981-2006" (Washington)
The Bush Tax Cuts: If we ignore how the cuts are paid for, who benefits from them?

If the 2001 and 2003 tax cuts were made permanent and the number of taxpayers subject to the alternative minimum tax were held at levels that would have prevailed under pre-2001 law, about 73 percent of tax-filing units would receive a direct tax cut in 2010; that share rises with income, from only 16 percent of units in the bottom income quintile to more than 99 percent in the top quintile. This, however, is not a complete picture of the ultimate impact of the tax cuts, because it does not take into account the tax increases or spending cuts that will eventually be needed to pay for the tax cuts. That accounting is presented in another entry.

- The percentage change in after-tax income, TPC’s preferred measure for comparing the benefits of tax cuts across income groups, rises under this scenario as income rises, from an increase of 0.3 percent in after-tax income in the bottom quintile (see table) to a rise of 4.3 percent in the top quintile. It rises even further within the top quintile, with a 6.4 percent increase for the top 1 percent and a 7.5 percent increase for the top 0.1 percent (not shown). Thus the tax cuts would be regressive, raising after-tax income by a greater percentage for high-income households than for all others.
• Several other commonly used measures of the distributional effects also suggest that the benefits of making the tax cuts permanent would be tilted toward high-income households in general and toward households in the top 1 percent of the income distribution in particular. The average effective tax rate would fall more for the top 1 percent than for any other group. Their share of the tax cut (73.1 percent) would exceed their share of tax burdens in the absence of the tax cut (71.7 percent); as a result, their share of total federal taxes paid would decline. And the tax cut in absolute dollars is clearly far larger for high-income than for low-income groups.

• At least two other measures sometimes cited, if taken at face value, suggest that the tax cuts would actually help other households more than high-income households. First, the reduction in federal tax liability that households in the top 1 percent would receive (11.1 percent), although slightly larger than the average reduction (11.0 percent), would be smaller than the reduction for households in the second-lowest income quintile (18.2 percent). Second, households in the top 1 percent would actually pay a greater share of the income tax (but not of total federal tax) after the tax cuts than before. Some have used this finding to conclude that the tax cut is progressive.

See Also
The Bush Tax Cuts: How are the distributional effects measured?
The Bush Tax Cuts: If we account for how the cuts are paid for, who benefits from them?
The Bush Tax Cuts: Who benefits when their cost and potential economic growth are accounted for?

Further Reading


The Bush Tax Cuts: If we account for how the cuts are paid for, who benefits from them?

The Bush tax cuts will be financed in the future by some combination of tax increases and spending cuts, but it is impossible to say today what the mix will be. TPC has estimated changes in tax burdens across income groups under a variety of assumptions about how the tax cuts will eventually be paid for. In all of these hypothetical scenarios, two common conclusions emerge: a majority of households are made worse off by the tax cuts, and the net effect of the tax cuts is a transfer of wealth from lower-income households to wealthier households.

- We examine here two of these hypothetical scenarios. In both, for ease of comparison, the financing is set so that the cost of the tax cuts (that is, the revenue lost) in a given year is fully paid in that same year. The first scenario assumes that the cost is divided equally among all households, so that each pays the same dollar amount to finance the tax cuts. In this scenario each tax unit "pays" $1,869 (in 2010 dollars) in some combination of reductions in benefits from government spending or increases in taxes other than income tax. Something close to this "lump-sum" or "equal-dollar" financing scenario could occur if the tax cuts were financed largely or entirely through spending cuts that affected all households equally. The second scenario assumes that each household pays the same percentage of its income to finance the tax cuts. In this case the cost per household is 2.6 percent of its income. Something close to this "proportional financing" scenario could occur if the tax cuts were financed through a combination of spending cuts and progressive tax increases.

- Under equal-dollar financing, every measure of the distributional effects shows that high-income taxpayers would gain and all other taxpayer groups would lose if the tax cuts were made permanent (see table 1). Those made worse off include almost every household in the bottom 40 percent of the income distribution, 94 percent in the middle quintile, and even 80 percent in the fourth quintile; in all, 76 percent of taxpayers would be made worse off. In sharp contrast, 89 percent of taxpayers in the top quintile and 95 percent of households in the top 1 percent end up better off, receiving average benefits of more than $54,000.
• The assumption of proportional financing yields similar results (table 2): again, all of the measures indicate that high-income households would be better off, while other households as a group (and about 80 percent of all households, including a majority in every quintile) would be worse off. The top quintile is the only group to receive a net tax cut, but even within that group almost two-thirds of all households in the 80th to the 99th percentile would face net tax increases. In addition, both of the measures that did not show greater gains for the highest-income households when financing was ignored—the reduction in total federal tax liability and the share of income tax paid—now also show that households in the bottom 80 percent of the income distribution would be worse off on average, while those in the top quintile would be better off.
<table>
<thead>
<tr>
<th>Cash income quintile</th>
<th>Share receiving tax cut (percent)</th>
<th>Change in after-tax income (percent)</th>
<th>Average change in tax owed (dollars)</th>
<th>Change in average tax rate (percentage points)</th>
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</tbody>
</table>

Notes:
(a) Changes are from pre-EGTRRA law, evaluated in 2010. The AMT exemption is assumed to be raised to $S4,000 for married couples filing jointly, and to $38,250 for single filers, to keep the number of AMT taxpayers equal to the number who would have been subject to the AMT under pre-EGTRRA law. The tax cuts are assumed to be financed by all tax units paying an equal share (2.6 percent) of their cash income.

Source: Results of the Urban-Brookings Policy Center Microsimulation Model (version 0304-3).
See Also

The Bush Tax Cuts: If we ignore how the cuts are paid for, who benefits from them?

The Bush Tax Cuts: Who benefits when their cost and potential economic growth are accounted for?

The Bush Tax Cuts: How are the distributional effects measured?

Further Reading


Authors: William Gale and Benjamin Harris

Last Updated: January 23, 2008
The Bush Tax Cuts: Who benefits when their cost and potential economic growth are accounted for?

Distributional analysis of the Bush tax cuts often assumes no effect on economic growth. If the tax cuts raised economic growth, could they have raised the incomes of low- and middle-income taxpayers enough to offset the losses they suffer after accounting for the cost of the tax cuts? TPC finds that the answer is no: even with a plausible increase in economic growth, about two-thirds of households would still be worse off. Even a substantial economic growth effect would not be sufficient to rescue most households from being worse off if the tax cuts were made permanent, once the financing of the tax cuts is taken into account.

- If one assumes that the tax cuts raised each component of pre-tax household income by 1 percent, the combination of the direct tax cut and the increase in income would raise after-tax income by 4.5 percent, if the financing of the cuts is ignored. That growth in after-tax income is skewed toward higher-income households, but all groups would obtain some direct benefit. When financing is included, however, the aggregate change in after-tax income falls to 1.1 percent. More important, however, for the distributional analysis is that, in this full accounting, most households would end up worse off, even with a 1 percent increase in pre-tax cash income, than they would have been without the tax cuts. How many would be worse off depends on how the burden of paying for the tax cuts is shared.

- If all households contributed the same dollar amount to paying for the tax cuts (equal-dollar financing), more than two-thirds of households would be made worse off, including almost everyone in the bottom 40 percent of the income distribution, almost 90 percent of those in the middle quintile, and a majority of those in the fourth quintile. The bottom 60 percent of the income distribution would see a decline in after-tax income, even though the economy grew.

- If instead the financing of the tax cuts were proportional to income, 60 percent of households would be made worse off. As a whole, the bottom 20 percent would see a decline in income, and
the next 40 percent would see only a very small increase in average after-tax income. Households in the top quintile receive the vast majority of all benefits in this scenario.

See Also

The Bush Tax Cuts: If we account for how the cuts are paid for, who benefits from them?
The Bush Tax Cuts: If we ignore how the cuts are paid for, who benefits from them?
The Bush Tax Cuts: How are the distributional effects measured?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


The Bush Tax Cuts: How are the distributional effects measured?

A number of methodological choices have to be made in estimating the distributional impact of a tax cut. These decisions include determining who actually bears the burden of a tax, how to count the income of households, and which metric of the distributional impact itself to use. Different choices can lead to quite different results.

- Identifying who is made worse off by a tax is more complicated than it may initially appear, since the person or entity who pays the tax to the government may not be the one who ultimately bears the burden. For example, taxes on a business eventually burden some individuals, but that may be the customers, workers, or suppliers rather than the business owners, if the business can shift the cost of the tax on to them.

- Economists have developed some reasonable conventions on these issues. For example, it is assumed that the burden of the individual income tax is borne by the payer and is not shifted to anyone else. By contrast, it is assumed that the corporate income tax is borne by recipients of capital income generally, not just shareholders in the corporations subject to the tax. The reason is that investors can shift their funds to the most profitable venture with relative ease; a tax on one form of capital thus affects the after-tax return to all forms of capital, because investors constantly compare such after-tax returns and reallocate their investments accordingly. The estate tax is assumed to be borne by those whose estates actually have to pay the tax. Workers are assumed to bear the burden of the payroll tax, including the share nominally paid by the employer, since firms are typically able to shift the cost onto workers by depressing wages.

- As a standard, comprehensive measure of income, and thus of a household’s well-being, the Urban-Brookings Tax Policy Center (TPC) uses a measure called "cash income," which comprises adjusted gross income (AGI, a measure frequently used for tax purposes) plus a variety of additional forms of income including cash benefits from public programs, interest on tax-exempt bonds, contributions to pension plans, the component of Social Security benefits not included in AGI, and some other items. It is important that the measure of income include not just wages and salaries, but also capital gains, dividends, interest, and business income, because these categories account for far more of the incomes of high-income than of low-income households. Excluding such capital income could thus lead to a biased result.

- Another important choice is the metric used to assess the distributional impact of a tax change. TPC’s preferred measure is the percentage change in after-tax income. If a tax cut changes everyone’s after-tax income by the same percentage, the distribution of after-tax income remains the same as before.

- Another issue is which taxes to include. TPC’s estimates include a wide range of federal taxes, including taxes on individual and corporate income, payroll, and estates. It is important to use a broad measure of federal taxes, because different taxes are distributed differently across income levels. The estate tax and the corporate tax, for example, tend to fall more heavily on those with high incomes - that is, they are more progressive. Conversely, the payroll tax that finances Social Security is only paid up to a certain level of income, so it tends to fall more heavily on those with low and moderate incomes and is therefore less progressive than the income tax.
### Distributional Effects of Making the Bush Tax Cuts Permanent and Adjusting the AMT, 2010

<table>
<thead>
<tr>
<th>Cash income quintile</th>
<th>Share receiving tax cut (percent)</th>
<th>Change in after-tax income (percent)</th>
<th>Share of total tax cut (percent)</th>
<th>Average change in tax owed (dollars)</th>
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</table>

**Notes:**
(a) Changes are from pre-EGTRRA law, evaluated in 2010. The AMT exemption is assumed to be raised to $54,000 for married couples filing jointly, and to $36,250 for single filers, to keep the number of AMT taxpayers equal to the number who would have been subject to the AMT under pre-EGTRRA law. The analysis does not take into account the eventual financing of the tax cuts.

Source: Results of the Urban-Brookings Policy Center Microsimulation Model (version 0304-3).
See Also

The Bush Tax Cuts: If we account for how the cuts are paid for, who benefits from them?

The Bush Tax Cuts: If we ignore how the cuts are paid for, who benefits from them?

The Bush Tax Cuts: Who benefits when their cost and potential economic growth are accounted for?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


Furman, Jason, "The Effect of the 2001-06 Tax Cuts on After-Tax Incomes," Testimony before the U.S. House Committee on Ways and Means (September 2007).


The Bush Tax Cuts: How have they affected tax revenue?

The Bush tax cuts contributed, along with underlying economic conditions, to a historic decline in federal tax revenue. In 2000 total federal tax revenue was as high in proportion to the U.S. economy as it had ever been. By 2004 federal tax revenue in proportion to the economy had fallen to its lowest level in almost fifty years.

- In recent decades the federal tax take has generally fluctuated between 17 and 19 percent of gross domestic product (GDP). By 2000, however, total federal tax receipts had reached 20.9 percent of GDP, their highest level since 1970 and matched only in 1944, when the federal government collected 20.9 percent of GDP in taxes at the height of fighting World War II. By 2004, however, federal tax receipts had fallen to 16.3 percent of GDP, which is not only the lowest level since 1970, but the lowest since 1959.

- Most of the decline in the ratio of federal tax revenue to GDP can be traced to the individual income tax. From 1970 to 2000 these taxes were typically in the range of 8 to 9 percent of GDP. In 2000 individual income taxes were 10.3 percent of GDP, their highest level ever. By 2004 individual income taxes had dropped to 7.0 percent of GDP, their lowest level since 1951. Total federal tax revenue declined by 4.6 percent of GDP from 2000 to 2004; of that total, 3.3 percentage points, or almost three-quarters, was due to the decline in individual income tax revenue.

- Most of the remaining decline in the revenue-to-GDP ratio resulted from a drop in the share in total revenue coming from corporate income taxes, which fell by 0.5 percent of GDP from 2000 to 2004, and a drop in the share coming from the payroll taxes that finance Social Security and Medicare, which declined by 0.4 percent of GDP over that period.

See Also

The Bush Tax Cuts: How big are the cuts?

The Bush Tax Cuts: How do the AMT and interest payments affect the cost?

Data Sources

Tax Policy Center, "Make EGTRRA, JGTRRA, and WFTRA Permanent with No AMT Relief," Table T06-0042 (Washington, February 2006).

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


The Bush Tax Cuts: How big are the cuts?

By any measure, the Bush tax cuts have been extraordinarily expensive. The congressional Joint Committee on Taxation calculated a score, or revenue change, for each of the seven major tax cut bills passed during the Bush administration: their combined cost sums to over $2.0 trillion from 2001-17. Extending these tax cuts into the future would carry a similar cost: the Congressional Budget Office (CBO) recently estimated the cost of extending them through 2017 at $1.9 trillion, not counting the costs of debt service, and not counting the cost of indexing the alternative minimum tax (AMT) to inflation to prevent it from undoing much of the cuts.

- In January 2001, at the start of the Bush administration, CBO projected a fiscal surplus of $5.6 trillion spanning fiscal 2002-11. Today, with over half of those fiscal years completed, the budget is on track to have a deficit of $2.1 trillion for the fiscal period 2002-11, for a total deterioration of $7.7 trillion. This drastic reversal is due to a combination of factors including higher government spending and changes in economic conditions, as well as the tax cuts. CBO estimates indicate that about one-third of the fiscal reversal is directly due to the tax cuts.

- If tax cuts are not accompanied by spending cuts, as has been the case during the Bush administration, they will lead to high interest payments on the increased national debt. CBO estimates that the cost of extending the President’s tax cuts through 2017 increases by $340 billion if the cost of extra interest payments is included.

- The future treatment of the AMT has an impact on ("interacts with") the projected cost of extending the Bush tax cuts. Under current law the AMT will revert to pre-2001 levels in 2007 and afterward; given that the AMT is not indexed to inflation, this means it will ensnare many more taxpayers than before, and as a consequence will take back much of tax cuts. CBO estimates that if the AMT were kept at its 2006 level, the cost of extending the Bush tax cuts through 2017 would increase by $470 billion, plus an additional $70 billion in extra debt service costs.

- If one takes into account the direct effects of the tax cuts, extra interest payments, and the extra "interaction" cost of reforming the AMT while extending the Bush tax cuts, the combined cost of extending the tax cuts through 2017 adds up to $2.8 trillion.
See Also

The Bush Tax Cuts: How have they affected tax revenue?

The Bush Tax Cuts: How do the AMT and interest payments affect the cost?

The Bush Tax Cuts: How do they compare with the Reagan cuts?

Data Sources

Tax Policy Center, "Make EGTRRA, JGTRRA, and WFTRA Permanent with No AMT Relief," Table T06-0042 (February 2006).

Further Reading


The Bush Tax Cuts: How do they compare with the Reagan cuts?

One way to gain perspective on the cost of the 2001-04 Bush tax cuts is by comparison with the 1981 Reagan tax cut, embodied in the Economic Recovery Tax Act, or ERTA. Although both tax cuts involved major and sustained reductions in tax rates and in revenue, both the details of the cuts and the circumstances in which they were enacted differed greatly, leading to quite different effects.

- The tax code was not indexed to the price level before 1985, so that even with no change in the tax code, tax collections rose over time as inflation pushed up wages and salaries, which in turn pushed individuals into higher tax brackets. This tended to erode the revenue loss from the Reagan tax cut relatively quickly; the Bush tax cuts are not subject to such erosion.

- Fiscal deficits are a greater economic threat today than they were in the 1980s and early 1990s. The retirement of the baby boomers is twenty-five years closer now than in the early 1980s, giving the budget little time to recover before the fiscal pressures begin in earnest. Private saving was significantly higher in the early 1980s than it is now, public debt was a smaller share of GDP, and the United States was an international creditor then but is a substantial international debtor today.

- The economic benefit of tax cuts was likely higher in the early 1980s, because marginal tax rates were much higher then and thus more likely to have had distortive economic effects than the more moderate rates of the 1990s.

- The Reagan administration proved willing to raise taxes when the ill effects of the 1981 tax cut became apparent—a move the Bush administration shows no interest in considering. The 1981 tax cut was followed a year later by a tax increase, in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The revenue costs of ERTA, minus the revenue increase in TEFRA, amounted to about 2.1 percent of GDP. On this basis, the Bush tax cuts are approximately the same size as the Reagan tax cuts.

See Also

- The Bush Tax Cuts: How big are the cuts?
- The Bush Tax Cuts: How have they affected tax revenue?

Further Reading


Data Sources

Tax Policy Center, "Make EGTRRA Permanent," Table T02-0001 (November 2002)

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008
The Bush Tax Cuts: Did they reduce the size of government?

President Bush and some of his supporters have argued that one purpose of the tax cuts is to "starve the beast," that is, to contain or reduce the size of government by depriving it of revenue. It is true that, in the long run, simple arithmetic dictates that the government’s spending must equal its revenue. Thus, if taxes are cut (or at least never increase), government spending must eventually decline. In practice, however, the Bush tax cuts have been accompanied by an acceleration in spending, both in inflation-adjusted dollars and in proportion to the economy, which means that the tax cuts have not led to lower government spending but have instead increased the budget deficit.

- In practice, neither tax cuts in general nor the Bush tax cuts in particular seem especially effective in restraining spending. The data over the past twenty-five years appear much more consistent with the view that once fiscal discipline erodes on the tax side of the budget, it tends to erode on the spending side, too.

- Since the Bush tax cuts were enacted, government spending has increased significantly in all major categories: defense spending, domestic spending, and entitlement spending. As a proportion of the economy, total government spending has gradually increased over President Bush’s tenure, from 18.4 percent of GDP in 2000 to 20.3 percent of GDP in 2006.

**See Also**

The Bush Tax Cuts: Are they justified as part of a "starve the beast" strategy?

The Bush Tax Cuts: Are tax cuts an effective way to reduce government spending?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

**Further Reading**


The Bush Tax Cuts: Are they justified as part of a "starve the beast" strategy?

Even if the starve-the-beast strategy had "worked" in the sense that the Bush tax cuts restrained government spending, the result would still not justify the specific tax cuts of President Bush’s first term, nor would it justify making those tax cuts permanent. Such an outcome would have been deeply unfair, as the spending cuts probably would have affected less affluent households the most, while the tax cuts went overwhelmingly to the rich. In any case, the strategy has not worked, and, with huge deficits looming, extending the tax cuts in the hope that the strategy will someday work would be a dangerous course.

- Many components of government spending predominantly benefit low- and middle-income households. If the goal (or the effect) was to cut spending on these programs, then, as a matter of fairness, a starve-the-beast strategy should have offset the negative impact on low- and middle-income households by giving them a disproportionately large share of the tax cut. However, the Bush tax cuts did just the opposite—they tilted the benefits toward high-income households.

- Whatever resonance "starve the beast" had in 2001, when the government had been running surpluses for several years, the government is now running substantial deficits that are on course to continue and grow. In this budgetary context, a "starve the beast" strategy becomes quite risky. After all, if such a strategy is vigorously pursued over many years but does not result in lower spending, the eventual outcome will be much larger budget deficits, with their growth-reducing drag—and even the risk of a full-blown fiscal crisis.

- There are ways to encourage fiscal discipline and reduce government spending (if that is the goal) other than cutting taxes sharply and hoping that spending falls into line. One approach would be to draw up new budget rules, perhaps somewhat similar to those in place in the late 1980s and into the 1990s, which would place more emphasis in the budget process on the long-term fiscal imbalance facing the nation. An emphasis on the long-term imbalance would make the deficits appear larger, which, in the spirit of the "starve the beast" hypothesis, should create political pressure to hold down spending. Reforming budget procedures to focus on the long-run budget picture would provide a more accurate picture of the government’s true finances while not encouraging unaffordable tax cuts or unaffordable spending increases. Even if an altered set of budget rules failed to restrain spending, it is at least highly unlikely to create deeper fiscal problems, unlike the "starve the beast" strategy. Budget reforms thus seem likely to be at least as effective at restraining government spending and significantly less risky than making the Bush tax cuts permanent.
See Also

The Bush Tax Cuts: Did they reduce the size of government?

The Bush Tax Cuts: Are tax cuts an effective way to reduce government spending?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


The Bush Tax Cuts: Are tax cuts an effective way to reduce government spending?

The "starve the beast" theory relies on the intuition that if government has less revenue, it will be pressured to reduce spending. We offer an alternative theory that we call "coordinated fiscal discipline," which holds that policymaking institutions go through alternating periods of fiscal largesse and fiscal restraint. Periods of largesse see both tax cuts and spending increases, whereas periods of restraint involve both tax increases and spending cuts. One mechanism by which this might happen is that granting large tax cuts to some groups makes it less politically feasible to rein in the desires of other constituencies for increases in their preferred spending programs. Several suggestive pieces of evidence favor the "coordinated fiscal discipline" view over the "starve the beast" view.

- Budget rules and legislative agreements have proved effective at reducing spending and balancing the budget in the past only when restrictions were placed on both tax cuts and spending increases at the same time. For example, a series of budget rules were imposed first in 1990 and then extended in 1993 and 1997 in an attempt to reduce budget deficits. These rules imposed restraints on both sides of the budget. Tax cuts and increases in mandatory spending (that is, spending obligated by virtue of previously enacted laws, often on entitlement programs such as Medicare or Social Security, rather than enacted by laws in the current year) had to be paid for with tax increases or cuts in other mandatory spending. Discretionary spending (that is, spending set by annual appropriation) was made subject to caps. Likewise, the budget deals that were enacted to reduce deficits in 1990 and 1993 involved both spending cuts and revenue increases. This series of policies helped contribute to the budget surpluses that emerged starting in 1998.

- Many in Congress who voted for the Bush tax cuts have also voted for substantial increases in government spending. One study examined the voting records of members who had signed a "no new taxes" pledge. The signers voted overwhelmingly in favor of the Bush administration’s tax cuts and have committed themselves not to vote for future tax increases. Yet 86 percent of signers also voted for the extremely expensive Medicare Modernization Act of 2003, which extended Medicare to cover prescription drugs, despite estimates that it would increase federal spending by $395 billion over 2004 to 2013 and substantially more thereafter. Almost three-quarters of those who had taken the no-new-taxes pledge supported the pork-laden 2004 highway bill, which would have spent about $300 billion over six years had it passed. Thus many of the same people who voted for tax cuts also voted for large permanent spending increases, at a time when budget deficits were large and growing—hardly behavior consistent with a strategy of "starving the beast."

- The "starve the beast" theory suggests that lower revenue should be accompanied by lower spending, and higher revenue by higher spending. Conversely, the coordinated fiscal discipline view implies that lower revenue will accompany higher spending, and higher revenue will accompany lower spending. The data over the past twenty-five years generally display a pattern consistent with the latter view.

- Testing these alternative hypotheses empirically requires that the spending and revenue data must be "standardized" to remove the effects of the business cycle on the federal budget. The reduced economic activity in a recession tends to lower tax revenue automatically, without any policy intervention, while spending on welfare, unemployment insurance, and related programs rises automatically as well. An economic upswing has the opposite effects. Thus the movements of the business cycle will make taxes and spending move in ways that appear to favor the coor-
dinated fiscal discipline hypothesis. Taking out these spurious effects is thus necessary for a fair test of whether taxes and spending tend to rise and fall together or to move in opposite directions.

- The results of such an analysis show that even after controlling for the business cycle, changes in spending and changes in taxes moved opposite to each other, rather than with each other, over three recent major periods. In the first, between 1981 and 1992, revenue fell and total outlays rose. In the second, between 1992 and 2000, revenue rose and spending fell. Finally, between 2000 and 2004, revenue fell relative to GDP but spending rose. (This period included the September 11, 2001, terrorist attacks and the beginnings of the wars in Afghanistan and Iraq, but only about half of the increase in noninterest spending was due to increased defense and homeland security appropriations.) All of these patterns are inconsistent with the "starve the beast" view.

- It is true that between 1981 and 1992, as revenue fell, standardized noninterest spending fell, too. But this pattern can hardly be taken as strong evidence of effective fiscal discipline. Standardized noninterest spending fell by only 0.4 percent of GDP, while the ratio of public debt to GDP almost doubled, from 26 percent in 1981 to 48 percent in 1992, the largest peacetime growth in the debt-to-GDP ratio in U.S. history aside from the Great Depression. Thus lower revenue has proved to be neither necessary (witness the 1990s) nor sufficient (witness the 1980s and the period since 2000) to reduce federal spending.

- The past several years underscore the questions about the starve-the-beast view. It is hard to believe that spending would have increased by much more than it did between 2000 and 2004 if the tax cuts had not been enacted. Discretionary spending rose from 6.3 percent of GDP in 2000 to 7.8 percent in 2004 (defense spending accounts for 60 percent of that increase). Mandatory spending meanwhile rose from 9.8 percent of GDP in 2000 to 10.7 percent of GDP, and future growth in such spending was ensured by the passage of a large new entitlement program, the Medicare prescription drug benefit.

- The formal econometric evidence on whether tax reductions are followed by spending reductions is mixed: the available studies were mostly done back in the 1980s, and there are results supporting each side. The more recent evidence does suggest that larger budget deficits constrain both spending increases and tax reductions. This evidence, however, does not distinguish between the "starve the beast" and the "coordinated fiscal discipline" theories. The pattern of larger budget deficits leading to higher taxes and lower spending is based on historical experience in which both spending reductions and tax increases were considered jointly as part of fiscal restraint packages. This pattern does not prove (nor does it disprove) that revenue reductions will induce spending reductions. In short, there is simply no compelling evidence that tax cuts constrain spending.
See Also

The Bush Tax Cuts: Did they reduce the size of government?

The Bush Tax Cuts: Are they justified as part of a "starve the beast" strategy?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


The Bush Tax Cuts: How do the AMT and interest payments affect the cost?

Revenue estimates of the cost of the Bush tax cuts often understate their likely cost, since they make no long-term adjustment for limiting the pending expansion of the alternative minimum tax (AMT). As its reach gradually expands to cover more and more taxpayers, the AMT takes back an increasing share of the tax cuts, reducing their apparent cost. If the AMT exemption were indexed to inflation in 2008 and afterward, as opposed to revertting to its statutory levels of $45,000 for joint filers and $33,750 for single filers, the ten-year revenue loss from making the tax cuts permanent would increase from $1.9 trillion to $2.4 trillion, not counting the cost of additional debt service.

- There are various ways to estimate the cost of the Bush tax cuts, depending in particular on assumptions about whether the tax cuts will expire on schedule, whether the interest costs from additional borrowing are included, and what is done with the AMT. One comprehensive measure assumes the extension of the tax cuts enacted to date, assumes that the AMT exemption continues to be indexed to inflation, and includes the additional interest costs on the larger public debt. By this measure, the tax cuts reduce revenue between 2008 and 2017 by an estimated $1.9 trillion and increase the budget deficit over that period by $3.4 trillion. In 2017 alone, the revenue loss amounts to $421 billion, or almost 2 percent of projected GDP in that year.

See Also

The Bush Tax Cuts: How big are the cuts?
The Bush Tax Cuts: How have they affected tax revenue?

Data Sources

Tax Policy Center, "Make EGTRRA Permanent," Table T02-0001 (November 2002).

Further Reading


The Bush Tax Cuts: What is their impact on government borrowing and interest payments?

If tax cuts are not offset by either lower government spending or higher taxes elsewhere, the revenue loss from the cuts results in increased government borrowing. The additional borrowing, in turn, increases future interest payments owed by the government. The total budget cost of a tax cut in any future year therefore includes both the revenue loss in that year and the higher interest payments that result from previous revenue losses. Economists estimate these interest costs using projected interest rates generated by the Congressional Budget Office for this purpose. With debt service costs included, the budgetary cost of the Bush tax cuts as legislated for fiscal 2001 to 2010 is almost $2.2 trillion, or 1.7 percent of GDP.

See Also

The Bush Tax Cuts: What are the indirect effects on economic growth?

The Bush Tax Cuts: How have they affected tax revenue?

The Bush Tax Cuts: How do the AMT and interest payments affect the cost?

Further Reading


The Bush Tax Cuts: What spending and revenue measures would pay for making them permanent?

The Congressional Budget Office (CBO) estimates that the Bush tax cuts, if extended beyond 2010, and assuming indexation of the alternative minimum tax (AMT), will reduce tax revenue in 2017 by $444 billion. Paying for these cuts would require spending cuts or other revenue increases that are well beyond the range of those currently being proposed in any public discussion. In other words, no politically plausible way is in evidence by which the tax cuts could be financed.

- If the tax cuts were financed in 2017 (the last year of the current ten-year budget window) by an across-the-board cut in spending on everything the federal government does, from defense to national parks to Social Security and Medicare, all federal spending would have to be reduced by 12 percent, relative to the CBO’s projected baseline, to pay for the Bush tax cuts and AMT indexation (see table).

| Changes in Federal Spending or Revenue Required to Offset Making the Bush Tax Cuts Permanent, 2017* |
|-------------------------------------------------|----------------------------------|------------------|
|                                                  | Extended tax cuts | Extended tax cuts and index AMT | Memorandum: 2017 baseline spending or revenue (billions of $) |
| Revenue loss in 2017 (billions of $)             | 444               | 501                            |                                                 |
| Required percentage change in b                   |                    |                                |                                                 |
| All noninterest outlays                           | -11.6             | -13.1                          | 3,831                                          |
| Discretionary Spending                            | -35.5             | -40.1                          | 1,250                                          |
| Defense, homeland security, and international     | -59.4             | -67.0                          | 748                                            |
| Other                                            | -88.5             | -99.8                          | 502                                            |
| Mandatory Spending                                | -17.2             | -19.4                          | 2,580                                          |
| Social Security                                   | -43.4             | -49.0                          | 1,024                                          |
| Medicare                                         | -52.6             | -59.3                          | 845                                            |
| Medicaid                                         | -106.5            | -120.2                         | 411                                            |
| All three                                        | -19.4             | -21.9                          | 2,286                                          |
| All spending except interest, Social Security, Medicare expenditures and offsetting receipts, Medicaid, defense, and homeland security | -46.2             | -52.1                          | 962                                            |
| Revenue                                          |                    |                                |                                                 |
| Payroll tax                                      | 32.8              | 37.0                           | 1,354                                          |
| Corporate tax                                     | 119.1             | 134.4                          | 373                                            |

Notes:
(a) Percent except where stated otherwise.
(b) Percentage cuts exceeding 100 are arithmetic artifacts; no program can be cut more than 100 percent.

• If instead spending cuts were limited to nondefense discretionary spending (a measure that includes all government functions other than Social Security, Medicare, Medicaid, defense, homeland security, and net interest payments), a 46 percent cut relative to the CBO baseline would be required.

• If the cuts were instead targeted in a single specific spending area, either a 43 percent cut in Social Security benefits or a 53 percent cut in Medicare benefits would be required. Except for defense, no other area of federal spending, including the federal component of the Medicaid program, is large enough that even its total elimination would make up for the cost of the tax cuts.

• If, instead of spending cuts, the tax cuts were paid for by increases in other taxes, it would require, as examples, a 33 percent increase in payroll taxes or a 119 percent increase in corporate tax revenue.

See Also

The Bush Tax Cuts: How big are the cuts?
The Bush Tax Cuts: How have they affected tax revenue?
The Bush Tax Cuts: What is their impact on government borrowing and interest payments?

Further Reading


The Bush Tax Cuts: How did they affect corporate investment?

The Bush tax cuts directly lowered the after-tax user cost of capital. But this reduction must be balanced against the increase in that user cost due to the larger budget deficits and higher interest rates brought about by the tax cuts. Research into the effects of the tax cuts has shown that when the analysis includes even relatively modest effects of the larger deficits on interest rates, the net effect is to raise the user cost of capital under almost all the scenarios considered.

- Traditionally, the effects of tax policy on firms’ demand for investment are summarized in estimates of the user cost of capital, which is the minimum return a firm needs to cover depreciation, taxes, and the opportunity costs of the funds used to finance the project. (The opportunity cost can be thought of as the cost of borrowing money to finance the investment, or the returns that are sacrificed when funds are invested in physical equipment rather than in financial instruments.) A lower user cost of capital typically translates into higher investment.

- A number of studies have suggested that lower tax rates, like those enacted in the first term of the Bush administration, generally reduce the user cost of capital and thus boost corporate investment. However, these analyses have either explicitly or implicitly considered tax changes that are revenue-neutral—that is, cuts in tax rates that are paid for either by offsetting increases in other parts of the tax code or by lower government spending. The Bush tax cuts, in contrast, were not immediately offset by other spending cuts or tax increases. Consequently, it is not be appropriate to conclude from an analysis of the direct effects alone that the Bush tax cuts lowered the user cost of capital.

- One study explicitly studied the effects of the provisions of the Bush tax cuts directed toward corporate investment, notably the bonus depreciation provisions, and found that their aggregate impact on investment was just 1 to 2 percent, "far too small to offset the double-digit declines of the early 2000s."

See Also

The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

The Bush Tax Cuts: How did the 2004 tax cuts change the tax code?

Further Reading


The Bush Tax Cuts: How are small businesses and entrepreneurs affected?

Once the financing of the 2001-03 tax cuts is taken into account in plausible ways, a majority of households that report small business income will end up worse off than they would have been without the tax cuts. Small businesses are also hurt in two other ways. First, their cost of capital for new investment will rise as higher budget deficits raise interest rates. Second, some of the tax cuts seek to reduce a bias in the tax code that used to favor small businesses over corporations. The net result is that many small businesses and entrepreneurs are negatively affected by the Bush tax cuts.

- Capital invested in the corporate sector typically faces a higher tax rate than capital invested in the noncorporate sector, which includes most small businesses. The reason is that capital invested in the corporate sector can be taxed twice: once at the level of the corporation, and again when the corporation distributes income to shareholders in the form of dividends or capital gains. The 2003 tax cut provisions that reduce taxes on dividends reduce this bias in the allocation of capital, which should shift investment funds away from noncorporate businesses, which are disproportionately owned by entrepreneurs, and toward corporations.

- While the 2001-2003 tax cuts were described as "pro-entrepreneur," a recent study found that the majority of taxpayers would see their tax burden rise, once the eventual financing of the cuts was taken into account. Specifically, the study found that 72 percent of taxpayers with business income would be worse off if the tax cuts were eventually paid for by proportional financing, and that 58 percent of filers with business income would be worse off if the cuts were eventually paid for with equal-dollar financing.

- Since the Bush tax cuts are not offset by either reduced spending or higher taxes elsewhere, they lead to higher budget deficits. Higher deficits, in turn, typically drive up interest rates, thus increasing the cost of new investment and reducing the amount of investment undertaken. Several studies have determined that the eventual result of the Bush tax cuts is higher interest rates, leading to decreased new investment.
See Also

The Bush Tax Cuts: Were they well designed to strengthen long-term economic growth?

The Bush Tax Cuts: What are the indirect effects on economic growth?

The Bush Tax Cuts: What is their impact on government borrowing and interest payments?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008
The Bush Tax Cuts: How did they affect incentives to work?

The Bush tax cuts actually had a surprisingly small effect on the marginal tax rates faced by most Americans. Many households in the bottom half of the income distribution owed little or no federal income tax even before the tax cuts. Others higher up in the income distribution are subject to the alternative minimum tax, which was reduced by the Bush tax cut legislation, but only temporarily. These factors and others meant that the tax cuts did not reduce marginal tax rates for about three-fourths of households, indicating that the tax cuts did not change incentives to work for the majority of workers.

- A study using the tax model at the U.S. Department of the Treasury showed that the 2001 tax cut, when fully phased in, would provide no reduction in marginal tax rates for 76 percent of households. Even among those with positive tax liability, 64 percent would experience no reduction in marginal rates, according to the study.

- Similarly, calculations using the TPC microsimulation model indicate that if both the 2001 and 2003 tax cuts were made permanent, 60 percent of filers, who collectively represent more than 40 percent of taxpayers and report 30 percent of all taxable income, would not see a reduction in marginal tax rates relative to pre-2001 tax law.

- Many provisions of the tax cuts reduced taxes owed but did not increase the incentive to work. For example, the creation of the new 10 percent tax bracket meant lower taxes for those further up the income ladder, but many of those taxpayers continued to face the same marginal tax rates of 15 percent or more. The expansion of the child tax credit reduced taxes for income taxpayers with children but did not alter the marginal tax rate for many of them. Calculations using the TPC microsimulation model indicate that if the tax cuts were made permanent, 44 percent of all filers with an income tax cut, representing 34 percent of taxable income, would receive a net tax cut in the sense of facing a lower total tax bill, but would not experience a reduction in marginal tax rates on wages. (Indeed, this model shows that because of complex interactions in the tax code, the tax "cuts" actually caused 7.7 million filers to face increases in marginal rates!) Thus the tax cuts did reduce taxes for many households, raising their after-tax income in a way similar to receiving a bonus check, but did not reduce their marginal tax rate, which is what matters when deciding whether to earn additional income.

- The standard presumption in economic theory—and the evidence from research—is that when people get more income, but their incentives to earn additional income do not increase, at least some will choose to work less. In effect, they will take some of their tax cut in the form of more hours of leisure.
See Also

The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


Office of Tax Analysis, "A Dynamic Analysis of Permanent Extension of the President’s Tax Relief" (Washington, July 25, 2006)
The Bush Tax Cuts: How did they affect retirement saving?

The Bush tax cuts did little to change saving incentives for low- and middle-income households, focusing instead on providing tax cuts to wealthier households by increasing annual maximum contribution limits to Individual Retirement Accounts (IRAs) and 401(k)s. This reform benefited only the small proportion of households with sufficient wealth to contribute more than the pre-tax cut maximum. Since many of the provisions to encourage retirement saving applied primarily to high-income households whose pension contributions are likely to represent little new saving, the Bush tax cuts were more effective at shifting assets from taxable to tax-preferred accounts than at raising saving. They thus cost the Treasury revenue while doing little to achieve the intended objective.

- The changes in maximum contribution limits to 401(k)s and IRAs were aimed at high-income taxpayers. In 2001 workers were allowed to deposit a maximum of $10,500 in a 401(k) account. The 2001 tax legislation (known by its legislative acronym EGTRRA) raised the maximum gradually to $15,000 by 2006. These higher limits benefit only those who would have saved the maximum anyway under pre-EGTRRA law and wished to save more. Similarly, EGTRRA more than doubled the amount that a taxpayer and spouse may contribute each year to an IRA. The vast majority of Americans did not make the maximum contributions to their 401(k)s or IRAs even under the older limits, and therefore they benefit little if at all from the raised limits.

- A 2000 study by an economist at the Department of the Treasury found that only 4 percent of all taxpayers who were eligible to deduct their contribution to traditional IRAs in 1995 made what was then the maximum allowable contribution of $2,000. The percentage of the population affected by the 401(k) changes was likewise very small. The General Accounting Office (now called the Government Accountability Office) concluded that the increase in the contribution limit for 401(k)s directly benefits fewer than 3 percent of participants. Other recent studies have reached similar conclusions.

- The households who were constrained by the previous limits are disproportionately high-income households, and a variety of empirical evidence shows that these households are likely to respond to the higher limits by shifting other saving into 401(k)s and IRAs to benefit from the tax advantage. In other words, the change is likely to represent an expensive tax subsidy for saving that high-income households would have done in any case. Contributions to tax-advantaged retirement accounts that are financed by shifting other assets into the accounts do not increase private saving. Little new saving is thus likely to result from these retirement saving provisions.
See Also

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading


The Bush Tax Cuts: Were they well designed to strengthen long-term economic growth?

For any tax cut to raise economic growth, it must have a powerful enough direct effect on incentives for work, saving, and investment to overcome the drag on growth from the larger budget deficit (or smaller surplus) it causes. The Bush tax cuts are not well designed to provide strong incentives for additional saving, investment, and work. As a result, after taking the drag from the larger budget deficits into account, the net effect from the tax cuts is likely to be a reduction in long-term growth.

- One study of the long-term effects of making the 2001 tax cut permanent combined estimates of the actual changes in incentives provided by the tax cut with estimates of how a given change in tax incentives affects saving, investment, labor supply, and human capital accumulation. The study found that these "supply-side" effects would indeed, taken alone, increase GDP by almost 1 percent by 2011, but that the increase in the deficit due to the tax cuts would reduce national saving, which would cause GDP to fall by about 1.6 percent by 2011; the net effect of these factors, and others, would be to reduce GDP by about 0.3 percent by 2011.

- The impact of the tax cuts on long-term economic growth depends on how the budget is eventually adjusted to accommodate the reduced revenue due to the tax cuts; that is, tax cuts must eventually be "paid for" either by reducing spending or by raising taxes in the future. A recent Treasury study found that, under either scenario, the tax cuts’ long-run impact on the economy would be small and could be either positive or negative, depending on the fiscal response.
See Also

The Bush Tax Cuts: Did they provide good "bang for the buck?"

The Bush Tax Cuts: Were they well timed to spur economic growth?

The Bush Tax Cuts: What are the indirect effects on economic growth?

The Bush Tax Cuts: What is their impact on government borrowing and interest payments?

The Bush Tax Cuts: What spending and revenue measures would pay for making them permanent?

Further Reading


_________, "Bush Administration Tax Policy: Short-Term Stimulus," Tax Notes 105, no. 6 (November 2004).


Office of Tax Analysis, "A Dynamic Analysis of Permanent Extension of the President’s Tax Relief" (Washington, July 25, 2006).
The Bush Tax Cuts: Were they well timed to spur economic growth?

Historically, tax cuts aimed at increasing demand and stimulating the economy out of a recession have not worked especially well. Timing has been a major problem. It takes months for Congress to enact tax cut legislation, and often yet more months for the legislation to have a significant economic impact. Not uncommonly, the recession has ended and the economy is on an upswing by the time the stimulus legislation takes effect. The Bush administration’s tax cuts, in contrast, were well timed to address the economic slowdown. The 2001 tax cut (known by its legislative acronym EGTRRA) was enacted while the economy was still in recession, and the 2002 and 2003 tax cuts (the latter known as JGTRRA) were enacted while economic activity remained sluggish. However, as explained in another entry, the tax cuts were designed poorly for the purpose of giving the economy an immediate short-term boost.

See Also

The Bush Tax Cuts: Didn’t they help the economy recover from the 2001 recession?

The Bush Tax Cuts: Were they well designed to strengthen long-term economic growth?

The Bush Tax Cuts: What are the indirect effects on economic growth?

Further Reading


_________, "Bush Administration Tax Policy: Short-Term Stimulus," Tax Notes 105, no. 6 (November 2004)
The Bush Tax Cuts: What are the indirect effects on economic growth?

The manner in which tax cuts are financed can affect long-term economic growth, but the effect is tricky to analyze in the case of the Bush tax cuts because their ultimate financing remains unclear. So far the tax cuts have been financed with higher budget deficits. If extended, the tax cuts will increase the accumulated federal debt by $5 trillion in 2015, or 25 percent of GDP in that year. The accumulation of these deficits will injure long-term economic growth, because budget deficits reduce national saving, which in turn reduces the rate at which the economy accumulates capital.

- Increased budget deficits need not reduce long-term growth if they are fully offset by an increase in private saving. However, history suggests that increased private saving by Americans will suffice to offset only about one-quarter of the increase in public debt. On net, then, national saving is likely to fall by 75 cents for every dollar in deficits. This implies that the capital stock owned by Americans after a decade would be $3.75 trillion (75 percent of the $5 trillion in additional public debt) lower than if the tax cuts had never been enacted. If capital earns 6 percent (a reasonable assumption), that "missing" $3.75 trillion in American-owned capital will reduce national income in 2015 by $225 billion, or about 1 percent of GDP in that year as projected by the Congressional Budget Office.

- The reduction in the domestic capital stock due to budget deficits is facilitated by an increase in interest rates. A variety of estimates suggest that the rise in budget deficits in the next decade will raise long-term interest rates by about 1 percentage point, or perhaps a little less. Higher interest rates mean that firms will have to pay more to borrow funds for investment in plant and physical equipment, and they will have a greater incentive to use their internally generated funds for financial investments instead of investing in their business. The cost of capital would rise for corporate equipment and structures, noncorporate equipment and structures, and owner-occupied housing. This higher cost of capital would reduce new investment.

- Large and sustained budget deficits would also reduce future national income through increased borrowing from abroad by American households, firms, and government. Such borrowing in effect "mortgages" the income generated by part of the U.S. domestic capital stock. In other words, the future returns to the domestic investments financed by foreign borrowing would accrue to foreign investors rather than U.S. residents. This effect is included in the estimated $225 billion loss to national income cited above.
See Also

The Bush Tax Cuts: How have they affected tax revenue?

The Bush Tax Cuts: Were they well designed to strengthen long-term economic growth?

The Bush Tax Cuts: Were they well timed to spur economic growth?

The Bush Tax Cuts: What is their impact on government borrowing and interest payments?

Further Reading


The Bush Tax Cuts: Did they provide good "bang for the buck?"

The Bush tax cuts of 2001 to 2003 provided much less stimulus to the economy than other policies of equal cost would have. The underlying reason is that although the tax cuts were well-timed to provide a short-run economic stimulus, they were poorly designed for this task.

- The 2001 tax cut phased in reductions in marginal tax rates over a period of years, so that most of their impact came several years after their enactment. Such "backloading" reduces the ability of a tax cut to stimulate the economy in the immediate present. In fact, backloading can even reduce current economic activity, by encouraging people to postpone purchases or increases in work until after the full reduction in taxes has phased in. As the Wall Street Journal editorial board, a staunch advocate of tax cuts, has put it, "Delayed tax cuts are likely to depress the economy."

- The tax cuts provided larger percentage increases in after-tax income for higher-income households than for lower-income households. However, low-income households are more likely to spend any additional income they receive than higher-income households. Evidence from the 2001 tax cuts bears out this tendency. One study, using data from the Consumer Expenditure Survey, shows that households in their low-income category consumed 75 percent of their 2001 rebate, whereas the average household consumed 20 to 40 percent of its rebate. Thus the Bush tax cuts were not aimed at the segments of the population where they would have the greatest impact in stimulating additional purchases of goods and services.

- Many of the provisions of the 2001 and 2003 tax cuts-including the repeal of the estate tax and the expanded provisions for tax-free saving-were ostensibly designed to raise saving. Apart from the question of how effective these provisions were on that score, the appropriate strategy when one wants to provide a short-term stimulus to a weak economy is exactly the opposite: to raise spending, not saving.

- Even some of the provisions of the tax cuts that were ostensibly designed to raise consumption were inefficient ways of doing so. For example, one claim was that cuts in dividend taxes would boost the value of the stock market, raising wealth for many people and therefore raising consumption. But most people adjust their current consumption little in response to changes in the value of the stocks they own. One rough calculation suggests that when the value of stock holdings rises by one dollar, current consumption spending increases by just three to five cents.

- The 2002 tax cut allowed firms to count 30 percent of the value of new investment as an expense in the first year if made before September 11, 2004. These and other bonus depreciation provisions in the 2002 legislation were intended to encourage businesses to increase investment. Temporary investment incentives should indeed encourage a greater surge of investment in the near term, because firms have an incentive to take advantage of such provisions before they expire, and the bonus depreciation provisions were explicitly temporary at least partly for this reason. However, in 2003 Congress and the president extended the expiration date to the end of 2004 and expanded the first-year write-off to 50 percent. Meanwhile the Bush administration repeatedly insisted that the other tax cuts should eventually be made permanent. These actions, and perhaps the general sense that "temporary" tax cuts always get extended, may have led businesses to think that policymakers would continue to extend the bonus depreciation provisions and perhaps make them permanent. That would have undermined their ability to encourage investment in the short term. Indeed, a survey by the National Association of Business
Economists released in January, 2004, found that 62 percent of respondents expected the provisions to be extended. (Interestingly, an even larger share, 73 percent, reported that bonus depreciation had no effect on their firm’s investment.) In the end, the provision was not extended when it expired at the end of 2004.

See Also

The Bush Tax Cuts: How big are the cuts?
The Bush Tax Cuts: How did they affect corporate investment?
The Bush Tax Cuts: How did they affect incentives to work?
The Bush Tax Cuts: Were they well designed to strengthen long-term economic growth?
The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2002 tax cuts change the tax code?
The Bush Tax Cuts: How did the 2003 tax cuts change the tax code?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008
The Bush Tax Cuts: Didn’t they help the economy recover from the 2001 recession?

Casual commentary on economic policy is often based on the post hoc ergo propter hoc ("after this, therefore because of this") fallacy. In the case of the Bush tax cuts, it is argued that because an economic recovery followed the tax cuts, the tax cuts must have caused the recovery. In truth the economy recovered from the 2001 recession for a variety of reasons unrelated to the tax cuts, which were poorly designed to deliver a short-term economic stimulus.

- Several factors contributed to the turnaround in economic growth following the 2001 recession. The Federal Reserve reduced interest rates to historic lows, spurring huge amounts of mortgage refinancing; this reduced homeowners’ monthly payments, which in turn increased consumer demand for other products. A period of economic and political uncertainty followed the terrorist attacks of September 11, 2001, but by 2003, when the major military campaign in Iraq had begun, at least some of that uncertainty had dissipated. Government spending also increased in these years, including for defense and homeland security. Meanwhile the technology cycle continued to turn: investment went from boom in the late 1990s to a drought in 2001 and 2002, but by 2003 firms were once again willing to invest. Compared with these factors, the Bush tax cuts of 2001, 2002, and 2003 had a small effect in stimulating the economy out of the recession of 2001 and the slow growth of 2002 and 2003.

See Also

- The Bush Tax Cuts: How did the 2001 tax cuts change the tax code?
- The Bush Tax Cuts: Were they well timed to spur economic growth?
- The Bush Tax Cuts: What are the indirect effects on economic growth?

Authors: William Gale and Benjamin Harris
Last Updated: January 23, 2008

Further Reading

- ________, "Bush Administration Tax Policy: Short-Term Stimulus," Tax Notes 105, no. 6 (November 2004)
What is the personal exemption? ................................................................. II-1-1
Has the personal exemption kept up with prices and incomes? .................. II-1-2
What is the child tax credit (CTC)? ............................................................. II-1-4
What is the Earned Income Tax Credit (EITC)? ........................................... II-1-7
How does the tax system subsidize child care expenses? ............................ II-1-13
What tax incentives exist to help families save for college? ........................ II-1-17
What incentives exist to help families pay for college? ............................... II-1-20
What are marriage penalties and bonuses? ................................................. II-1-24
Taxation and the Family: What is the personal exemption?

Personal exemptions provide that only a person’s income above some defined basic level is subject to tax. They thus help ensure that the poorest of the poor pay little if any income tax. The personal exemption has been a basic feature of the modern individual income tax since it was enacted. In 1913 it was set at $3,000 (equivalent to $66,937 in 2011 dollars), so that very few persons were expected to pay tax. The 2011 personal exemption, at $3,700, is substantially lower in real terms, but the tax code has added other features since 1913, such as the standard deduction and various tax credits, that have partly offset the exemption’s decline in value.

- The value of the personal exemption depends on an individual’s marginal tax rate. For instance, a single taxpayer who would otherwise owe 15 percent on his or her first $3,700 of income saves $555, whereas a single taxpayer in a 35 percent bracket saves $1,295. Thus, under a progressive income tax, exemptions are worth more to upper-income filers than to low-income filers. The rate structure itself can, however, be adjusted to compensate for that effect and achieve any desired degree of progressivity.

- Since 1990, the personal exemption has been phased out at higher income levels. Current tax law reduces the phase-out for the 2006-09 tax years and removes it entirely in 2010, 2011, and 2012 before returning it to full force in 2013.

- The alternative minimum tax (AMT) denies taxpayers the use of personal exemptions. As a result, larger families are more likely to owe AMT than smaller families.

- In 2008 tax filers reported $8 trillion in adjusted gross income (AGI) and claimed $981 billion in personal exemptions (although not all exemptions could be fully used to reduce tax). Returns that owed tax reported $7.6 trillion of that AGI and claimed personal exemptions totaling $592 billion.

See Also

Taxation and the Family: Has the personal exemption kept up with prices and incomes?

Data Sources

Individual Income Tax Parameters (Including Brackets), 1945-2011

TPC Tax Facts: Personal Exemption and Standard Deduction 2008

Authors: Adam Carasso and C. Eugene Steuerle
Last Updated: July 22, 2011

Further Reading


Taxation and the Family: Has the personal exemption kept up with prices and incomes?

As the federal government expanded greatly in the postwar era, individual income taxes rose, and the personal exemption, which was fixed in nominal dollars, failed to keep pace with growing personal income or rising prices. Lawmakers increased it only occasionally before finally indexing it to increases in prices beginning in 1981.

- Had the personal exemption been indexed to prices beginning in 1948, its value in 2009 would have been roughly 50 percent higher than it was: $5,499 rather than the actual $3,650 (see figure). Setting the exemption at that higher level would, however, reduce annual revenues by more than $53 billion.

- Had the personal exemption been indexed to personal income per capita since 1948, it would have been $17,189 in 2011, more than four times what it actually is, and annual revenues would fall more than $235 billion below current levels.

- Congress has, however, partially offset the erosion of the personal exemption with other changes to the tax code. Most importantly, it created the child credit and the earned income tax credit, both of which have helped to hold down taxes, particularly for larger, low- and middle-income households that are most affected by the falling real value of the exemption.
See Also

Taxation and the Family: What is the child tax credit?

Taxation and the Family: What is the earned income tax credit?

Data Sources

History of the Personal Exemption

Authors: Adam Carasso and C. Eugene Steuerle

Last Updated: June 22, 2011

Further Reading

Taxation and the Family: What is the child tax credit (CTC)?

Taxpayers can claim a child tax credit (CTC) of up to $1,000 per child under age 17. The credit is reduced by 5 percent of adjusted gross income over $110,000 for married couples ($75,000 for single parents). If the credit exceeds taxes owed, taxpayers can receive some or all of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The ACTC is limited to 15 percent of earnings above a threshold that is indexed to inflation; the threshold is temporarily reduced to $3,000 in 2011 and 2012. Because the income range over which the ACTC phases in overlaps at least part of the range over which the earned income tax credit (EITC) phases out, the CTC partly offsets the high marginal tax rates associated with that phase-out.

The CTC is the largest tax code provision benefiting families with children. TPC projects that 35 million families will claim credits totaling about $52 billion in 2011. (Urban-Brookings Tax Policy Center Microsimulation Model, version 0411-2) The temporary reduction of the ACTC earnings’ threshold means that families in the lowest income quintile get a larger share of total benefits than under permanent law: 8 percent in 2011 compared with less than 1 percent in 2001. In 2011, TPC estimates that more than 80 percent of benefits will go to families in the middle three quintiles and the remaining 11 percent to families in the highest income quintile.

- The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) doubled the CTC from $500 to $1,000 per child, made it refundable for more families and allowed it regardless of AMT liability. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended those temporary provisions through 2012. Barring fur-
ther extension, the CTC will revert to $500 per child when the temporary provisions sunset in 2013, and many families will lose eligibility for the refundable portion of the credit.

- Before EGTRRA, only families with at least three children could receive a refundable CTC and then only up to the Social Security and payroll taxes they paid in excess of their Earned Income Tax Credit.
- EGTRRA extended the refundable CTC to all families with children, setting it equal to 15 percent of earnings over a threshold that is indexed annually for inflation. Under EGTRRA, the 2011 threshold would have been $12,750.
- If Congress allows the temporary provisions to expire in 2013 as scheduled, the new form of refundability—15 percent of earnings over a threshold—will disappear and only the much more limited refundability for larger families would apply.
- The refundable CTC complicates tax filing, especially for larger families who may calculate their credit under both the EGTRRA and pre-EGTRRA rules.

- Because the CTC is not indexed for inflation, its value erodes each year. Furthermore, the only credit parameter indexed to inflation is the permanent threshold over which families may receive a refundable credit. As the nominal threshold rises, families must earn more each year to receive the same refundable credit. This situation only affects families who do not have enough tax liability to get the entire $1,000 per child credit.
- In 2011, 28 percent of children whose parents work lived in families that received less than the full credit because the parents earned too little. Five percent of these children were in families which received no credit at all because their earnings fell below the refundability threshold. The proportion of children in this situation has declined considerably after the refundability threshold was lowered in 2009.
- Possible reforms of the CTC include:
  - Make the $1,000 value permanent (even if the other EGTRRA provisions are not);
  - Index the value of the credit and the phaseout thresholds;
  - Index the maximum CTC for inflation but limit it to taxpayers who obtain health insurance for their children; or
  - Permanently lower or eliminate the refundability threshold so that all working families, especially those with low incomes could receive the credit.

The President’s 2012 Budget proposed to make temporary provisions of the Child Tax Credit permanent: a $1,000 credit per child, refundable up to an amount equal to 15 percent of income earned in excess of $3,000 (not indexed for inflation) and allowable regardless of AMT liability.
See Also

Taxation and the Family: [What is the Earned Income Tax Credit?](#)

Taxation and the Family: [How does the tax system subsidize child care expenses?](#)

Data Sources

Distribution of Tax Benefits for Units with Eligible Children

- By cash income: [Table T10-0074](#)
- By cash income percentile: [Table T10-0075](#)

Authors: Elaine Maag and Adam Carasso

Last Updated: June 25, 2011

Further Reading


Taxation and the Family: What is the Earned Income Tax Credit (EITC)?

The earned income tax credit (EITC) provides a subsidy for low-income working families. The credit equals a fixed percentage of earnings from the first dollar of earnings until the credit reaches a maximum; both the percentage and the maximum credit depend on the number of children in the family. The credit then stays flat at that maximum as earnings continue to rise, but eventually earnings reach a phase-out range. From that point the credit falls with each additional dollar of income until it disappears entirely (figures 1 and 2). The phaseout begins at a higher income for married couples than for single parents. The credit is fully refundable: any excess beyond a family’s income tax liability is paid as a tax refund.

Underlying Data: Download

- Families with three or more children may receive a credit of up to $5,751 in 2011. The maximum credit is $5,112 for families with two children, $3,094 for families with one child, and just $464 for those without children.
- In addition, 23 states and the District of Columbia are administering their own state EITCs in 2010. States typically offer the EITC as a fixed percentage of the federal credit and the EITC is refundable in 19 states and the District of Columbia.
After the Supplemental Nutritional Assistance Program (SNAP), the EITC is the largest cash or near cash assistance program targeted at low-income families. An estimated 26 million households received a total of $55 billion in reduced taxes and refunds in 2010 (Urban-Brookings Tax Policy Center Microsimulation Model, version 0411-2). The IRS estimates that in 2009, the credit lifted nearly 7 million people out of poverty, including over 3 million children. The IRS also reports that more than three-fourths of eligible families claimed the Earned Income Tax Credit in 2009, a much higher take-up rate than that for Temporary Assistance to Needy Families (40 percent in 2005) or for SNAP (60 percent in 2005).

### Figure 2. 2011 Earned Income Tax Credit Parameters

<table>
<thead>
<tr>
<th>Type of Return</th>
<th>Single Filers</th>
<th>Married Couples Filing Jointly</th>
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<tr>
<td></td>
<td>Maximum eligible earnings</td>
<td>Maximum eligible earnings</td>
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<tr>
<td></td>
<td>Dollars</td>
<td>Beginning</td>
</tr>
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<tr>
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<td>Two children</td>
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<td>5,112</td>
</tr>
<tr>
<td>Three or More Children</td>
<td>12,780</td>
<td>5,751</td>
</tr>
</tbody>
</table>
The EITC has been successful at encouraging people, particularly single mothers, to take jobs. Its effectiveness at increasing hours worked is more ambiguous.

Critics complain that the EITC is too complex, forcing potential recipients to seek help filing their federal tax return: two-thirds of low-income parents get such assistance, typically from paid tax preparers.

The credit’s complexity may also contribute to its relatively high error rate. In 2011 the IRS reported that about a quarter of EITC claims ($11-$13 billion annually) are paid out in error. Misreporting of income is the principal error made by tax filers claiming the credit.

The EITC imposes significant marriage penalties on some families. If a single parent receiving the EITC marries, the addition of the spouse’s income may reduce or eliminate the credit. To address this issue, the Economic Growth and Tax Relief Reconciliation Act of 2001 raised the income level at which the EITC begins to phase out for couples to $3,000 above that for single filers. The American Recovery and Reinvestment Act of 2009 (ARRA) increased that amount to $5,000 for 2009 and indexed that threshold to inflation. The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended ARRA’s EITC provisions through 2012: this resulted in the 2011 phaseout threshold for joint

Underlying Data: [Download](#)
filers being $5,080 higher than that for singles.

- Several reforms to the EITC have been proposed. One would increase the credit for childless workers to an amount closer to that for families with children; that would provide much-needed assistance for many additional poor workers.

- The EITC could also be consolidated with other tax provisions benefiting families with children into a single family credit, with lower phaseout rates and a uniform definition of who counts as a child. That could simplify tax filing and increase the assistance provided to working families with children.

- Separating the EITC into two parts—one directed at providing an incentive to work and the other at costs associated with raising children—could both increase work effort and provide more assistance for needy families with children.

- The Administration’s FY2012 Budget proposed to make permanent the higher credit percentage and phaseout threshold for families with three or more children and the $5,000 increase in the phaseout threshold for joint filers.
See Also

Taxation and the Family: What is the Child Tax Credit (CTC)?

Taxation and the Family: How does the tax system subsidize child care expenses?

Data Sources

Tables T07-0109 & T07-0110: Distribution of the Tax Benefits of the Earned Income Tax Credit by Cash Income Percentile

Tables T07-0163 & T07-0095 Options to expand the EITC for childless workers T07-0097: Options for EITC for 3+ kids

Authors: Elaine Maag and Adam Carasso

Last updated: June 22, 2011

Further Reading


June 2005).


Taxation and the Family: How does the tax system subsidize child care expenses?

Working parents can utilize two primary tax benefits to offset child care costs: the child and dependent care tax credit (CDCTC) and the employer-provided child care exclusion. To receive the CDCTC, parents report up to $3,000 of expenses per child (to a maximum of $6,000) and receive a credit of between 20 and 35 percent of that amount, depending on their adjusted gross income (AGI). Higher credit rates are available to families with lower incomes. To benefit from the exclusion, employees arrange with their employer to exclude up to $5,000 from their salary, regardless of the number of children receiving care. These dollars are pre-tax. Higher-income families generally benefit more from the exclusion than from the credit, since the excluded income avoids both income and payroll taxes, but it is only available to those taxpayers whose employers offer it.

Although the same expenses cannot be used to claim both the CDCTC and the exclusion, parents can still in some cases benefit from both provisions. If a parent’s child care expenses exceed the amount excluded from income, these excess expenses may be applied to the CDCTC, provided the total expenses claimed under both provisions do not exceed the maximum eligible amount under the CDCTC. For example, families with two or more children excluding the maximum $5,000 can still claim a CDCTC for an additional $1,000 of expenses, so long as their total child care expenses are at least $6,000.

- To benefit from the CDCTC, both parents must be working or in school. The expenses claimed may not exceed the lower-earning parent’s earnings. The exclusion, however, can be used even if only one parent is working.

- The highest credit rate for the CDCTC (35 percent) applies to families with AGI below $15,000 and decreases by 1 percentage point for each additional $2,000 of AGI. The lowest credit rate (20 percent) applies to families with AGI greater than $43,000.

- In 2011, among families claiming the CDCTC, the largest average benefit went to those with incomes between $100,000 and $200,000. People in the highest income quintile received the greatest share of benefits, both because their average expenses are higher than other income groups and because more people in this quintile have child care expenses (figure 1).
Because the CDCTC is not refundable, only families who owe income taxes can benefit, and low-income families rarely qualify for the maximum benefit.

Maximum eligible expenses for the CDCTC are scheduled to revert back to their pre-2001 levels in 2013 ($2,400 per child, $4,800 maximum per family), and the maximum credit rate will be reduced to 30 percent. In the 2012 budget, the President proposes instead to continue to the EGTRRA credit rules and apply the 35 percent credit rate to all families with AGI under $75,000. After that, the credit would phase-down until it reached 20 percent for families with AGI exceeding $103,000.

The exclusion applies to both payroll and income taxes; its value (that is, the actual reduction in tax) is thus the excluded income times the sum of the rates of the two taxes. Because income tax rates rise with income, the value of the employer exclusion is greater for higher-income taxpayers.

Maximum allowable expenses for both the CDCTC and the exclusion are not indexed for inflation. Thus each year the value of these provisions erodes.

Possible reforms to the CDCTC would make it refundable, so that low-income families can receive the maximum benefit regardless of their income tax liability; raise the ceiling on eligible expenses for both the credit and the exclusion, to more closely align them with actual expenses people face (or, more modestly, allowable expenses could be indexed for inflation); or extend...
the credit rates and allowable expenses under current law to keep them from reverting to their lower, pre-EGTRRA levels.

- On paper, the CDCTC appears larger than it actually is. Most taxpayers eligible for the higher rates have insufficient tax liability to benefit from the credit. Figure 2 shows the benefit taxpayers actually receive compared to what the law suggests they could receive.

Underlying Data: Download
See Also

Taxation and the Family: What is the Earned Income Tax Credit?

Taxation and the Family: What is the Child Tax Credit (CTC)?

Data Sources

TPC Table T11-0251: Federal Tax Benefits of the Child and Dependent Care Tax Credit, Distribution by Cash Income Percentile, 2011

TPC Table T07-0156 Fully Refundable Child and Dependent Care Tax Credit (CDCTC), Returns and Amount Reported Compared to Current Law, 2006

TPC Table T07-0158 EGTRRA Changes to Child and Dependent Care Tax Credit (CDCTC), Distribution of Federal Tax Change by Cash Income Class, 2006

TPC Table T07-0160 EGTRRA Changes to Child and Dependent Care Tax Credit (CDCTC), Returns and Amount Reported Compared to Pre-EGTRRA Law, 2006

TPC Table T07-0162 Child and Dependent Care Tax Credit (CDCTC) Options, Static Impact on Individual Income Tax Liability and Revenue ($ billions), 2007-17

Further Reading


Maag, Elaine, "Recent Expansions to the Child and Dependent Care Tax Credit," Tax Notes, p. 539, October 27, 2003.


Author: Elaine Maag
Last Updated: June 22, 2011
Taxation and the Family: What tax incentives exist to help families save for college?

Three tax-favored savings instruments encourage families to save for college: Coverdell savings accounts, qualified tuition programs (commonly referred to as 529 plans), and the education savings bond program. Use of funds from any of these three programs for other than permitted educational expenses subjects those funds to income taxes and penalties. In addition, certain retirement savings vehicles such as Roth Individual Retirement Accounts (IRAs) may be used to pay for higher education without penalty. Because the benefits of each of these programs are proportional to the family’s marginal tax rate, they give greater saving incentives to higher-income than to lower-income families.

- Anyone, regardless of income, may contribute to a 529 plan for a named beneficiary. A donor may contribute up to $12,000 annually for each beneficiary without triggering a gift tax and may make up to five years of contributions in a lump sum without triggering a gift tax so long as no additional gifts are given to the beneficiary during the five-year period. Funds in a 529 plan grow untaxed. Since the passage of EGTRRA, funds used to pay for postsecondary education are not taxed when withdrawn. Donors retain ownership of the accounts but may use the funds to pay educational expenses only for the named beneficiary. They may, however, transfer funds to another beneficiary, subject to relationship requirements between the original and the new beneficiary.

- Growth of 529 plans since 1996 has been tremendous. At that time only 500,000 accounts existed, containing $2.4 billion in assets (see figure). As of September 2007 there were 10.2 million 529 plan accounts, containing $127 billion in assets.

- Every state except Wyoming sponsors a 529 plan (but Wyoming residents receive preferred treatment in the Colorado 529 plan). In states with a personal income tax, residents investing in their state-sponsored 529 plan often receive a state tax break for at least part of their investment. In 2007 families with adjusted gross income (AGI) below $110,000 ($220,000 if filing a joint return) may deposit up to $2,000 per beneficiary in a Coverdell account on an after-tax basis. Funds grow untaxed and may be withdrawn tax free if used to pay educational expenses.

- The education savings bond program allows users to exclude interest on certain bonds from income tax if the money is used to pay for postsecondary education. In 2007 families could cash in these bonds tax free only if their AGI was less than $80,600 ($128,400 if filing a joint return; income limits are indexed for inflation). This program is substantially smaller than the other two.
• All families face the same 10 percent penalty if account funds are used for other than permitted educational expenses, regardless of how much benefit they would receive if they used the money for education. Even with the penalty, high-income families can benefit from 529 plans and Coverdell accounts because the accounts let them shift money to their children, who typically face lower tax rates. That benefit does not extend to low-income families, who already face lower tax rates.

• The benefits of 529 plans and Coverdell accounts are also less for low-income families because they can reduce financial aid for which they would otherwise qualify.

• Benefits in college savings accounts accumulate over time. To reap the maximum benefit, families must invest well before they know whether a child will attend college. That uncertainty is greatest for low-income families, whose children are least likely to attend college, and this increases their risk of penalties for using the funds for noneducational purposes.

• The tax incentives that these programs provide are of greatest benefit to families whose children are most likely to attend college even without a subsidy. As a result, it is unlikely that these programs significantly increase college attendance.
See Also

Retirement Saving: How does tax-favored retirement saving affect national saving?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Data Sources

College Savings Plans Network

Further Reading


Taxation and the Family: What incentives exist to help families pay for college?

Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education: the Hope Credit, the Lifetime Learning Credit, and a deduction for tuition and fees. As a consequence, federal tax subsidies for college students rose from zero before enactment to roughly $6 billion in 2005-06. Other tax incentives encourage families to save for college (see Taxation of the Family: What tax incentives exist to help families save for college?).

The American Recovery and Reinvestment Tax Act of 2009 replaced the Hope Credit with the partially refundable American Opportunity Tax Credit (AOTC), increasing the amount of expenses eligible for the credit, extending coverage to the first four years of school (up from the first two years allowed by the Hope credit), expanding the types of expenses allowable for the credit, and making the credit partially refundable so it is available to more low-income students. Taxpayers may claim the new credit for 2009 and 2010 only. The President’s 2011 budget proposes extending the AOTC through 2011.

Before Congress created the AOTC, critics complained that the tax benefits had not had much effect on college enrollment, but rather had provided subsidies to people who are likely to attend college anyway. Many low-income students who might be most influenced by reduced college costs could get little or no benefit from the Hope and LLC credits because they are nonrefundable and thus can only offset income taxes owed. At the other end of the income scale, the credits are phased out for many high-income families. As a result, the largest average benefits go to families with annual incomes between $30,000 and $100,000. The impact of making the credit refundable is not yet known. Unless Congress acts to extend it, the AOTC will expire after 2010 and the Hope Credit will be restored.

- For each student, families may claim only one of the three tax benefits but they need not claim the same benefit for all students. Complexity associated with having to choose which benefit to take results in people frequently choosing sub-optimally (GAO 2005).

- The American Opportunity Tax Credit applies to tuition, fees, and required books for students enrolled at least half time in their first four years of college. The credit equals 100 percent of the first $2,000 of eligible expenses plus 25 percent of the next $2,000, yielding an annual maximum credit of $2,500 when qualifying expenses are at least $4,000. Forty percent of the credit is refundable and thus available to all students, regardless of their tax liability. Each qualifying student in the household may receive the AOTC.

- The Lifetime Learning Credit equals 20 percent of tuition and fees for any post-secondary education, up to a maximum annual credit of $2,000. That maximum applies to the combined expenses of all students in the household claiming the credit and is reached when total qualifying expenses reach $10,000.

- The maximum benefit for the American Opportunity Tax Credit phases out between adjusted gross income $80,000 and $90,000 (between $160,000 and $180,000 for married couples). The maximum benefit for the Lifetime Learning Credit phases out between adjusted gross incomes of $45,000 and $55,000 for single taxpayers, or between $90,000 and $110,000 for married couples.
The deduction for tuition and fees allows taxpayers (parents or students, whichever pays) to reduce taxable income by up to $4,000. To qualify, a family’s adjusted gross income may not exceed $65,000 for single filers or $130,000 for married filers. Single filers with AGI between $65,000 and $80,000 or married filers with AGI between $130,000 and $160,000 can deduct up to $2,000 of expenses. After that, a family is no longer eligible for the deduction. The tuition and fees deduction is scheduled to expire after 2009.

Most people who qualify for a tax credit for education expenses will benefit more from the American Opportunity Tax Credit than the Lifetime Learning Credit by virtue of the AOTC being the larger of the two. Students who do not qualify for the AOTC – those who are less than half-time, or are in their fifth year of school, for example – will benefit more from the LLC.

The Lifetime Learning Credit is nonrefundable, so only people who owe income tax can benefit. Similarly, the deduction for tuition and fees is valuable only for people with taxable income.

Prior to the enactment of the American Opportunity Tax Credit, the education tax programs provide relatively modest benefits: an average of $771 per household. Average benefits are highest for those receiving a Hope Credit ($1,069), followed by the Lifetime Learning Credit ($978), and finally the tuition and fees deduction ($324). Average benefits under the American Opportunity Tax Credit will be higher.

Using the tax system to subsidize higher education has two primary advantages: Students need not fill out the complicated Free Application for Federal Student Aid form, and every student who qualifies receives a benefit.

Figure 2. Distribution of Tax Expenditures for Education by Family Income, 2005
(Hope Credit, Lifetime Learning Credit and Deduction for Higher Education Expenses)

Possible options for reform

- Even though some books are now eligible expenses for the American Opportunity Tax Credit (as opposed to only tuition and fees for the Lifetime Learning Credit), additional assistance could be provided by broadening coverage to include more expenses such as room and board.

- Providing benefits directly to schools when students enroll (based on the previous year’s taxes) would help students cover college costs when they actually have to make payments, not months later when their families file tax returns.
See Also

Taxation of the Family: What tax incentives exist to help families save for college?

Data Sources

Education Tax Incentives, TPC Tables T06-0325 to T06-0336

Author: Elaine Maag
Last Updated: February 4, 2010

Further Reading


Taxation and the Family: What are marriage penalties and bonuses?

Couples face a marriage penalty when they pay more income tax filing jointly as a married couple than they would if they had remained single and filed separately as individuals. Conversely, a marriage bonus occurs if a couple pays less tax filing jointly than they would if they were single. Under a progressive income tax, marriage penalties and bonuses arise because the household rather than the individual is the unit of taxation. Tax provisions that phase in or phase out with income also produce penalties or bonuses. Many more married couples receive bonuses than incur penalties.

- Marriage penalties and bonuses result from the combination of progressive tax rates and taxation of a married couple as a single tax unit. With progressive taxes (which impose higher rates on higher incomes), combining spouses’ incomes can result in some income being taxed at higher rates than if spouses’ incomes were taxed separately. That can occur only if joint tax brackets are less than twice as wide as individual brackets. (A couple does not have to file a joint tax return but their alternative-filing separately as a married couple-almost always results in greater tax liability.)

- Couples in which spouses have similar incomes are more likely to incur marriage penalties than couples where one spouse earns most of the income, because combining incomes in joint filing can push both spouses into higher tax brackets.

  - Example of a marriage penalty: A husband and wife with two children earn $100,000 each and itemize deductions totaling $40,000. Filing jointly, their taxable income is $146,801, on which their 2008 income tax liability is $27,848. But the alternative minimum tax (AMT) raises that liability to $30,825. If they could file separately as single and head of household with two children, the single filer would owe a tax of $15,469 and the head-of-household filer would owe $10,438, or a total of $25,906, and they would not be subject to the AMT. Their joint tax bill is thus $4,919 higher than the sum of their individual tax bills, imposing on them a marriage penalty equal to 2.5 percent of their pretax income. (see example details)

- Couples in which one spouse earns all of the couple’s income never incur a marriage penalty and almost always receive a marriage bonus, because joint filing shifts the higher earner’s income into a lower tax bracket.

  - Example of a marriage bonus: A wife earns $200,000 and her husband earns nothing. They have two children and itemize deductions equal to $40,000. Filing jointly, their taxable income is $146,801, on which their 2008 income tax liability is $27,848. But the AMT raises that liability to $30,825. If they could file separately, the husband as single and the wife as head of household with two children, the wife would owe taxes of $38,957 (including the AMT) and the husband would owe nothing. Their joint tax bill is $8,132 less than their combined individual tax bills, giving them a marriage bonus equal to 4.1 percent of their pretax income. (see example details)

- Before the 2001 tax act, married couples were already significantly more likely to get bonuses than penalties. The Congressional Budget Office estimated that 51 percent of married couples received marriage bonuses totaling nearly $33 billion in 1996, and 42 percent incurred marriage penalties totaling almost $29 billion.
• Tax legislation since 2001 has substantially reduced marriage penalties and increased marriage bonuses, by raising the standard deduction for couples to twice that for single filers and by setting the income ranges of the 10 and 15 percent tax brackets for couples to twice the corresponding ranges for individuals. Legislation also raised the starting point for the earned income tax credit (EITC) phase-out range by $3,000 for married couples.

• Marriage penalty relief is costly. TPC estimates that extending the marriage penalty reductions from their scheduled sunset in 2010 through 2017 would cost more than $130 billion in tax revenue. Much of the cost results from raising marriage bonuses.

• Much of the benefit of marriage penalty relief goes to the wealthiest taxpayers. TPC estimates that marriage penalty tax cuts will increase after-tax income in 2010 by 0.66 percent for the average taxpayer in the top income quintile, but by only 0.24 percent for middle-quintile taxpayers (see figure).

• Despite the recent reductions, many aspects of the tax code perpetuate penalties. Joint filer brackets for tax rates above 15 percent are less than twice as wide as single brackets, and therefore combining income for joint filing can lead to higher tax rates. In fact, the 35 percent bracket starts at the same level of taxable income for single filers, joint filers, and heads of household and imposes significant marriage penalties on high-income couples. In addition, income limits on some tax subsidies are less than twice as high for couples as for single filers. For example, the child tax credit starts to phase out for unmarried filers when adjusted gross income exceeds $75,000; for married couples filing jointly, the threshold is $110,000, which is less than twice the single filer’s threshold and can thus cause marriage penalties for some taxpayers. Finally, AMT parameters for couples are less than twice those for unmarried individuals. For example, the 28 percent AMT bracket starts at $175,000 for both single and joint tax filers.

• Taxpayers who might qualify for the EITC can suffer particularly large marriage penalties if the income of one spouse disqualifies the other from getting the credit. However, marriage can increase the EITC if a nonworking parent marries a low-earning worker.

  o Example of a marriage penalty due to the EITC: A husband and wife with two children earn $20,000 each and claim the standard deduction of $10,900. Filing jointly, their taxable income is $15,100, on which their 2008 income tax liability is $1,510. They qualify for an EITC of $347 and a child credit of $2,000, yielding a net refund of $837. If they filed separately, the wife as a head of household with two children and the husband as single, the wife would have a tax bill of $150 minus an EITC of $3,927 and a child credit of $1,343, for a net refund of $5,119. The husband would owe $1,256 with no offsetting credits. Their separate tax bills would thus yield a combined net refund of $3,863, and so they incur a marriage penalty of $3,026, or 7.6 percent of their pretax income. (see example details)

• Marriage penalties are not confined to the tax system. Married couples often receive lower benefits from government programs than they would if they had not married.
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TAXES AND THE POOR

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Taxes and the Poor: How does the federal tax system affect low-income households?

Low-income households pay relatively low federal taxes, primarily because tax credits reduce or eliminate their income tax liability, and some (called refundable credits) result in net payments to them. In 2007, tax units in the lowest income quintile (that is, the 20 percent of all tax units with the lowest incomes) on average paid federal income, payroll, and estate taxes equal to 3.4 percent of their cash income, or less than one-sixth of the 21.7 percent average effective tax rate for all tax units (see table).

- Because the earned income tax credit (EITC) is refundable and the child tax credit (CTC) is partly so, the average effective individual income tax rate for the bottom two income quintiles in 2007 was negative; that is, the tax credits more than offset positive income tax liability, so that the average household in these quintiles received a net payment from the government.

- Low-income households face a lower than average effective payroll tax rate because they get less of their income from earnings and more from transfer payments than do higher-income households. In 2007, payroll taxes claimed 7.3 percent of the cash income of tax units in the lowest quintile, compared with 8.3 percent for all tax units.

- Tax units in the lowest income quintile pay a slightly higher average effective tax rate on corporate income (passed through to them as shareholders) than units in the next two quin-
tiles. That outcome occurs because low-income elderly households get a disproportionately large share of their income from their retirement savings.

- Not surprisingly, low-income households pay virtually no estate taxes. The current $2 million threshold for estate tax liability excludes taxpayers in all but the highest income quintile from the tax.

- Effective tax rates on low-income households have changed markedly over the past quarter century (see figure 1). Creation of the CTC and expansion of the EITC both served to lower the effective individual income tax rate for these households from about 0.5 percent in the early 1980s to its negative value more recently. In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over the same period. The effective corporate income tax rate for low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.

- Low-income married couples with children have seen a marked decline in their taxes since 1970 (see figure 2). For example, the average combined income and payroll tax rate for married couples with two children and income at the poverty level fell from about 7 percent in 1970 to negative 17 percent in 2006. That decline resulted in large part from the creation and subsequent expansion of the refundable EITC and partially refundable CTC.
See Also

Taxation and the Family: What is the child tax credit?

Taxation and the Family: What is the earned income tax credit?

Taxes and the Poor: Can poor families benefit from the child tax credit?

Further Reading


Data Sources


Author: Roberton Williams
Last Updated: May 2, 2008
Taxes and the Poor: How do refundable and nonrefundable credits differ?

Taxpayers may claim the full value of most tax credits only if their tax liability before applying the credit exceeds the value of the credit. Stated another way, most tax credits cannot reduce a person’s tax bill below zero. Three tax credits—the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC)—do not face that limitation; they are termed refundable because they can generate cash refunds that exceed the taxpayer’s tax liability. The EITC and the HCTC are fully refundable: taxpayers may receive their full value regardless of their other tax liability. In contrast, the CTC is only partially refundable because it can result in negative tax bills only in specified circumstances.

- The federal budget distinguishes between the portion of a tax credit that offsets positive tax liability and the portion that is refundable. Most of the EITC—an estimated $39.4 billion of the 2008 total of $46.5 billion—is refundable. Much less of the CTC is refundable: $16.3 billion out of $44.8 billion in 2008.

- Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. Particularly in the cases of the EITC and the CTC, precisely those low-income households most in need of assistance would be denied the benefit of the credits if they were not refundable. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.
• Opponents of refundable credits raise four objections: that the tax code should not redistribute income; that the government should not use the tax code to carry out social policies; that everyone should pay some tax as a responsibility of citizenship; and that refundable credits increase administrative and compliance costs and encourage fraud and abuse.

• Like the federal government, states have few refundable tax credits. However, fourteen states—Colorado, Illinois, Indiana, Kansas, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin—and the District of Columbia do provide a refundable EITC. Part of Maryland’s EITC is refundable and part is not. Four states—Delaware, Iowa, Maine, and Virginia—have a nonrefundable EITC.

See Also
Taxation and the Family: What is the earned income tax credit?
Taxation and the Family: What is the child tax credit?
Income Tax Issues: What is the difference between tax deductions and tax credits?

Data Sources

Author: Roberton Williams
Last Updated: April 9, 2008

Further Reading
Taxes and the Poor: Can poor families benefit from the child tax credit?

Taxpayers may claim a child tax credit (CTC) of up to $1,000 per qualifying child under age 17. The CTC is partially refundable, technically as an "additional child tax credit" (ACTC): in 2008 the credit can exceed tax liability by up to 15 percent of earnings above $12,050. Thus, for example, a family with two or more qualifying children and earnings of $22,050 may claim a refund of up to $1,500 over and above any tax liability. However, low-income families that earn $12,050 or less receive no CTC or ACTC.

- In 2005 more than one-quarter of all qualifying children were in families that could not receive the full CTC because they earned too little. Nearly half of those children were in families that received no credit at all.

- The families of nearly half of all black children and 46 percent of Hispanic children received less than the full CTC in 2005 because they earned too little.

- Prior to 2001, only families with three or more children could receive the ACTC. The refundable portion of the CTC was limited to the amount by which a family's Social Security and Medicare taxes exceed their earned income tax credit (EITC). Few families qualified for the ACTC.

- The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the ACTC to equal 15 percent of a family's earnings over a threshold - set at $10,000 in 2001 and indexed annually for inflation. Indexing the threshold meant that poor families whose earnings failed to keep pace with inflation received less and less ACTC over time.

- The American Recovery and Reinvestment Act of 2009 temporarily reduced the ACTC threshold to $3,000 for 2009 and 2010, extending refundability to more poor families.

- The ACTC provisions of both EGTRRA and ARRA expire after 2010. Unless Congress acts, the ACTC will again be limited to families with at least three children with significant earnings.

See Also

Taxation and the Family: What is the child tax credit?
Author: Roberton Williams
Last Updated: March 19, 2008

Further Reading


Taxes and the Poor: Why do low-income families use paid tax preparers?

Many low-income families do not have to file federal income tax returns because they owe no tax, but not filing can cost them tax benefits such as the earned income tax credit (EITC). Those who do file often need help preparing their returns, which nearly always comes from a paid preparer. Getting that help—and associated services such as refund anticipation loans (RALs)—eroses the value of the EITC and other refundable credits for these families. That cost might be worth bearing if preparers help their clients claim tax benefits that otherwise might be missed, but evidence suggests that some families who use paid preparers and qualify for the EITC still fail to claim the credit. On the other hand, some preparers not only do inform their low-income clients of their EITC eligibility, but further help them by identifying nontax forms of assistance for which they might qualify, and some even assist in the application process.

- A majority of low-income families that file tax returns receive help to do so. In 2002, two-thirds of families with income below twice the poverty line (about $36,500 for a couple with two children, for example) received help, and virtually all used paid preparers. Hispanic and African-American families and families with less than a college education were more likely than the average low-income family to receive help.

- Using a paid preparer does not appear to make tax filers more aware of available tax benefits such as the EITC, but it does increase the likelihood that a filer who knows about the EITC will claim the credit. Roughly 70 percent of low-income tax filers reported knowing about the EITC in 2002, but among those who knew of the credit, about 80 percent of those using paid preparers actually claimed the credit, compared with 70 percent of those who filed on their own.

- Some paid preparers help their low-income clients apply for nontax benefits. For example, one firm provided food stamp applications to all qualifying clients in the largest states, along with assistance in completing and filing the forms.

- Low-income tax filers who use paid preparers can take advantage of refund anticipation loans (RALs), which are immediate cash loans from private lenders, backed by the tax refunds the borrowers have claimed on their prepared returns. RALs proliferated after 1999, when the Internal Revenue Service reinstated the debt indicator program, which allows tax preparers to find out whether a filer’s tax refund will be redirected by the Internal Revenue Service to pay that filer’s debts. The National Consumer Law Center reports that in 2006 nearly 9 million taxpayers took out RALs. Although that number was down from the 2004 record high of 12.4 million, tax filers still paid nearly $1 billion in loan and other fees. Another 10.8 million taxpayers spent $324 million on other types of financial products to receive their refunds more quickly. A 2005 study found that RAL fees for a $2,000 refund typically ran between $35 and $115, resulting in effective annual interest rates between 40 percent and over 700 percent (because of the short duration of the actual loan).

- EITC recipients are much more likely than nonrecipients to take out RALs. In 2006 nearly two-thirds of RALs went to tax filers claiming the EITC, even though they filed just one-sixth of all tax returns.
See Also

Taxation and the Family: What is the earned income tax credit?

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SAVINGS AND RETIREMENT

What kinds of tax-favored accounts are there? ............................................................. II-3-1
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Savings and Retirement: What kinds of tax-favored accounts are there?

Taxpayers have a variety of options for receiving tax benefits for retirement saving. Tax-favored accounts fall into two broad categories: those offered through an employer and those established by an individual. Accounts offered through an employer in turn are of two types. Defined-benefit plans generally distribute funds during retirement according to a formula that accounts for a worker’s years of service at a firm and earnings. In defined-contribution plans, of which the 401(k) plan is the most common, distributions depend on the size of past employee and employer contributions and on the investment returns on those contributions over time. Accounts established by an individual include two types of Individual Retirement Accounts (IRAs): traditional IRAs and Roth IRAs. Traditional IRAs and 401(k)s allow taxpayers to deduct the value of contributions, up to a limit, from taxable income, but tax the value of the distributions made during retirement. Contributions to Roth IRAs and Roth 401(k)s generate no immediate tax deductions but allow distributions to be received tax-free after the worker has reached retirement age. In all of these arrangements the accumulation of interest, dividends, and capital gains inside the account is not taxed.

- Employers are not required to offer their employees retirement benefits, and only about half of all workers do receive retirement benefits through their employer. Employees of large companies are more likely to receive employer-sponsored retirement benefits than employees of small firms. About two-thirds of workers at medium-size and large firms receive retirement benefits, compared with just one-third of workers at small firms. Almost all government employees receive retirement benefits.

- Worker participation in IRAs is less common. In any given year about one worker in twelve contributes to an IRA, although a higher percentage of workers own IRAs. Participation in IRAs is approximately evenly split between traditional and Roth IRAs.

See Also

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

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Savings and Retirement: How large are the tax expenditures for retirement saving?

Provisions in the tax code designed to encourage retirement saving cost the U.S. Treasury billions of dollars in forgone revenue each year. Provisions of this type, which reduce tax revenue for the sake of promoting other public goals, are called tax expenditures. Of all the tax expenditures in the tax code, the one allowing tax-free employer contributions to employee pension plans is the second largest, costing $108.6 billion in 2007 according to estimates by the congressional Joint Committee on Taxation. All of the retirement saving incentives in the tax code together amounted to $133.8 billion in tax expenditure in that year and $760.3 billion over five years.

- The second-largest tax expenditure for retirement saving is the exclusion of contributions to and earnings in Individual Retirement Accounts, both Roth IRAs and traditional IRAs. This tax expenditure is an estimated $15.5 billion in 2007 and $94.1 billion over five years, significantly less than the cost of employer-sponsored pensions. The retirement saving expenditure for Keogh plans, which cover self-employed workers, amounted to $8.8 billion in 2007 and $54.5 billion over five years.
See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


**Savings and Retirement: What are defined-benefit retirement plans?**

Defined-benefit plans provide pension income to retired employees on the basis of a formula that accounts for a worker’s years of service at a firm and earnings. Distributions are typically made for the remainder of the employee’s life, making the plan similar to an annuity. Contributions are generally made by the employer only, who is responsible for determining what level of contributions is necessary to provide the promised benefits to all current and future employees. Contributions to defined-benefits plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulated earnings.

- Compared with other types of retirement accounts, the risk in a defined-benefit plan is borne mostly by the employer. If employees live longer in retirement than anticipated, or if the investments financing the employees’ pensions fail to meet expectations, it is the employer’s responsibility to increase contributions so as to make good on the promised benefits.

- Defined-benefit plans are more likely to be offered by large employers, who are better suited to bear the risk involved.

- Defined-benefit plans have been decreasing in popularity over the past few decades. From 1991 to 2003 the share of full-time employees at medium-size and large establishments participating in defined-benefit plans fell from 59 percent to 33 percent. Defined-benefit plans, however, are still the most common type of plan for government employees.

- Defined-benefit plans are insured by the Pension Benefit Guarantee Corporation, a federal entity whose responsibility is to ensure that employees receive a minimum pension benefit in the event that their employer is unable to pay the promised benefits in full.
See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

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Savings and Retirement: Who uses tax-favored retirement savings accounts?

Almost all workers are eligible to participate in at least one type of tax-favored retirement savings account, yet only about half do. Older workers and workers with higher incomes are more likely to participate than other workers. Married earners also have higher rates of participation than unmarried earners.

- The likelihood of participation in a tax-favored retirement savings account varies by age. In recent years fewer than one-third of workers under age thirty participated in an account, compared with almost two-thirds of workers aged forty-five to fifty-nine (see table).

- Workers with higher incomes are also more likely to participate in a tax-favored savings account. In recent years, about four out of five high-income workers did so, but only one out of five low-income workers.

- Middle-income workers have higher rates of participation in defined-benefit plans than higher-income workers, who in turn are more likely to participate in defined-contribution plans. In re-
recent years the participation rate of higher-income workers in 401(k)-type plans was over twice that for lower-income workers.

- Participation rates in traditional and Roth Individual Retirement Accounts (IRAs) tend to increase with income. The wealthiest workers, who are ineligible to participate in Roth IRAs, are more likely to participate in traditional IRAs compared to middle-income taxpayers.

- Among those workers participating in a plan, contributions to 401(k)-type plans are highly correlated with income. The average contribution to a 401(k)-type account was $3,700 in 2003, but high-income workers earning over $160,000 contributed an average of about three times that amount ($9,503), while workers earning between $20,000 and $40,000 contributed, on average, just $726.

- IRA contribution limits are more restrictive than those for 401(k)s, and partly as a consequence, average taxpayer contributions vary less with income for IRAs than for 401(k)-type plans. In 2003 the average contribution to an IRA was $2,197. The average contribution varied somewhat by income, with those in the $20,000 to $40,000 range contributing an average of $1,962 and those earning more than $160,000 contributing an average of $2,941. As workers approach retirement, the average contribution increases. There is little difference in contribution levels to IRAs for married and unmarried workers.

- About half of all IRA participants contribute the maximum amount allowed. Among those with traditional IRAs, 55 percent contributed the maximum deductible amount in 2003, and a significantly higher proportion of high-income taxpayers did so than of lower-income taxpayers. Among those with Roth IRAs, 44 percent contributed the maximum amount, with higher-income taxpayers again doing so more frequently. This contribution pattern illustrates one reason why proposals to increase the maximum IRA contribution would benefit wealthy taxpayers more than low- and middle-income taxpayers.
See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

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Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Savings and Retirement: What are defined-contribution retirement plans?

A defined-contribution plan is a plan in which an employee’s benefits during retirement depend on the contributions made to and the investment performance of the assets in his or her account, rather than on the employee’s years of service or earnings history. Like a typical savings account, a defined-contribution account contains a specific balance at any given time, which is equal to the market value of the assets accumulated in the account. Unlike with a defined-benefit plan, employees have substantial control over how the contributions to their plan are invested and may generally choose from an assortment of stocks (often including company stock), bonds, mutual funds, and other investment vehicles. Examples of defined-contribution plans include 401(k) plans, 403(b) plans, and 457 plans, all of which share similar characteristics.

- The proportion of employees participating in defined-contribution plans has gradually increased over the past several decades, and today stands at about half of all workers nationwide. However, within the defined-contribution universe, savings and thrift-type plans have grown in popularity at the expense of profit-sharing plans.

- Compared with defined-benefit plans, which offer employees an annuity at retirement, defined-contribution plans are riskier for employees, because the employee bears the risk of underperforming assets and extended longevity. This risk can be muted if employees use the assets in their defined-contribution plan to purchase annuities at retirement.

- Contributions to defined-contribution plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulated earnings. However, the employee does pay tax when funds are withdrawn. Exceptions to this rule are Roth 401(k) plans, which tax contributions when they are made rather than when the contributions are withdrawn.

- Withdrawals from defined-contribution accounts are generally not permitted before age 59 except in certain circumstances, such as the purchase of a first home or the payment of certain educational or medical expenses. In these circumstances, tax penalties may reduce the value of the account.
See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Savings and Retirement: What types of non-employer-sponsored accounts are available?

Workers can receive tax-favored benefits for retirement saving through arrangements that do not involve their employer. The Individual Retirement Account (IRA) comes in two forms, traditional IRAs and Roth IRAs. (Other types of IRAs are available to workers through their employer, including SIMPLE and SEP plans.) The primary difference between traditional and Roth IRAs is in the timing of the tax on contributions. Qualified contributions to traditional IRAs are excluded from tax and allowed to grow tax-free, but withdrawals during retirement are taxed. Contributions to Roth IRAs, conversely, are taxed in the year they are made but are allowed to grow tax-free, and withdrawals during retirement are not taxed. About 45 million households own at least one IRA.

- Traditional IRAs and Roth IRAs also differ in the amount of funds that can be sheltered from taxation, with Roth IRAs shielding a higher level of funds from taxation than traditional IRAs. This is due to the Roth IRA characteristic that allows contributions to grow tax-free and never be taxed after the initial contribution, which is generally more favorable than the tax treatment of contributions with a traditional account.

- The tax code limits the extent to which individuals may take advantage of the tax benefits associated with traditional and Roth IRAs. Taxpayers with income beyond a certain level, which varies with filing status, may not contribute to a Roth IRA and may not deduct contributions to a traditional IRA; taxpayers who participate, or whose spouse participates, in an employer-provided pension also may not deduct traditional IRA contributions if their income exceeds a certain amount.

- Since traditional IRAs were originally designed to be a parallel tax benefit for employees lacking access to an employer-sponsored saving plan such as a 401(k), taxpayers participating in such a plan face stricter criteria for traditional IRA eligibility.

- For single taxpayers without access to an employer-sponsored pension, and for married couples where neither spouse participates in such a pension, there are no income restrictions on the deductibility of traditional IRA contributions. A married taxpayer who does not participate in an employer-sponsored plan but whose a spouse does participate may contribute the maximum statutory amount to an IRA, provided the couple’s joint income does not exceed $156,000.
See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Savings and Retirement: How does tax-favored retirement saving affect national saving?

One of the most important and controversial aspects of the taxation of retirement saving is its effect on private saving, wealth accumulation, and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and Individual Retirement Accounts (IRAs) clearly make up a sizable share of households’ wealth, both in their preretirement years and during retirement, it is less clear how much of that wealth represents incremental balances, that is, wealth that would not have existed in some other form in the absence of favored tax treatment of retirement saving.

- The accounts raise private saving to the extent that they induce households to finance their own contributions through either reductions in consumption or increases in labor supply. Saving incentives do not raise private saving to the extent that households finance their contributions by shifting their existing assets into a tax-favored account, or by shifting current-period saving that would have occurred even in the absence of the incentive, or by increasing their debt. Likewise, there is no increase in private saving to the extent that households respond to employer-provided pensions or contributions by reducing their other saving or increasing their borrowing.

- The earliest research on both traditional defined-benefit pensions and defined-contribution plans appeared to demonstrate very strong effects on private wealth and saving. These efforts, however, were marred by a series of econometric and statistical problems. More recent research, using improved methods, has found significantly smaller impacts of tax-preferred saving vehicles on private saving and wealth, and in some cases has found no net effects on private wealth at all.
See Also

Savings and Retirement: Where does the tax saving come from?

Savings and Retirement: How might saving be encouraged for low- and middle-income households?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Savings and Retirement: Where does the tax saving come from?

The tax saving in tax-favored retirement saving accounts primarily comes from the favored tax treatment of the returns on assets held within the account. Some types of tax-favored accounts tax assets when withdrawn from an account, whereas others do not, but all such accounts share the characteristic that saved assets are permitted to grow untaxed. Over time, this benefit can become substantial.

- Broadly speaking, there are two classes of subsidized retirement saving accounts: front-loaded accounts, such as traditional IRAs and 401(k)s, and back-loaded accounts, such as Roth IRAs. In front-loaded accounts, contributions are tax-deductible and withdrawals are taxed. In back-loaded accounts, contributions are not tax-deductible but withdrawals are not taxed. In both types of accounts the investment returns on assets kept within the account are untaxed.

- Whether taxpayers benefit more from a front-loaded or a back-loaded account depends on the difference in tax rates during their working years and in retirement. Someone with a high tax rate during his or her working years and a lower tax rate in retirement would benefit more from a front-loaded account, since the original contribution is deducted against a high tax rate and the withdrawal is taxed at a lower rate. Someone whose tax rate is expected to be higher in retirement would benefit more from the back-loaded account.

- An additional consideration is that one can effectively shelter more saving in a back-loaded account than in a front-loaded account if the two accounts have the same contribution limit. For example, if an individual facing a 25 percent marginal income tax rate contributes $1,000 to a front-loaded account, she is really contributing $750, or \((1.00 - 0.25) \times 1,000\) of her own funds, and $250 of government funds because of the tax deduction. When the funds are withdrawn, the government reclaims its share of the amount withdrawn. In contrast, in a back-loaded account, the entire amount grows tax-free and can be withdrawn tax-free.

See Also

- Retirement Saving: What kinds of tax-favored accounts are there?
- Retirement Saving: What are defined-benefit retirement plans?
- Retirement Saving: What are defined-contribution retirement plans?
- Retirement Saving: What types of non-employer-sponsored accounts are available?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
Savings and Retirement: What is an automatic 401(k)?

An automatic 401(k) is simply a 401(k) plan that automatically enrolls workers in the plan, rather than requiring workers to decide on their own to sign up. Eligible workers are assigned a default contribution rate, usually 3 percent or less of wages, and a default allocation of funds contributed to the retirement account. As with a traditional 401(k), workers still have a choice about whether to participate and how much to contribute: they can opt out of automatic enrollment or change the default contribution rate. The difference is that, under an automatic 401(k) plan, inaction on the worker’s part will automatically result in the worker saving for retirement.

- In traditional 401(k) plans, workers must make numerous choices, including whether to sign up, how much to contribute, how to allocate their investment funds, how often to rebalance their portfolios, what to do with the accumulated funds when they change jobs, and when and in what form to withdraw the funds during retirement. These decisions can be difficult, and many workers, daunted by the complexity, either make poor choices or never sign up at all. Thus they remain outside of the retirement savings system and are deprived of the tax-advantaged saving opportunities that 401(k)s provide.

- With an automatic 401(k)-sometimes called an opt-out plan-workers are automatically enrolled unless they actively choose not to participate; they are assigned a reasonable contribution level,
which rises over time, and a reasonable allocation of investments across stocks and bonds. That is, each stage of the process is automatically set at a pro-saving default. Workers can choose to override any of these choices, but the same inertia that leads them not to make decisions in a traditional 401(k) is likely to make them stay at the defaults in an automatic 401(k).

- Automatic enrollment has been shown to raise 401(k) participation rates dramatically when applied to new hires, especially those who are female, members of minority groups, or low earners.

- The automatic escalation of contributions over time raises overall contributions to 401(k)s relatively painlessly, as employees become accustomed to deferring receipt of a portion of their pay. Escalation also helps ensure that inertia does not keep some employees at a default contribution rate lower than the rate they would have chosen absent the default.

- Under reasonable assumptions about the effect of the automatic 401(k) on overall saving behavior, it is estimated that this simple proposal, applied nationwide, would raise national saving by 0.06 percent of GDP. Private saving would rise by 0.07 percent of GDP, but because 401(k) contributions are tax-favored, government saving would fall by 0.01 percent of GDP.

See Also

Retirement Saving: What kinds of tax-favored accounts are there?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Savings and Retirement: How might saving be encouraged for low- and middle-income households?

In 2007 the tax code contained $108.6 billion in tax expenditures that subsidized retirement saving, but only a small fraction is aimed at low- and middle-income households. Several reforms would help to encourage saving among these households. One would be a reform of the savers’ credit. A second would be to encourage automatic enrollment in 401(k) plans and Individual Retirement Accounts (IRAs). Taken together, these two changes would make saving easier and more rewarding.

- Current retirement saving incentives are inefficient and poorly targeted. They are worth the least to lower-income families and thus provide minimal encouragement to those households who most need to save more to provide for basic needs in retirement. Also, as a strategy for promoting aggregate national saving, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. Because low- and middle-income households are much less likely to have other assets to shift in this way, any deposits they make to tax-preferred accounts are more likely to represent new saving.

- The saver’s credit is a credit to low- and middle-income households for contributions to retirement savings plans. The credit rate is not fixed but declines as income rises. For married couples filing jointly, the credit rate is 50 percent for adjusted gross incomes (AGI) below $31,000, 20 percent for AGI between $31,000 and $34,000, and 10 percent for AGI between $34,000 and $52,000. For single filers, the credit rate is 50 percent for AGI below $15,500, 20 percent for AGI between $15,500 and $17,000, and 10 percent for AGI between $17,000 and $26,000.

- The saver’s credit could be improved in several ways. First, if it were made refundable, it would benefit the millions of low-income families who face no net federal income tax liability but do pay other taxes. Second, if it were simplified by setting a fixed credit rate, with the contribution limit phasing down as income rises, it would be easier for taxpayers to understand. Third, if the credit were converted to a match (a 50 percent credit is equivalent to a 100 percent match) and deposited directly into the account rather than refunded as a tax reduction, it would make the credit operate more like a standard 401(k) match and help improve account balances.

- Reform of the saver’s credit would make saving more rewarding; other options would make saving easier. The automatic 401(k) proposal would automatically enroll eligible workers in their employer’s 401(k) or other retirement savings plan, if the employer has one. Saving for retirement would thus become the default option: employees taking no action would automatically be on the path to better saving for retirement; employees not wishing to participate could still opt out. Similarly, the automatic IRA proposal would automatically enroll employees in an IRA if their employer does not offer a retirement plan. When automatic enrollment has been instituted on a company level, it has shown to be an effective method of raising the participation rates of low- and middle-income workers in company retirement plans.

- These incentives to make saving more rewarding and efforts to make saving easier could be mutually reinforcing: the saver’s credit will reach more people if automatic enrollment is expanded, and the value of automatic enrollment is enhanced if the saver’s credit is reformed.
Some provisions of current policy actually discourage retirement saving. For example, outdated asset tests in means-tested public assistance programs penalize low- and moderate-income households that respond by saving. Applicants for public assistance programs generally must meet both an asset test and an income test, and any retirement savings they hold in defined-contribution plans are often counted in their assets. This has the effect of a steep implicit tax on 401(k) and IRA saving, producing a disincentive for these families to save. Changing the rules of asset tests to exclude the value of retirement savings accounts would generate stronger incentives for low-income families to save.

See Also

Savings and Retirement: What kinds of tax-favored accounts are there?

Savings and Retirement: How large are the tax expenditures for retirement saving?

Savings and Retirement: Who uses tax-favored retirement savings accounts?

Further Reading


ALTERNATIVE MINIMUM TAX

What is the AMT? ......................................................................................................................... II-4-1
Who pays the AMT? ..................................................................................................................... II-4-5
How much revenue does the AMT raise? ..................................................................................... II-4-9
What is the effect of the 2001-06 tax cuts on the AMT? ............................................................. II-4-11
What is the effect of the AMT on the 2001-06 tax cuts? ............................................................. II-4-14
What has been the effect of annual "patches?" ........................................................................... II-4-17
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Alternative Minimum Tax: What is the AMT?

Congress originally enacted the individual alternative minimum tax (AMT) in 1969 to guarantee that high-income individuals paid at least a minimal amount of tax. After calculating their regular income tax, middle- and upper-income taxpayers must add a number of "preference items" to their taxable income, subtract a special AMT exemption, and recalculate their tax according to the AMT tax schedule. If the tax under that schedule is higher than the regular income tax, taxpayers pay the difference as AMT.

The AMT will affect just over 4 million taxpayers in 2011, but the number will explode to over 31 million in 2012 unless the temporarily higher AMT exemption is extended (see table).

<table>
<thead>
<tr>
<th>Year</th>
<th>Married filing jointly</th>
<th>Single and head of household</th>
<th>Married filing separately</th>
<th>Returns (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$74,450</td>
<td>$48,450</td>
<td>$37,225</td>
<td>4.3</td>
</tr>
<tr>
<td>2012</td>
<td>$45,000</td>
<td>$33,750</td>
<td>$22,500</td>
<td>31.2</td>
</tr>
</tbody>
</table>

Source: Office of Tax Analysis, Department of Treasury (unpublished tabulation).

- The AMT has two tax rates: the first $175,000 of income above the exemption is taxed at a 26-percent rate, and incomes above that amount are taxed at 28 percent. The AMT exemption phases out beginning at $112,500 for singles and heads of household, $150,000 for married couples filing joint returns, and $75,000 for married couples filing separate returns. Since the exemption phases out at a 25-percent rate, it creates effective AMT tax rates of 32.5 percent (125 percent of 26 percent) and 35 percent (125 percent of 28 percent).

- The AMT disallows state and local tax deductions and dependent exemptions. Those two adjustments account for nearly 80 percent of the difference between the AMT and the regular income tax (Figure 1). As a consequence, middle-income families with children who live in high-tax states are among those most likely to owe AMT.

- Because the AMT is not indexed for inflation, the number of AMT taxpayers grows every year under current law. The 2001-06 tax cuts roughly doubled the size of the problem by cutting the regular income tax without a corresponding long-term fix to the AMT.
Without Congressional action, the number of taxpayers subject to the AMT will drop after the tax cuts expire, from 31 million in 2012 to 21 million in 2013. But the lack of inflation indexing in the AMT will continue to push that number inexorably back upward (see Figure 2).
Repealing or fixing the AMT would be expensive. If all of the temporary provisions that were extended in 2010 expire in 2013 as scheduled, the AMT will increase tax revenues by $1.4 trillion between 2013 and 2022. Extending all of the temporary provisions without adjusting the exemption would nearly double that amount to more than $2.5 trillion. In contrast, extending the temporary tax provisions and indexing the 2011 AMT exemption for inflation would slash AMT revenue to just $670 billion over the next decade.

For the latest on the AMT, see [www.taxpolicycenter.org/taxtopics/AMT.cfm](http://www.taxpolicycenter.org/taxtopics/AMT.cfm).
See Also

AMT: Who pays the AMT?

AMT: How much revenue does the AMT raise?

AMT: What is the effect of the AMT on the 2001-10 tax cuts?

AMT: What is the effect of the 2001-10 tax cuts on the AMT?

Data Sources

T11-0147 Extend AMT Patch and Index Parameters for Inflation, Impact on Tax Liability, Revenue and AMT Taxpayers, 2012-22.


T11-0134 AMT Revenue per AMT Taxpayer

Authors: Len Burman and Jeffrey Rohaly
Last Updated: June 22, 2011

Further Reading


Alternative Minimum Tax: Who pays the AMT?

Although most Alternative Minimum Tax (AMT) payers are moderately well off, the tax is steadily encroaching on families that most would consider to be solidly middle and upper-middle class. In 2012—and barring congressional action—45 percent of all tax filers with cash income between $75,000 and $100,000 will pay the AMT, up from 0.4 percent in 2011, when the temporary AMT fix or "patch" is in place. The AMT is also more likely to strike taxpayers with large families, who are married, or who live in high-tax states.

<table>
<thead>
<tr>
<th>Cash income (thousands of 2011 dollars)</th>
<th>Current law</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011</td>
</tr>
<tr>
<td>Less than 30</td>
<td>*</td>
</tr>
<tr>
<td>30 - 50</td>
<td>*</td>
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<tr>
<td>50 - 75</td>
<td>.01</td>
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<tr>
<td>75 - 100</td>
<td>.04</td>
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<tr>
<td>100 - 200</td>
<td>3.5</td>
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<td>200 - 500</td>
<td>51.7</td>
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<tr>
<td>500 - 1,000</td>
<td>66.8</td>
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<tr>
<td>1,000 and more</td>
<td>41.6</td>
</tr>
<tr>
<td>All Filers</td>
<td>2.6</td>
</tr>
</tbody>
</table>

* Less than 0.05
Notes:
(a) Includes returns with AMT liability on Form 8251, with lost credits and reduced deductions. Tax units who are dependents of other tax units are excluded from the analysis.
Taxpayers effectively pay the higher of their tax calculated under regular income tax rules and their tax calculated under AMT rules. Since the 35 percent top rate under the regular income tax is higher than the 28 percent top statutory rate under the AMT, households with very high incomes who do not shelter a substantial portion of their income typically end up in the regular tax system. Households with lower but still moderately high incomes face lower regular tax rates and are thus more likely to owe AMT.

In 2011, 42 percent of tax filers with cash income greater than $1 million will be affected by the AMT, compared with nearly 52 percent of those with cash income between $200,000 and $500,000. In 2012, the difference will increase if there is no AMT patch: only 51 percent of millionaires will pay the AMT, compared with 94 percent of those with income between $200,000 and $500,000.

Legislation enacted by the Congress since 2000 temporarily increased the AMT exemption and allowed certain non-refundable credits to be used regardless of AMT liability. Those temporary features, referred to as the “patch,” are currently scheduled to expire at the end of 2011. Barring Congressional action, AMT revenue will soar rapidly, particularly among upper-middle class families, who were helped the most by the temporarily higher exemption amount. In 2011, 0.4 percent of tax filers making between $75,000 and $100,000 (cash income) will pay the AMT; in

<table>
<thead>
<tr>
<th>Group</th>
<th>Current law</th>
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<tbody>
<tr>
<td></td>
<td>2011</td>
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<td>Tax Filers by Number of children</td>
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<td>1</td>
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<tr>
<td>2</td>
<td>5.5</td>
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<tr>
<td>3 or more</td>
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<tr>
<td>Tax Filers by State tax level</td>
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<tr>
<td>High</td>
<td>4.9</td>
</tr>
<tr>
<td>Middle</td>
<td>2.9</td>
</tr>
<tr>
<td>Low</td>
<td>2.0</td>
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<tr>
<td>Tax Filers by Filing Status</td>
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<tr>
<td>Single</td>
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<td>Married filing jointly</td>
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<td>Head of household</td>
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<tr>
<td>Married filing separate</td>
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<tr>
<td>Married couple, 2+ children, $75,000 &lt; cash income &lt; $100,000</td>
<td></td>
</tr>
<tr>
<td>*</td>
<td>63.3</td>
</tr>
<tr>
<td>Married couple, 2+ children, $75,000 &lt; AGI &lt; $100,000</td>
<td>0.2</td>
</tr>
</tbody>
</table>

* less than .05 percent
Notes:
(a) Includes returns with AMT liability on Form 6251, with lost credits and reduced deductions. Tax units that are dependents or other tax units are excluded from the analysis.
2012, 45 percent will. For those making between $100,000 and $200,000 (cash income), the percent of filers affected by the AMT will rise from 4 percent in 2011 to 81 percent in 2012. In contrast, not extending the patch would affect highest-income tax units less—42 percent of them would pay AMT in 2011 and 51 percent in 2012.

- The regular income tax allows a personal exemption for each family member but the AMT does not. In 2011, taxpayers with three or more children are three and a half times more likely to owe AMT than those with no children. Under current law, 44 percent of filers with three or more children will find themselves on the AMT in 2012, compared to only 17 percent for those without children.

- State and local taxes are deductible under the regular income tax but not the AMT. Thus in 2011, tax filers in high-tax states are much more likely to be on the AMT than those in low-tax states—5 percent of those in high-tax states will face the AMT compared with only 2 percent in low-tax states.

- The projected rapid growth of the AMT in coming years will sharply reduce the state-by-state differential in AMT exposure. With a patch in place in 2011, residents of high-tax states will be two and a half times more likely to fall prey to the AMT than those in low-tax states. With patch in 2012, they’ll only be a third more likely to pay AMT—27 percent vs. 20 percent.

- Most married couples receive a "marriage bonus," paying less regular income tax than they would if they were single. This is not true for the AMT.

  - AMT tax brackets are identical for married and single taxpayers and the permanent AMT exemption is just one-third larger for couples than for singles. (The 2011 exemption for couples is about one and a half times that for singles.) In contrast, the standard deduction for couples under the regular income tax is twice that for singles and tax brackets for married couples are twice as wide as those for singles.

- AMT marriage penalties, combined with the fact that married couples often have children and tend to have higher household incomes than single individuals, result in married couples being nearly 6 times as likely to owe AMT as singles in 2011. In 2012, with expiration of the temporary AMT patch, married couples will be 12 times as likely to owe AMT as singles.

- Taxpayer characteristics can combine to create very high probabilities of being subject to the AMT. In 2011, the AMT affects less than 0.2 percent of married couples with two or more children and adjusted gross income between $75,000 and $100,000. Under current law, without an AMT patch, that share will rise to nearly 90 percent in 2012.

For the latest on the AMT, see www.taxpolicycenter.org/taxtopics/AMT.cfm.
See Also

AMT: What is the AMT?
AMT: How much revenue does the AMT raise?
AMT: What is the effect of the 2001-2010 Tax Cuts on the AMT?
AMT: What is the effect of the AMT on the 2001-2010 Tax Cuts?
AMT: Should the AMT replace the regular income tax?

Data Sources


Authors: Greg Leiserson and Jeffrey Rohaly
Last Updated: June 22, 2011

Further Reading


Alternative Minimum Tax: How much revenue does the AMT raise?

In 1970, the original minimum tax collected only $122 million (about $671 million in 2009 dollars), representing just over one-tenth of one percent of all individual income tax revenue. Barring legislative action, in 2010 the current alternative minimum tax (AMT) will generate $102 billion or 10.4 percent of all individual income tax revenue. If the 2001-06 tax cuts are made permanent without a corresponding AMT fix, by 2019, the AMT will generate 13.1 percent of individual income tax revenue or $271 billion.

<table>
<thead>
<tr>
<th>Year</th>
<th>Current law</th>
<th>Extend 2011 Law</th>
<th>Extend 2011 Law without AMT Fix</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ Billions</td>
<td>$ Billions</td>
<td>$ Billions</td>
</tr>
<tr>
<td></td>
<td>Percent</td>
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<tr>
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</table>


Underlying Data: [Download](#)
The original minimum tax was an "add-on" tax that was paid in addition to regular individual income tax. It applied to certain income items—referred to as "preferences"—that were taxed relatively lightly or not at all under the regular income tax. The largest preference item was the portion of capital gains excluded from the regular income tax. The add-on tax grew rapidly from $122 million (0.14 percent of aggregate individual income tax revenue) in 1970 to $1.5 billion (0.84 percent) in 1978.

Congress enacted the modern AMT in 1979 to operate alongside the add-on minimum tax. The main preference items, including capital gains, moved from the add-on tax to the AMT, causing revenue from the add-on tax to drop sharply to $300 million in 1979. Congress repealed the add-on tax, effective in 1983.

AMT revenue climbed rapidly from $870 million (about 0.4 percent of aggregate income tax revenue) in 1979 to $6.7 billion (2 percent) in 1986.

The Tax Reform Act (TRA) of 1986 made major changes to both the regular income tax and the AMT. The act eliminated much sheltering activity and thus eliminated a large part of the AMT tax base; if the regular income tax did not shelter income, that income did not fall prey to the AMT. In particular, TRA eliminated the partial exclusion of capital gains, which had accounted for 85 percent of AMT preferences in 1985. Consequently, AMT revenue dropped to $1.7 billion in 1987, back to the same 0.4 percent share of aggregate individual income tax revenue that obtained in 1979.

AMT revenue steadily increased after 1987, primarily because, unlike the regular income tax, the AMT is not indexed for inflation. Over time, inflation causes AMT liability to rise relative...
to regular income tax liability. Since taxpayers effectively pay the larger of the two taxes, inflationary effects push more people onto the AMT over time.

• The 2001-06 tax cuts temporarily increased the AMT exemption and allowed certain non-refundable credits to be used regardless of AMT liability. Congress has successively extended those temporary features, referred to as the "patch," through 2011. Barring further Congressional action, AMT revenue and the number of tax-payers affected by the AMT will soar after that.

• In 2011, the last year with the patch in place, the AMT will raise an estimated $39 billion. Barring legislative action, that value will more than triple in 2012 to $132 billion, 11 percent of individual income tax revenue.

• The scheduled sunset after 2012 of all the temporary provisions enacted between 2001 and 2010 will cause AMT revenue to drop off sharply in 2013 to $56 billion or 4 percent of individual income tax revenues. Alternatively, if Congress makes the 2001-2010 tax cuts and other temporary provisions permanent without reforming the AMT, AMT revenue will continue to climb to nearly $400 billion in 2022, one-sixth of individual income tax revenue.

For the latest on the AMT, see www.taxpolicycenter.org/taxtopics/AMT.cfm.

See Also
AMT: What is the AMT?
AMT: Who pays the AMT?
AMT: What is the effect of the 2001-2010 Tax Cuts on the AMT?
AMT: What is the effect of the AMT on the 2001-2010 Tax Cuts?
AMT: Should the AMT replace the regular income tax?

Further Reading

Data Sources

Authors: Greg Leiserson and Jeffrey Rohaly
Last Updated: June 22, 2011
Alternative Minimum Tax: What is the effect of the 2001-06 tax cuts on the AMT?

The Administration’s extension in 2010 of the various tax cuts and stimulus measures enacted between 2001 and 2010 reduced regular income tax liability for the years 2011-12 but lowered alternative minimum tax (AMT) liability only for 2011. Since taxpayers must pay the higher of the two, the reduction in regular tax liability without a corresponding reduction in AMT liability in 2012 will lead to a dramatic increase in the number of taxpayers affected by the AMT. In 2012, assuming no change in current law, an estimated 31 million taxpayers will be subject to the AMT, two-thirds more than the estimated 19 million who would have been affected had Congress not enacted the tax cuts.

Because taxpayers must pay the higher of their regular individual income tax or the AMT, the AMT acts as a floor on their individual income tax liability. The AMT thus affects more and more taxpayers as regular tax liability falls—assuming AMT liability doesn’t change.

The tax cuts and stimulus measures enacted between 2001 and 2010 reduced regular income tax liabilities through 2012 but changed the AMT only through 2011. A temporary patch enacted in 2010 extended AMT relief for two years—2010 and 2011—boosting the 2011 AMT exemption from $45,000 to $74,450 for married couples and from $33,750 to $48,450 for singles. Temporary legislation also allowed the use of certain nonrefundable credits, such as the education credits and the child and dependent care credit, against both the regular tax and the AMT. Both the increase in the exemption and the allowance of these credits expire at the end of 2011, but Congress may renew both provisions as it has done repeatedly in recent years.
Absent further AMT relief, the number of AMT taxpayers will explode in 2012 relative to what it would have been without all the tax legislation of the past decade. The AMT will affect 31 million taxpayers in 2012—more than a third of all taxpayers. If Congress extends the patch again, the higher AMT exemption and the credit provision would reduce the number of taxpayers subject to the AMT by 85 percent to fewer than 5 million.

The tax cuts also raised the amount of revenue the AMT will collect. In 2012, again assuming no reform, the AMT will generate an estimated $132 billion, or 11 percent of all individual income tax revenue. Under pre-2001 law, the AMT would have collected less than $70 billion, under 5 percent of all individual income tax revenue.

If Congress makes the tax cuts permanent and doesn’t change the AMT, 67 million taxpayers will be on the AMT by 2022, compared with 55 million if Congress lets the cuts expire.

Even if Congress allows all the temporary provisions to expire as scheduled, the number of taxpayers subject to the AMT will continue to grow, primarily because the AMT is not indexed for inflation while the regular income tax is. If a household’s income just keeps pace with inflation each year, its regular income tax remains constant (in real terms) but its AMT liability rises. Thus inflation pushes more and more households onto the AMT over time.

For the latest on the AMT, see www.taxpolicycenter.org/taxtopics/AMT.cfm.
See Also

AMT: What is the AMT?
AMT: Who pays the AMT?
AMT: How much revenue does the AMT raise?
AMT: What is the effect of the AMT on the 2001-2010 Tax Cuts?
AMT: Should the AMT replace the regular income tax?

Data Sources


Further Reading


_________, "What is Responsible for the Growth of the AMT?" (Washington: Urban Institute, March 13, 2007).
Alternative Minimum Tax: What is the effect of the AMT on the 2001-06 tax cuts?

The tax cuts and stimulus measures enacted between 2001 and 2010 did not permanently reform the alternative minimum tax (AMT). As a result, unless Congress extends the temporary AMT fixes that accompanied those cuts, the AMT will claw back much of the individual income tax reduction that taxpayers would have received in a world without the AMT. In fact, 3 percent of all taxpayers will receive no benefit from the tax cuts in 2012 because of the AMT and millions more will find their tax cuts reduced. The clawback also makes the budget impact of the large promised cuts in the regular income tax appear smaller than it otherwise would be, because many people will not actually receive them.

<table>
<thead>
<tr>
<th>Income (thousands of 2011 dollars)</th>
<th>Tax Units</th>
<th>Percent of Tax Units With No Cut Due to AMT</th>
<th>Percent of Tax Cut Taken Back By AMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 30</td>
<td>72,816</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>30-50</td>
<td>31,335</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>50-75</td>
<td>20,187</td>
<td>1.5</td>
<td>3.4</td>
</tr>
<tr>
<td>75-100</td>
<td>13,383</td>
<td>5.1</td>
<td>14.8</td>
</tr>
<tr>
<td>100-200</td>
<td>18,707</td>
<td>13.7</td>
<td>52.4</td>
</tr>
<tr>
<td>200-500</td>
<td>5,808</td>
<td>24.4</td>
<td>73.6</td>
</tr>
<tr>
<td>500-1,000</td>
<td>1,003</td>
<td>4.7</td>
<td>29.5</td>
</tr>
<tr>
<td>More than 1,000</td>
<td>503</td>
<td>1.9</td>
<td>5.2</td>
</tr>
<tr>
<td>All taxpayers</td>
<td>165,201</td>
<td>3.1</td>
<td>27.4</td>
</tr>
</tbody>
</table>


* Less than 0.05 percent.

1 Data are for calendar year 2012. The effect of the AMT on the 2001-2010 individual income tax cuts is determined by comparing a) the reduction in individual income tax liability between pre-ESTRRA law and 2011 tax law, both with no AMT and b) the reduction in tax liability between the two laws with the AMT in effect for both.

2 Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

3 For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

4 Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

5 Percentage reduction in the aggregate tax cut for the income group as a result of the AMT.

- Taxpayers who are potentially subject to the AMT must calculate their tax liability twice: once under the rules of the regular tax system and once under the rules of the AMT. They must then pay whichever amount is higher. Thus the AMT acts as a floor on individual income tax liability: a taxpayer cannot pay less than the amount calculated under the AMT.
As an example, suppose that prior to all the tax cuts, a household’s tax calculated under the regular income tax rules was $5,000 and its tax calculated under the AMT was $4,000. That household would have paid the regular tax liability of $5,000, the larger of the two. Now suppose the tax cuts reduce the household’s liability under the regular income tax rules to $3,000. Under those rules, the household would thus receive a $2,000 tax cut. But assuming no accompanying change in the AMT rules, the household would actually owe $4,000, the now larger AMT liability. Thus the AMT would take away half of household’s expected $2,000 tax cut.

Taxpayers who were already paying the AMT under pre-2001 tax cut get no benefit at all from the 2001-2010 cuts in the regular income tax. Because their AMT liability is unchanged and thus remains the higher of the two, they continue to pay the AMT regardless of the change in regular tax liability. In 2012, over 3 percent of all tax units will face that situation and receive no tax cut because of the AMT.

In 2012, the AMT will cause taxpayers to lose, on average, more than a quarter of their 2001-10 tax cuts. Taxpayers in the income ranges most affected by the AMT will lose substantially more: those with cash incomes between $100,000 and $200,000 will lose more than half of their tax cuts and those in the $200,000-$500,000 range will lose nearly three-fourths of their tax cuts.

Because the top regular income tax rate of 35 percent is higher than the top statutory AMT rate of 28 percent, the AMT affects relatively few of the highest-income taxpayers. As a result, the AMT claws back a smaller fraction of the tax cuts for those at the very top. Thus in 2012, taxpayers with at least $1 million of cash income will lose only 5 percent of the tax cuts they would have received without the AMT.

About 25 percent of taxpayers in the $200,000-$500,000 cash income range will receive no tax cut because of the AMT, compared with only 2 percent of those making $1 million or more.

If the 2001-10 tax legislation had provided rate cuts in the AMT similar to those in the regular income tax, it would have raised the revenue cost over the 2001-10 period by more than $240 billion, or about 9 percent of the cost of the tax cuts and stimulus provisions as enacted in this period.

For the latest on the AMT, see www.taxpolicycenter.org/taxtopics/AMT.cfm.
See Also

AMT: What is the AMT?
AMT: Who pays the AMT?
AMT: How much revenue does the AMT raise?
AMT: What is the effect of the 2001-2010 Tax Cuts on the AMT?
AMT: Should the AMT replace the regular income tax?

Data Sources


Further Reading


Alternative Minimum Tax: What has been the effect of annual "patches?"

Since 2001, Congress has repeatedly increased the individual alternative minimum tax (AMT) exemption level on a temporary basis to prevent too many taxpayers from being subject to the tax. The temporary legislation also allows taxpayers subject to the AMT to use personal nonrefundable tax credits, including credits for child care and higher education, which the AMT normally disallows. Absent these stopgap measures, sometimes called "the patch," the AMT exemption would be set at levels established in 1993, and almost a third of all taxpayers would be affected by the AMT.

The most recent patch expires at the end of 2011 and applies to taxes due on income earned in that year. Unless Congress extends the higher exemption, about 31 million taxpayers will owe AMT in 2012.

The main attraction of the patch is that it appears to reduce tax revenue by far less than a permanent fix, but that occurs only because it affects budgetary costs for only a year or two in the customary ten-year budget window. For example, a one-year patch enacted for 2012 would reduce federal tax revenue by about $85 billion, compared with a $1.1 trillion price tag for permanently indexing the AMT exemption for inflation, and a $1.4 trillion cost of full repeal over the 2012-2022 period.
The patch creates unnecessary uncertainty for taxpayers. For one thing, it makes it difficult to plan estimated tax payments. Had Congress not enacted the most recent patch, for example, married taxpayers with cash income between $200,000 and $500,000 might have owed as much as $5,800 in additional taxes, along with possible penalties for underpayment of estimated taxes. Uncertainty surrounding the patch also makes it unclear whether some taxpayers will benefit from nonrefundable tax credits, such as the hybrid vehicles tax credit.

Enacting the patch late in the year, as happened in 2007 and 2010, creates processing problems for the Internal Revenue Service (IRS). After Congress enacted the AMT patch on December 19, 2007, the IRS had to reprogram its five forms affecting AMT returns. That required taxpayers potentially affected by the AMT patch to delay filing their returns till February 11, 2008. In 2010, the IRS followed a request from the chairs and ranking members of the Senate Finance Committee and the House Committee on Ways and Means and programmed higher AMT exemptions into its system prior to passage of actual legislation in mid-December. While that prevented any delays in processing returns, taxpayers might have experienced delayed tax refunds if Congress had not patched the AMT as expected.

Extending the higher exemption year by year masks the long-term budget problems, because conventional scoring rules assume that the patch will be allowed to expire as scheduled. It also makes income tax rate cuts appear much less expensive than they actually turn out to be, because, without the patch, the AMT would take back all or part of the rate cuts enacted in 2001 for many taxpayers.

For the latest on the AMT, see [www.taxpolicycenter.org/taxtopics/AMT.cfm](http://www.taxpolicycenter.org/taxtopics/AMT.cfm)
See Also

Alternative Minimum Tax: What is the AMT?

Alternative Minimum Tax: Who pays the AMT?

Alternative Minimum Tax: How much revenue does the AMT raise?

Alternative Minimum Tax: What is the effect of the AMT on the 2001-10 tax cuts?

Alternative Minimum Tax: What is the effect of the 2001-10 tax cuts on the AMT?

Alternative Minimum Tax: Should it replace the regular income tax?

Data Sources


T11-0147 Extend and Index Parameters for Inflation, Impact on Tax Liability, Revenue and AMT Taxpayers, 2012-22

T11-0138 Effect of the AMT on 2001-10 Individual Income Tax Cuts, 2012

Author: Len Burman and Jeffrey Rohaly
Last Updated: June 22, 2011

Further Reading


Alternative Minimum Tax: Should it replace the regular income tax?

Some commentators, with varying degrees of seriousness, have suggested that Congress repeal the regular individual income tax and instead make the alternative minimum tax (AMT) the only federal income tax on individuals. Proponents claim that the AMT applies a lower, nearly flat rate to a broader base and therefore would raise revenue more efficiently than the regular income tax. However, that characterization of the AMT applies only to the highest-income taxpayers, the original target of the tax. Most taxpayers affected by the AMT today pay a higher marginal rate on a narrower income base than they would if they were subject to only the regular income tax. In addition, the AMT imposes large marriage penalties and causes "bracket creep," since it is not indexed for inflation.

- The AMT has only two statutory rates: 26 percent on the first $175,000 of alternative minimum taxable income (AMTI), and 28 percent on AMTI above that level. But the AMT actually imposes four marginal tax rates, not two, because the AMT exemption phases out as income rises. The exemption phases out at a rate of 25 cents for each extra dollar of AMTI above an income threshold ($150,000 of AMTI for married couples and $112,500 for singles). The phase-out thus eliminates the exemption entirely for couples with AMTI above $330,000 ($247,500 for singles). As a result, taxpayers in the phase-out range actually face higher effective tax rates of 32.5 or 35 percent, the latter equal to the top rate under the regular income tax (see figure 1).

- Significantly more AMT taxpayers-79 percent in 2009-face higher effective marginal tax rates under the AMT than they would under the regular income tax. That figure will rise to 90 percent by 2010 as the AMT ensnares more and more middle-income filers who would have faced statutory rates of 15 or 25 percent under the regular income tax (see figure 2).
In addition, the relatively high AMT exemption means that the amount of income subject to tax under the AMT is often less than it is under the regular income tax. In 2009, 58 percent of AMT taxpayers had more income subject to tax under the regular tax than they did under the AMT. That number will rise to 89 percent by 2010. Thus the conventional wisdom that the AMT applies a lower marginal tax rate to a broader income base is incorrect. In fact, exactly the opposite is true. Most AMT taxpayers face a higher marginal rate applied to a narrower tax base than they would if they were in the regular income tax system.

The AMT creates enormous marriage penalties. In 2006, if the AMT had been the only tax system, a married couple with two children in which each spouse earns $50,000 would have paid $5,837 more in tax than if they were single and one spouse claimed custody of the children. The marriage penalty grows even larger at higher incomes, reaching a maximum of over $15,000 for couples with incomes of about $450,000 (although marriage penalties under current law are nearly as large at such high income levels).
The AMT incurs significant "bracket creep:" the lack of indexing for inflation means that the tax rises in real terms as prices rise, unlike the regular income tax, which is indexed. Inflation pushes more income above the unindexed exemption threshold and, for high-income taxpayers, subjects more income to the exemption phase-out and the 28 percent AMT rate.

For the latest on the AMT, see http://www.taxpolicycenter.org/taxtopics/AMT.cfm
See Also

AMT: What is the AMT?

AMT: Who pays the AMT?

AMT: How much revenue does the AMT raise?

AMT: What is the effect of the 2001-2006 Tax Cuts on the AMT?

AMT: What is the effect of the AMT on the 2001-2006 Tax Cuts?

Data Sources

TPC Table T09-0191. Income Subject to Tax and Effective Marginal Tax Rates in the Regular Income Tax and the AMT Among AMT Taxpayers, Current Law.

Authors: Greg Leiserson and Jeffrey Rohaly
Last Updated: April 2, 2009

Further Reading


Kinsley, Michael, "A Viable Alternative: Defending the tax the GOP wants to kill" (Slate, 2007)


HEALTH INSURANCE AND HEALTH CARE

How much does the federal government spend? ................................................................. II-5-1
Who has health insurance coverage? .................................................................................. II-5-2
What tax provisions subsidize the cost of health care? ..................................................... II-5-4
How does the tax exclusion for employer-sponsored health insurance work? .................. II-5-6
How does the employer-sponsored insurance exclusion affect coverage? ....................... II-5-8
Health Care: How much does the federal government spend?

The administration estimates that the federal government will spend over $600 billion on health care in fiscal 2008 (see table). Of that, Medicare will claim roughly $390 billion, Medicaid and the State Children’s Health Insurance Program (SCHIP) about $210 billion, and veterans’ medical care about $34 billion. In addition to these direct outlays, various tax provisions for health create tax expenditures that total roughly $175 billion; about 85 percent of that figure comes from the exclusion from taxable income of employers’ payments for their workers’ health insurance premiums.

![Estimated Federal Spending and Tax Expenditures for Health Care, Fiscal 2008](image)

**Spending**
- Medicare: 391,266
- Medicaid and SCHIP: 211,353
- Veterans’ medical care: 33,979

**Tax expenditures**
- Exclusion of employer contributions for medical insurance premiums and medical care: 151,810
- Deductibility of medical expenses by individuals: 5,060
- Deductibility of charitable contributions to health organizations: 4,890
- Self-employed medical insurance premiums: 4,680
- Exclusion of interest on hospital construction bonds: 2,950
- Medical Savings Accounts and Health Savings Accounts: 1,140
- Special Blue Cross and Blue Shield deduction: 640
- Tax credit for orphan drug research: 290
- Distributions from retirement plans for premiums for health and long-term care insurance: 240
- Tax credit for health insurance purchased by certain displaced and retired individuals: 10

**Sources:**

See Also

Health Care: What tax provisions subsidize the cost?

Health Care: How does the tax exclusion for employer-sponsored health insurance work?

Author: Roberton Williams
Last Updated: April 9, 2008

Data Sources

Office of Management and Budget, Budget of the United States Government Fiscal Year 2009.

Health Care: Who has health insurance coverage?

More than 60 percent of the nonelderly population in 2006 obtained health insurance coverage through their employer (see left-hand column in figure). About 5 percent purchased coverage on their own in the private insurance market, and about 14 percent were covered by Medicaid. Nearly one-fifth were uninsured. Virtually all elderly individuals participate in Medicare, and those with low income also receive assistance through Medicaid.

- The likelihood that a given individual will be covered by health insurance rises sharply with his or her income (see figure). Only one-fifth of the nonelderly in households with income below the poverty level had private coverage in 2006, and nearly 40 percent reported having no health insurance. In contrast, two-thirds of those in households with income between two and three times the poverty line had private coverage, and 20 percent had no insurance. Over 90 percent of the nonelderly in households with income above four times the poverty level had private coverage, and just 5 percent said they lacked health insurance.
See Also

Health Care: What tax provisions subsidize the cost of health care?

Health Care: How does the tax exclusion for employer-sponsored health insurance work?

Author: Roberton Williams
Last Updated: April 11, 2008

Data Sources

Health Care: What tax provisions subsidize the cost of health care?

Consumers of health care face reduced after-tax costs because a number of tax provisions subsidize either the purchase of health insurance or out-of-pocket medical expenses. Among the provisions generating the largest subsidies are (in descending order of size) the combined employer exclusion and employee deduction for employee health insurance premiums, the exclusion for Medicare and Medicaid coverage and benefits, the individual deduction for health insurance and expenses, the deduction for Health Savings Accounts, the deduction of insurance premiums for the self-employed, the deduction of premiums and benefits for the military, and the deduction for Flexible Spending Accounts.

- Employer contributions to pay premiums for employee health insurance are not subject to income or payroll tax. In addition, employee contributions are often deducted from income before tax is withheld, so that employees pay no tax on the income they use to pay premiums for employer-sponsored health insurance. Estimated revenue cost in 2008: $116.5 billion (all estimates from the congressional Joint Committee on Taxation).

- Health insurance coverage under Medicare or Medicaid is excluded from taxable income. Benefits paid from either program are similarly exempt from taxation. Estimated revenue cost in fiscal 2008: $42.8 billion.

- Individuals may claim as an itemized deduction the portion of their health insurance premiums and other medical expenses that exceeds 7.5 percent of their adjusted gross income. Estimated revenue cost in fiscal 2008: $9.5 billion.

- Individuals under 65 who are covered by a high-deductible health insurance plan, whether through their employer or through the nongroup market, may contribute to a Health Savings Account. The 2008 contribution limits are $2,900 for individuals with self-only coverage and $5,800 for individuals with family coverage. Individuals age 55 and older may make additional contributions of up to $900. Individual contributions are deductible from taxable income. Employer contributions (up to the limit minus any employee contribution) are not subject to income or payroll tax. Withdrawals from Health Savings Accounts for medical expenses are not subject to income tax. Estimated revenue cost in fiscal 2008: $8.1 billion.

- Self-employed individuals may deduct from their income the entire cost of health insurance for themselves, their spouses, and their dependents (subject to certain conditions). Estimated revenue cost in fiscal 2008: $4.4 billion.

- Health insurance coverage and benefits for current and retired members of the military and their dependents are excluded from taxable income. Estimated revenue cost in fiscal 2008: $3.3 billion.

- Individuals whose employers offer Flexible Spending Accounts may set aside funds from their pay each year to cover health insurance premiums and most medical expenses. Employers set maximum funding levels with no legislated limit. Contributions are not subject to income or payroll taxes. Participants must set the level of their contributions before the beginning of the benefit year and forfeit any funds not used to pay for qualified medical expenses during the year. Estimated revenue cost in fiscal 2008: not available.
See Also

Health Care: How does the tax exclusion for employer-sponsored insurance work?

Data Sources


Authors: Austin Nichols and Carol Rosenberg
Last Updated: March 13, 2008

Further Reading


_________, "Testimony on the Tax Treatment of Employment-Based Health Insurance" (Washington: April 26, 1994).

Health Care: How does the tax exclusion for employer-sponsored health insurance work?

Employers’ payments covering premiums for employer-sponsored health insurance are exempt from federal income and payroll taxes. Any portion of premiums paid by the employee is typically excluded from taxable income and is therefore also tax-free, although some employers require employees to pay their share of premiums out of after-tax income. The exclusion of premiums lowers most workers’ tax bills and thus reduces their after-tax cost of health insurance coverage. This effective tax subsidy is a major reason why most Americans have health insurance coverage through either their own employer or that of a family member. Other factors also play a role, however, including the lower costs of group coverage and reduced administrative expenses.

- Some employers provide only access to group insurance and do not help pay premiums. Even in such cases, however, the premiums that workers pay are typically exempt from income tax.

- Because the exclusion of premiums for employer-sponsored insurance reduces taxable income, it is worth more to taxpayers in higher income tax brackets than to those in lower brackets. Consider a worker in the 15 percent bracket who also (in effect) pays a combined (employer and employee) payroll tax of 15.3 percent. If his insurance premium is $1,000, his taxes fall by $303, that is, 30.3 percent (15 percent + 15.3 percent) of $1,000. His after-tax cost of health insurance is thus $1,000 less $303, or $697. In contrast, a worker in the 25 percent bracket faces a total tax rate of 40.3 percent (25 percent + 15.3 percent). For her, the after-tax cost of a $1,000 premium is just $597 ($1,000 minus 40.3 percent of $1,000). Savings on state and local taxes could further lower the cost for both workers.

- For low-income workers who face a negative tax rate because of the earned income tax credit (EITC), the exclusion actually raises the after-tax cost of health insurance. For example, a worker with two children and earnings of $12,000 faces a net tax rate of -24.7 percent (her negative 40 percent rate due to the EITC plus the 15.3 percent payroll tax rate). If the worker excludes $1,000 paid to cover her health insurance premium, her after-tax income (before paying for health insurance) falls by $247, because she loses $400 of EITC, which is only partially offset by her savings of $153 in payroll taxes. In effect, her cost for health insurance is $1,247.

- Replacing the tax deduction for health insurance with a tax credit would equalize the tax benefits across taxpayers in different tax brackets, as well as between those who get insurance through their employers and those who obtain coverage from other sources. Making the credit refundable would extend that benefit to those whose tax liability falls below the value of the credit.
See Also

Health Care: What tax provisions subsidize the cost of health care?

Health Care: How does the employer-sponsored insurance exclusion affect health insurance coverage?

Authors: Austin Nichols and Carol Rosenberg
Last Updated: March 13, 2008

Further Reading

Health Care: How does the employer-sponsored insurance exclusion affect coverage?

The exclusion of employer-sponsored insurance (ESI) from taxable income tends to increase coverage rates because it lowers the cost of insurance for most people, spurring demand. Its effects are uneven, however, and alternative policies that focus subsidies more broadly and on those less likely to get insurance on their own could have greater impact at the same cost. Because the cost reduction increases with the individual’s marginal tax rate, the ESI exclusion gives smaller benefits to lower-income workers than to those with higher incomes, who are already more likely to obtain insurance coverage. In contrast, a refundable tax credit available to everyone would provide the same subsidy for all insured workers as well as nonworkers, and thus would not exacerbate already unequal coverage rates. Shifting to such a policy could increase coverage without raising costs.

- About 83 percent of all workers are offered health insurance by their employers, and roughly two-thirds of those workers accept the offer (see table).

![Table showing Health Insurance Coverage by Marginal Effective Income Tax Rate, 2007](image)

- Workers facing the lowest marginal tax rates are much less likely to be offered insurance coverage than those facing higher rates. Only about 70 percent of workers with marginal tax
Take-up rates for single workers first rise and then fall as the marginal tax rate rises. About one-fifth of all single workers with the lowest tax rates receive and accept an offer of ESI, rising to about five-sixths of those with tax rates around 28 percent. But only about two-thirds of those facing the top marginal rate are offered and accept coverage. In contrast, about three-fifths of married and head-of-household workers across all but the two lowest tax categories in the table do so.

Married or head-of-household workers are much more likely than their single counterparts to get health insurance by virtue of being dependents of other workers, although those who face lower tax rates are less than half as likely to do so as those facing higher rates. More than half of married and head-of-household workers who face marginal tax rates above 10 percent and who do not get insurance from their own employers receive coverage as dependents.

Many factors besides cost affect whether people obtain health insurance coverage. Low-income individuals, especially younger ones, may face lower health risk and thus perceive less need for coverage. They may choose to spend their scarce resources on other goods and thus have lower willingness to pay for insurance. They may also find it easier than others to satisfy income and asset eligibility requirements for public coverage in the event of a serious health condition. These factors make it difficult to know whether low-income individuals would elect to purchase health insurance even if they faced the same price as higher-income individuals.

Many proposals to expand health insurance coverage focus on increasing tax incentives to obtain health insurance. Yet a 2004 study examined a range of tax policies designed to increase coverage and found that every one was much less efficient at increasing coverage than expansions of public insurance. The study did find, however, that policies tightly targeted to the lowest income earners were much more efficient at increasing coverage than those that are also available to households higher in the income distribution.
See Also

Health Care: How does the tax exclusion for employer-sponsored health insurance work?

Health Care: What tax provisions subsidize the cost of health care?

Authors: Austin Nichols and Surachai Khi-tatrakun
Last Updated: April 9, 2008

Further Reading


HOME OWNERSHIP

What are the tax benefits? .......................................................... II-6-1
Do existing tax incentives increase homeownership? ..................II-6-4
How could the tax incentives be improved? .............................II-6-6
Home Ownership: What are the tax benefits?

The tax code provides a number of benefits for people who own their homes. Homeowners may deduct both mortgage interest and property tax payments as well as certain other expenses from their federal income tax. They do not have to count the rental value of their homes as taxable income, even though that value is just as much a return on investment as are stock dividends or interest on a savings account. Finally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home. All of these benefits are worth more to taxpayers in higher-income tax brackets than to those in lower brackets.

- Homeowners who itemize deductions may reduce their taxable income by deducting any interest paid on a home mortgage. The congressional Joint Committee on Taxation (JCT) estimates that the deduction saved more than 35 million homeowners an average of over $1,850 in income tax in fiscal 2006. The deduction is limited to interest paid on up to $1 million of debt incurred to purchase or substantially rehabilitate a home. Homeowners may also deduct interest paid on up to $100,000 of home equity debt, regardless of how they use the borrowed funds. Taxpayers who do not own their home have no comparable ability to deduct interest paid on debt incurred to purchase goods and services.

- Homeowners who itemize deductions may also reduce their taxable income by deducting property taxes they pay on their homes. That deduction is effectively a transfer of federal funds to governments that impose a property tax (mostly local but also some state governments), allowing them to raise property tax revenue at a lower cost to their constituents. The JCT estimates that the deduction saved more than 40 million homeowners an average of nearly $600 in income tax in fiscal 2006.

- Buying a home is an investment, part of the returns from which is the opportunity to live in the home rent-free. Unlike returns from other investments, the return on homeownership—what economists call “imputed rent”—may be excluded from taxable income. In contrast, landlords must count as income the rent they receive, and renters may not deduct the rent they pay. A homeowner is effectively both landlord and renter, but the tax code treats homeowners the same as renters while ignoring their simultaneous role as their own landlords. The Office of Management and Budget estimates that the exclusion of imputed rent reduced federal revenue by nearly $29 billion in fiscal 2006.

- Taxpayers who sell assets must generally pay capital gains tax on any profits made on the sale. But homeowners may exclude from taxable income up to $250,000 ($500,000 for joint filers) of capital gains on the sale of their home if they satisfy certain criteria: they must have maintained the home as their principal residence in two out of the preceding five years and generally may not have claimed the capital gains exclusion for the sale of another home during the previous two years. The JCT estimates that the exclusion provision saved homeowners more than $24 billion in income tax in fiscal 2006.

- Buying a home is an investment, part of the returns from which is the opportunity to live in the home rent-free. Unlike the situation for other kinds of investment, homeowners exclude the value of those returns-what economists call "imputed rent"-from taxable income. In contrast, landlords who rent homes must count the rent they receive as income while renters cannot deduct the rent they pay. A homeowner is effectively both landlord and renter. The tax code treats
him the same as a renter in his renter role but does not tax the imputed rent he earns in his landlord role. The Office of Management and Budget estimates that the exclusion of imputed rent over and above housing expenses like interest reduced federal revenues by nearly $29 billion in fiscal year 2006.

- The deductions and exclusions available to homeowners are worth more to taxpayers in higher tax brackets than to those in lower brackets. For example, deducting $2,000 for property taxes paid saves a taxpayer in the 35 percent bracket $700 but saves a taxpayer in the 15 percent bracket only $300. In combination, the mortgage interest and property tax deductions reduced taxes for homeowners with income above $200,000 by an average of about $6,500 in fiscal 2006; in contrast, homeowners with income between $50,000 and $75,000 saved an average of about $1,300 (see figure). That difference results from three factors: compared with lower-income homeowners, those with higher incomes face higher marginal tax rates, typically pay more mortgage interest and property tax, and are more likely to itemize deductions on their tax returns.

![Average Tax Expenditure for Mortgage Interest and Real Estate Deductions, by Income Category, Fiscal 2006](http://www.house.gov/jct/s-3-07.pdf)
See Also

Homeownership: Do existing tax incentives increase homeownership?

Homeownership: How could the tax incentives be improved?

Data Sources

Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011, JCS-3-07, (September 24, 2007).

Office of Management and Budget, Fiscal Year 2008 Budget, Analytical Perspectives, Table 19.1, p. 288.

Further Reading


Author: Roberton Williams
Last updated: December 31, 2007
Homeownership: Do existing tax incentives increase homeownership?

The federal government spends more than $150 billion each year to subsidize homeownership yet the U.S. rate of homeownership differs little from that in countries that provide no similar subsidies. The bulk of the subsidies go to middle- and upper-income households who would likely own their homes anyway; thus these subsidies simply facilitate the consumption of more housing. In addition, evidence suggests that the tax subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.

- The U.S. homeownership rate is roughly the same as that in many other developed countries like the United Kingdom or Australia, that have no such subsidies, and lower than in some (see figure). Other factors, such as the ease of obtaining a mortgage, home prices, and cultural patterns play significant roles in determining homeownership rates.

- Because tax deductions are worth more to high-income households, who face the highest tax rates, the deductibility of property taxes and mortgage interest gives the most assistance to households that would likely own their own home even without a tax subsidy. Low-income
households, who typically are most in need of aid to afford homeownership, get little or no benefit from that deductibility.

- Beyond a base level, subsidies mainly support larger homes and second homes. In effect, the federal government encourages middle- and upper-income households to consume more housing than they otherwise would. Limits on the amount of mortgage debt for which taxpayers may deduct interest costs do, however, constrain those subsidies to some degree.

- Research suggests that housing subsidies raise housing costs, particularly where land is relatively scarce. By reducing the after-tax cost of housing, the subsidies enable people to pay more than they otherwise would. The resulting increase in demand for housing causes prices to rise and prices rise most in markets where supply cannot easily increase to meet that higher demand.

See Also

Homeownership: What are the tax benefits?

Homeownership: How could the tax incentives be improved?

Data Sources


Author: Roberton Williams
Last Updated: December 31, 2007

Further Reading


Homeownership: How could the tax incentives be improved?

Two kinds of changes could improve the tax incentives for homeownership. The first would redirect the tax subsidies from higher-income households to those with lower incomes to focus assistance on those most in need. The second would simply reduce existing incentives.

- Replacing the existing deductions for mortgage interest and property taxes with a tax credit would shift homeowner subsidies down the income distribution to households more in need. For example, replacing those deductions with a credit of up to $1,400 for property taxes paid on a primary residence would shift more than 40 percent of the subsidy from households in the top income quintile to other households, with no change in federal revenue (see table). About half of the benefits thus shifted would go to households in the bottom two-fifths of the income distribution.

- Making the credit refundable would increase the share of benefits going to households with the lowest incomes.

- The deduction for mortgage interest is currently limited to the interest on no more than $1 million of mortgage debt. Lowering that limit to $400,000 would increase federal revenue by $30 billion between 2008 and 2012 and nearly $60 billion more over the subsequent five years. Virtually all of the impact of lowering the limit would fall on households at the top of the income distribution. Congress could use the additional revenue to pay for direct subsidies to facilitate homeownership by lower-income households. The change would disproportionately affect households in high-cost housing markets, where prices for a large share of houses could require purchasers to take out large mortgages.
See Also

Homeownership: What are the tax benefits?

Homeownership: Do existing tax incentives increase homeownership?

Data Sources


Further Reading


Congressional Budget Office, Budget Options, February 2007, revenue option 7, pp. 267-68.

EDUCATION

What tax incentives exist to help families save for college? ..................................................II-7-1
What incentives exist to help families pay for college? ..........................................................II-7-4
Education: What tax incentives exist to help families save for college?

Three tax-favored savings instruments encourage families to save for college: Coverdell savings accounts, qualified tuition programs (commonly referred to as 529 plans), and the education savings bond program. Use of funds from any of these three programs for other than permitted educational expenses subjects those funds to income taxes and penalties. In addition, certain retirement savings vehicles such as Roth Individual Retirement Accounts (IRAs) may be used to pay for higher education without penalty. Because the benefits of each of these programs are proportional to the family’s marginal tax rate, they give greater saving incentives to higher-income than to lower-income families.

Anyone, regardless of income, may contribute to a 529 plan for a named beneficiary. A donor may contribute up to $12,000 annually for each beneficiary without triggering a gift tax and may make up to five years of contributions in a lump sum without triggering a gift tax so long as no additional gifts are given to the beneficiary during the five-year period. Funds in a 529 plan grow untaxed. Since the passage of EGTRRA, funds used to pay for postsecondary education are not taxed when withdrawn. Donors retain ownership of the accounts but may use the funds to pay educational expenses only for the named beneficiary. They may, however, transfer funds to another beneficiary, subject to relationship requirements between the original and the new beneficiary.

- Growth of 529 plans since 1996 has been tremendous. At that time only 500,000 accounts existed, containing $2.4 billion in assets (see figure). As of September 2007 there were 10.2 million 529 plan accounts, containing $127 billion in assets.
Every state except Wyoming sponsors a 529 plan (but Wyoming residents receive preferred treatment in the Colorado 529 plan). In states with a personal income tax, residents investing in their state-sponsored 529 plan often receive a state tax break for at least part of their investment.

In 2007 families with adjusted gross income (AGI) below $110,000 ($220,000 if filing a joint return) may deposit up to $2,000 per beneficiary in a Coverdell account on an after-tax basis. Funds grow untaxed and may be withdrawn tax free if used to pay educational expenses.

The education savings bond program allows users to exclude interest on certain bonds from income tax if the money is used to pay for postsecondary education. In 2007 families could cash in these bonds tax free only if their AGI was less than $80,600 ($128,400 if filing a joint return; income limits are indexed for inflation). This program is substantially smaller than the other two.

All families face the same 10 percent penalty if account funds are used for other than permitted educational expenses, regardless of how much benefit they would receive if they used the money for education. Even with the penalty, high-income families can benefit from 529 plans and Coverdell accounts because the accounts let them shift money to their children, who typically face lower tax rates. That benefit does not extend to low-income families, who already face lower tax rates.

The benefits of 529 plans and Coverdell accounts are also less for low-income families because they can reduce financial aid for which they would otherwise qualify.

Benefits in college savings accounts accumulate over time. To reap the maximum benefit, families must invest well before they know whether a child will attend college. That uncertainty is greatest for low-income families, whose children are least likely to attend college, and this increases their risk of penalties for using the funds for noneducational purposes.

The tax incentives that these programs provide are of greatest benefit to families whose children are most likely to attend college even without a subsidy. As a result, it is unlikely that these programs significantly increase college attendance.
See Also

Retirement Saving: How does tax-favored retirement saving affect national saving?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Data Sources

College Savings Plans Network

Further Reading


Education: What incentives exist to help families pay for college?

Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education: the Hope Credit, the Lifetime Learning Credit, and a deduction for tuition and fees. As a consequence, federal higher education in-school tax subsidies rose from zero before enactment to roughly $6 billion in 2005-06. College savings incentives also exist, not discussed here. Critics complain that the tax benefits have not changed enrollment patterns, but instead have provided subsidies to people who are likely to attend college anyway. Many low-income students who might be most influenced by reduced college costs receive little or no benefit from the credits because they are nonrefundable and thus can only offset income taxes owed. At the other end of the income scale, many high-income families are in or beyond the earnings range where eligibility phases out. As a result, the highest average benefits go to families with annual incomes between $30,000 and $100,000.

- For each student, families may claim only one of the three tax benefits but they need not claim the same benefit for all students. Complexity associated with having to choose which benefit to take results in people frequently choosing sub-optimally (GAO 2005).

- The Hope Credit applies to tuition and fees for students enrolled at least half time in their first two years of college. The credit equals 100 percent of the first $1,100 of eligible expenses plus 50 percent of the next $1,100, yielding an annual maximum credit of $1,650 when qualifying expenses are at least $2,200. Each qualifying student in the household can receive a Hope credit.
• The Lifetime Learning Credit equals 20 percent of tuition and fees for any post-secondary education, up to a maximum annual credit of $2,000. That maximum applies to the combined expenses of all students in the household claiming the credit and is reached when total qualifying expenses reach $10,000.

• The maximum benefit for both tax credits phases out between adjusted gross incomes of $45,000 and $55,000 for single taxpayers, or between $90,000 and $110,000 for married couples.

• The deduction for tuition and fees allows taxpayers (parents or students, whichever pays) to reduce taxable income by up to $4,000. To qualify, a family’s adjusted gross income may not exceed $65,000 for single filers or $130,000 for married filers. Single filers with AGI between $65,000 and $80,000 or married filers with AGI between $130,000 and $160,000 can deduct up to $2,000 of expenses. After that, a family is no longer eligible for the deduction. The tuition and fees deduction is scheduled to expire after 2008.

• Both the Hope Credit and the Lifetime Learning Credit are nonrefundable, so only people who owe income tax can benefit. Similarly, the deduction for tuition and fees is valuable only for people with taxable income.

• These tax programs provide relatively modest benefits: an average of $771 per household. Average benefits are highest for those receiving a Hope Credit ($1,069), followed by the Lifetime Learning Credit ($978), and finally the tuition and fees deduction ($324).

• Using the tax system to subsidize higher education has two primary advantages: Students need not fill out the complicated Free Application for Federal Student Aid form, and every student who qualifies receives a benefit.

• Little evidence exists to show that the programs actually influence behavior. Instead, they are likely subsidies to people who would attend college even without the tax benefits - with the majority of benefits flowing to tax units with income exceeding $50,000. This is in stark contrast to traditional aid programs such as the Pell grant, where benefits flow mostly to low-income families.
Possible options for reform

- Making the credits refundable would provide assistance for poorer families, who cannot benefit from the current credits because their tax bills are too low.

- Broadening the range of covered expenses to include, for example, room and board and books and raising the maximum allowable expenses would provide more assistance.

- Providing benefits directly to schools when students enroll (based on the previous year’s taxes) would help students cover college costs when they actually have to make payments, not months later when their families file tax returns.

- Combining the Hope and LLC into one credit (while allowing the tuition and fees deduction to expire) would avoid confusion over which tax benefit is most beneficial to families who currently qualify for multiple benefits.
See Also

Taxation of the Family: What tax incentives exist to help families save for college?

Data Sources

Education Tax Incentives, TPC Tables T06-0325 to T06-0336

Further Reading


CAPITAL GAINS AND DIVIDENDS

How are they taxed? ...................................................................................................................... II-8-1
What is the effect of a lower tax rate? .......................................................................................... II-8-3
Capital Gains: How are they taxed?

Capital gains are profits from the sale of a capital asset, such as shares of corporate stock, a business, a parcel of land, or a piece of art. Capital gains are generally included in taxable income but are often taxed at a lower rate; under current law, for example, most long-term capital gains face a top rate of 15 percent. Complicated rules impose a range of tax rates on different kinds of gains and can make it difficult for taxpayers to calculate their tax liability.

A capital gain occurs when a capital asset is sold or exchanged at a price higher than its basis (its purchase price plus commissions and the cost of improvements net of depreciation). Similarly, a capital loss occurs when an asset is sold for less than its basis. Gains and losses (like other forms of capital income and expense) are all measured in nominal terms—that is, unadjusted for inflation.

Capital gains and losses are considered long term if the asset was held for over one year, and short term if held for a year or less.

Taxpayers in the 10 and 15 percent tax brackets pay no tax on most long-term gains; under EGTRRA provisions, extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and taxpayers in higher brackets face a 15 percent rate on long-term capital gains. In 2013, when all the temporary provisions expire, those rates will revert to pre-2001 levels: 10 percent for those in the 15 percent tax bracket or lower and 20 percent for all others. Recaptured real estate depreciation (that is, gains up to the amount...
of depreciation deductions previously claimed) is taxed at ordinary income tax rates up to a maximum of 25 percent. Gains on art and collectibles are taxed as ordinary income up to a maximum 28 percent rate. The maximum rates apply under both the ordinary income tax and the alternative minimum tax (AMT). The figure shows how the maximum long-term capital gains tax rate has changed over the years.

- Capital losses may be used to offset capital gains and up to $3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.

- Taxpayers may realize up to $250,000 of gains on their principal residence tax-free. Married taxpayers filing jointly may exclude up to $500,000 from tax.

- The basis for an asset received as a gift equals the donor’s basis. However, the basis of an inherited asset is "stepped up" to the value of the asset on the date of the donor’s death. The step-up provision effectively exempts from income tax any gains on assets held until death. Assets inherited from people who died in 2010 (when the estate tax was repealed) qualified only for a limited step-up of $3 million for gifts made to a spouse plus $1.5 million for gifts made to anyone. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allowed estates of people who died in 2010 to choose between the 2010 law and the 2011 law, under which heirs get full step-up in basis but the estate is potentially taxable. (See What did the 2001-2010 Tax Acts do to the Estate, Gift and Generation Skipping Transfer Taxes?).

- Individuals may exclude up to 50 percent of capital gains on stock held for more than five years in a domestic C corporation with gross assets under $50 million on the date of the stock’s issuance.

- C corporations pay the regular corporate rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

- Capital gains may face effective tax rates above the statutory rates because of phase-outs in the tax code. For example, taxpayers in the phase-out range of the AMT exemption incur an implicit surtax of 6.5 percent (for taxpayers in the 26 percent AMT bracket) or 7 percent (for taxpayers in the 28 percent AMT bracket).

- If you find this description mind-numbingly complex, you have captured the essence of capital gains taxation.
See Also

Capital Gains: What is the effect of a lower tax rate?

Data Sources

Department of the Treasury, Office of Tax Analysis (December 30, 2010).

Authors: Len Burman and Carol Rosenberg
Last Updated: June 22, 2011

Further Reading


Capital Gains: What is the effect of a lower tax rate?

Throughout most of the existence of the income tax, capital gains have been taxed at lower rates than ordinary income. Some argue that the lower tax rate offsets taxes paid at the corporate level, encourages risk taking and entrepreneurship, offsets the effects of inflation, and prevents "lock-in" (the incentive to hold assets too long for tax purposes). Critics complain that the lower tax rate disproportionately benefits the wealthy and encourages tax sheltering.

Roughly half of all capital gains represent profits on the sale of corporate stock. However, about half of those profits are never taxed at the corporate level because of various tax breaks that benefit corporations. A lower rate of tax on capital gains appropriately offsets corporate taxes only in a minority of cases.

Assets that pay returns in the form of capital gains probably are riskier than average, and so a lower capital gains tax rate may in fact encourage risk taking; however, taxing gains while allowing deductions for losses on a symmetric basis reduces the after-tax variance of returns. Although loss deductions are limited in a given year, they may be carried forward: a study published in 1997 found that most losses are deductible either immediately or soon after realization. Under current law in 2011, taxpayers can use capital losses to offset capital gains and up to $3,000 of non-gain taxable income. Taxpayers can carry the remaining capital losses forward to future years.

It is true that part of almost any nominal capital gain is due simply to inflation. But inflation actually affects the returns on assets that are taxed currently (interest, dividends, rents, and royalties) more than it affects capital gains. And adjusting capital gains for inflation, either directly or through a lower tax rate, creates tax shelter opportunities if expense items (such as interest and depreciation) are not similarly indexed.
A capital gains tax discourages sales of assets—the so-called lock-in effect—which may be inefficient. However, a 1994 study found that this effect was very small for permanent changes in capital gains tax rates (but not for temporary changes).

The benefits of low tax rates on capital gains accrue disproportionately to the wealthy. In 2013, an estimated 94 percent of the tax benefit of low rates on capital gains will go to taxpayers with cash incomes over $200,000, and three-fourths of the benefits will accrue to millionaires.

Low tax rates on capital gains are an important part of many individual income tax shelters, which employ sophisticated financial techniques to convert ordinary income (such as wages and salaries) to capital gains. For top-bracket taxpayers, tax sheltering can save 20 cents per dollar of income sheltered. Tax sheltering is economically inefficient because the resources that go into designing and managing tax shelters could be used instead for productive purposes, and many tax shelter investments pay subpar returns, turning a profit only after considering the tax benefits.

The low rate on capital gains complicates tax filing. A significant portion of tax law and regulations is devoted to policing the boundary between returns on capital assets and ordinary income. And the alternative schedule for capital gains compounds the complexity: the entire back side of the schedule D is devoted to calculating the alternative rate.

For most of its history, the U.S. income tax excluded a portion of long-term capital gains from income and taxed the remainder at ordinary rates. This is a much simpler way to convey a preference to capital gains.
See Also

Capital Gains: How are capital gains taxed?

Data Sources

Tax Policy Center, "Historical Capital Gains and Taxes"

Author: Leonard Burman
Last Updated: June 22, 2011

Further Reading


## WEALTH TRANSFER TAXES

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<th>Question</th>
<th>Page</th>
</tr>
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<td>2</td>
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<tr>
<td>How many people pay the estate tax?</td>
<td>2</td>
</tr>
<tr>
<td>How could we reform the estate tax?</td>
<td>2</td>
</tr>
<tr>
<td>What did the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) do to the estate, gift, and generation-skipping transfer taxes?</td>
<td>2</td>
</tr>
<tr>
<td>What Is an Inheritance Tax?</td>
<td>2</td>
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</tbody>
</table>
Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer taxes work?

The United States has taxed the estates of deceased persons since 1916. In 1976 Congress linked taxes on estates, gifts made during life (inter vivos gifts), and generation-skipping transfers (GST). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut all three taxes sharply but only through 2010. The act gradually phased out the estate and GST taxes and repealed both entirely for 2010, leaving only the gift tax (at a reduced rate) in that year. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set a single rate of 35 percent and a $5 million exemption (indexed for inflation after 2011) for 2011 and 2012. Unless Congress acts to extend the 2010 law, all three taxes will revert to their pre-2001 parameters in 2013.

- The executor of an estate must file a federal estate tax return within nine months of a person’s death if that person’s gross estate exceeds the exempt amount ($5 million in 2011).

- The estate tax applies to a decedent’s gross estate, which generally includes all of the decedent’s assets, both financial (such as stocks, bonds, and mutual funds) and real (homes, land, and other tangible property). It also includes his or her share of jointly owned assets and life insurance proceeds from policies owned by the decedent.

- The estate tax allows an unlimited deduction for transfers to a surviving spouse and to charity. Estates may also deduct debts, funeral expenses, legal and administrative fees, and estate taxes paid to states. The taxable estate equals the gross estate less these deductions.

- A credit then effectively exempts a large portion of the estate: in 2011, the effective exemption is $5 million (see table). Any value of the estate over $5 million faces a tax rate of 35 percent.
After 2011, the estate tax returns to an effective exemption of $1 million and tax rates ranging from 41 to 55 percent, with some estates subject to a 5 percent surtax.

Special provisions reduce the tax or spread out payment over time for family-owned farms and closely-held businesses. Such estates that satisfy certain conditions may use a special-use formula to reduce the taxable value of their real estate, often by 40 to 70 percent. Estates where farms or businesses make up at least 35 percent of gross estate may pay the tax in installments over fourteen years at reduced interest rates, with only interest due during the first five years.

Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth to heirs before they die.

The gift tax provides a lifetime exemption of $1 million per donor, temporarily increased to $5 million for gifts made in 2011 and 2012. Beyond that exemption, donors must pay gift tax equal to 41 percent of the first $500,000 and 45 percent of any excess (the tax rate is reduced to 35 percent in 2011 and 2012).

An additional amount each year is also exempted from both the tax and the lifetime exemption. This exemption, $13,000 in 2011, is indexed for inflation in $1,000 increments and is granted separately for each recipient. Thus, for example, a married couple with three children could give their children a total of $78,000 each year ($13,000 from each parent to each child) without owing tax or counting toward the lifetime exemption.
Regardless of their size, neither inheritances nor gifts received count as taxable income to the recipient.

Congress enacted the GST tax in 1976 to prevent families from avoiding the estate tax for one or more generations by making gifts or bequests directly to grandchildren or great-grandchildren rather than passing them through each generation. The GST tax effectively imposes a second layer of tax (using the exemption and the top tax rate under the estate tax) on wealth transfers to recipients who are two or more generations younger than the donor.

For the latest on the estate tax, see: www.taxpolicycenter.org/taxtopics/estatetax.cfm.

See Also

Wealth Transfer Taxes: Who pays the estate tax?
Wealth Transfer Taxes: How many people pay the estate tax?
Wealth Transfer Taxes: What did EGTRRA do to estate, gift, and generation skipping transfer (GST) taxes?
Wealth Transfer Taxes: What is an Inheritance Tax?

Further Reading


Joint Committee on Taxation, "Taxation of Wealth Transfers within a Family: A Discussion of Selected Areas for Possible Reform, JCX-23-08 (April 2, 2008).


Author: Jeffrey Rohaly
Last Updated: June 13, 2011
Wealth Transfer Taxes: Who pays the estate tax?

The estate tax is highly progressive. The top ten percent of income earners pays virtually all of the tax; over half is paid by the richest 1 in 1,000. Much of the political debate about the estate tax centers around its impact on family farms and small businesses. In fact, very few farms or businesses actually pay the tax.

<table>
<thead>
<tr>
<th>Cash Income category</th>
<th>All</th>
<th>Top 10%</th>
<th>Top 5%</th>
<th>Top 1%</th>
<th>Top 0.1%</th>
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<tbody>
<tr>
<td>Number of returns</td>
<td>8,600</td>
<td>7,650</td>
<td>7,360</td>
<td>4,020</td>
<td>900</td>
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<tr>
<td>Number taxable</td>
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<td>2,960</td>
<td>2,880</td>
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<td>380</td>
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<tr>
<td>Percent of all taxable returns</td>
<td>100.0</td>
<td>90.5</td>
<td>88.2</td>
<td>47.4</td>
<td>11.7</td>
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<tr>
<td>Estate tax paid ($ millions)</td>
<td>10,560</td>
<td>10,360</td>
<td>10,300</td>
<td>8,280</td>
<td>5,410</td>
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<tr>
<td>Percent of all estate tax paid</td>
<td>100.0</td>
<td>98.1</td>
<td>97.5</td>
<td>78.5</td>
<td>51.3</td>
</tr>
</tbody>
</table>

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2)

(a) Figures are for estate tax returns filed for individuals who die in 2011.
(b) Estate tax returns on which farm and business assets represent at least half of gross estate.
(c) Estate tax returns on which farm and business assets represent at least half of gross estate and these assets are no more than $5 million.
(d) Number of returns is rounded to nearest multiple of ten.
(e) Estate tax paid is rounded to nearest multiple of ten million.

- TPC estimates that 8,600 individuals dying in 2011 will leave estates large enough to require filing an estate tax return (estates with a gross value under $5 million need not file a return in 2011). After allowing for deductions and credits, an estimated 3,270 estates will owe tax. Roughly 90 percent of these taxable estates will come from the top ten percent of income earners and nearly half will come from the top one percent alone (see table).

- Estate tax liability will total an estimated $10.6 billion in 2011. The top ten percent of income earners will pay 98 percent of this total. The richest 1 in 1,000 will pay $5.4 billion or 51 percent of the total.

- Less than 50 small farms and businesses - estates with farm and business assets making up at least half of gross estate and totaling $5 million or less - will pay any estate tax in 2011. Such estates will represent just 1.2 percent of all taxable estate tax returns.

- TPC estimates that small farms and businesses will pay under $10 million in estate tax in 2011, less than one tenth of 1 percent point of the total revenue the tax will collect.

For the latest on the estate tax, see: www.taxpolicycenter.org/taxtopics/estatetax.cfm
See Also

Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer (GST) taxes work?

Wealth Transfer Taxes: How many people pay the estate tax?

Wealth Transfer Taxes: What did EGTRRA do to estate, gift, and generation skipping transfer (GST) taxes?

Wealth Transfer Taxes: What is an Inheritance Tax?

Further Reading


Authors: Jeffrey Rohaly and Katherine Lim
Last Updated June 13, 2011
Wealth Transfer Taxes: How many people pay the estate tax?

The 2001 tax act, The Economic Growth and Tax Relief Reconciliation Act (EGTRRA), raised the estate tax exemption to $1 million in 2002 and to $3.5 million in a series of steps through 2009, sharply reducing the number of estates that have to pay estate taxes. For 2010 only, the estate tax was eliminated. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 put in place an estate tax with a $5 million exemption and 35% rate for 2011 and 2012 only. If Congress doesn’t act, the tax will revert to its pre-EGTRRA status in 2013 with a $1 million exemption, leading to a large increase in the number of estates owing the tax.

- Roughly 33,500 estates filed returns in 2009 but fewer than half—only 14,700—of those estates had to pay any estate tax at all. Estate tax liability totaled $20.6 billion.

- Estates must file tax returns within nine months of the decedent’s death and taxable estates usually wait as long as possible before filing. Thus, most returns filed in 2009 were for people dying in 2008 when the estate tax exemption was $2 million. About 2.4 million people died in that year; of those, only 1 in 73 generated an estate tax return and only 1 in 166 had to pay any estate tax.

- The 2010 act also allowed estates of people dying in 2010 to choose between the 2010 law with no estate tax but with limited step-up in basis and the 2011-2012 law with a $5 million exemption, 35 percent tax rate, and full step-up in basis.\(^1\) For some estates, getting step-up in basis for all assets can make it worthwhile to pay some estate tax.

- After a single year hiatus in 2010, the estate rate will return in 2011 with a $5 million exemption. TPC projects that 8,600 estate tax returns will be filed for people who died in that year, of which only 3,300 will owe estate tax totaling about $10.6 billion.

- In 2013 the estate tax exemption will drop to $1 million and many more estates will have to file returns. TPC estimates that 114,600 estates of people dying that year will file estate tax returns and 52,500 of those estates will pay taxes totaling over $40 billion.

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\(^1\) In general, estate tax laws allow heirs to set the basis of inherited assets at their values at the time of the decedent’s death, a process called “step-up in basis.” Step-up eliminates any tax on the decedent’s unrealized capital gains. The alternative is “carryover basis,” under which heirs assume the decedent’s basis and hence any unrealized capital gains. The 2010 estate tax allowed $1.3 million of step-up (plus an additional $3 million for surviving spouses) but required carry-over basis for any additional unrealized gains.
Estimated Estate Tax Returns and Liability, 2007-2013

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate tax returns (thousands)</td>
<td>38.0</td>
<td>38.4</td>
<td>33.5</td>
<td>0.0</td>
<td>8.6</td>
<td>8.6</td>
<td>114.6</td>
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<td>Taxable returns (thousands)</td>
<td>17.4</td>
<td>17.1</td>
<td>14.7</td>
<td>0.0</td>
<td>3.3</td>
<td>3.3</td>
<td>52.5</td>
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<tr>
<td>Estate tax liability ($ billions)</td>
<td>22.5</td>
<td>24.8</td>
<td>20.6</td>
<td>0.0</td>
<td>10.6</td>
<td>12.0</td>
<td>40.5</td>
</tr>
</tbody>
</table>

(a) Figures are for estate tax returns filed for decedents dying in each calendar year.

For the latest on the estate tax, see: www.taxpolicycenter.org/taxtopics/estatetax.cfm.

See Also

Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer (GST) taxes work?

Wealth Transfer Taxes: Who pays the estate tax?

Wealth Transfer Taxes: What did EGTRRA do to estate, gift, and generation skipping transfer (GST) taxes?

Wealth Transfer Taxes: What is an Inheritance Tax?

Further Reading


Data Sources

Statistics of Income Division, Internal Revenue Service, "SOI Tax Stats - Estate Tax Statistics".


Authors: Jeffrey Rohaly and Katherine Lim
Last Updated: June 13, 2011
Wealth Transfer Taxes: How could we reform the estate tax?

The federal estate and gift tax has changed virtually every year since 2001, raising the effective exemption to $3.5 million in 2009 and dropping the maximum tax rate to 45 percent, repealing it all together in 2010, and then increasing the exemption to $5 million and dropping the rate further to 35 percent for 2011 and 2012. Unless more changes are made, it will return as it was under pre-2001 law, with a $1 million exemption and a 55 percent maximum tax rate in 2013. The continuing changes in the tax have made estate planning difficult because of uncertainty about what tax rules will apply when a person dies. Making estate tax law permanent with a modestly higher exemption and a lower tax rate would remove that uncertainty and would maintain some estate tax revenue while protecting all but the largest estates from the tax.

- Reform should simplify the estate tax to make it easier for taxpayers to pay their fair share without complex estate planning. One simplification would allow married couples an exemption equal to twice that for singles, allocated between spouses as they wish. Tax planning already accomplishes this, but the change would make it automatic. The change would likely have little effect on revenue collections and would significantly reduce the need for estate planning.

- Reform should attack the loopholes such as special trust arrangements and valuation discounts. Those tax-avoidance measures both complicate estate planning and result in unequal taxes on comparable estates. Closing loopholes could increase revenues, allowing a higher estate tax exemption or a reduction of the national debt.

- Many members of Congress have called for immediate and permanent repeal of the tax. That would be expensive, however: the Joint Committee on Taxation estimates immediate repeal would reduce revenue by about $670 billion between 2008 and 2018. Repeal would also be regressive—the benefits would go almost entirely to people at the top of the income distribution—and would invite significant tax sheltering. Gifts from an estate to charity currently qualify for full deduction from the estate’s taxable value, creating a substantial incentive to leave bequests to charities. Economists have estimated that repealing the estate tax would cause charitable donations to fall by between 6 and 12 percent, or as much as $25 billion annually.

- If 2009 estate tax law were made permanent (exempting $3.5 million of assets and taxing any excess at top statutory rate of 45 percent), estate tax liability would be $276 billion between 2011 and 2020, about 57 percent of the liability under current law. If the exemption was indexed for inflation the liability would drop to $259 billion, or 53 percent of current law.

- If current 2011 law were made permanent (exempting $5 million, indexed for inflation, of assets and taxing any excess at 35 percent) estate liability would plummet down to one third of current law levels at $161 billion for 2011 to 2020.

- If pre-2001 law were made permanent (exempting $1 million of assets and taxing any excess at a top statutory rate of 55 percent) would increase estate liability relative to current law nearly 10 percent to $532 billion over the decade window 2011 to 2020.
### Data Sources

- Estimates related to the Estate Tax and Extension of Tax Relief Act of 2006 (ETETRA)
- Estimates of possible estate tax compromises (2006)

### See Also

- Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer taxes work?
- Wealth Transfer Taxes: Who pays the estate tax?
- Wealth Transfer Taxes: How many people pay the estate tax?
- Wealth Transfer Taxes: What did the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) do to the estate, gift, and generation-skipping transfer taxes?

### Further Reading

- Joint Committee on Taxation, "Taxation of Wealth Transfers within a Family: A Discussion of Selected Areas for Possible Reform, JCX-23-08 (April 2, 2008).


Author: Roberton Williams
Last Updated: June 13, 2011
Wealth Transfer Taxes: What did the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) do to the estate, gift, and generation-skipping transfer taxes?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made sweeping changes to wealth transfer taxation. The act gradually phased out the estate and generation-skipping transfer (GST) taxes and completely eliminated both in 2010, leaving only the gift tax (at a reduced rate) in that year. In 2011 and 2012 the estate tax returns with higher exemption levels and lower rates due to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. After 2012 the estate, gift, and GST taxes return in full force under the rules that existed before the 2001 act.

### Parameters of the Estate, Gift, and Generation-Skipping Transfer Taxes Before and After EGTRRA

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Maximum tax rate a (percent)</th>
<th>Estate tax exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before EGTRRA</td>
<td>After EGTRRA</td>
</tr>
<tr>
<td>2002</td>
<td>55</td>
<td>50</td>
</tr>
<tr>
<td>2003</td>
<td>55</td>
<td>49</td>
</tr>
<tr>
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<td>55</td>
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<td>2005</td>
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<td>2008</td>
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<td>45</td>
</tr>
<tr>
<td>2009</td>
<td>55</td>
<td>45</td>
</tr>
<tr>
<td>2010</td>
<td>55</td>
<td>35 c</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>GST Exemption</th>
<th>Gift Tax lifetime Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before EGTRRA b</td>
<td>After EGTRRA</td>
</tr>
<tr>
<td>2002</td>
<td>$1.1 Million</td>
<td>$1.1 Million</td>
</tr>
<tr>
<td>2003</td>
<td>$1.12 Million</td>
<td>$1.12 Million</td>
</tr>
<tr>
<td>2004</td>
<td>$1.14 Million</td>
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<td>2005</td>
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<td>2007</td>
<td>$1.24 Million</td>
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<td>2008</td>
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<td>2009</td>
<td>$1.3 Million</td>
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<tr>
<td>2010</td>
<td>$1.33 Million</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Notes:
(a) In addition, estates between $10 million and $17.184 million faced a surtax of 5 percent.
(b) The exemption was $1 million in 1998 and indexed to inflation thereafter in $10,000 increments. Values for 2006 and beyond are based on Congressional Budget Office projections of inflation.
(c) Gift tax only. The estate and GST taxes are eliminated.

Source: Internal Revenue Code
The Taxpayer Relief Act of 1997 (TRA97) reduced transfer taxes in a series of steps that were scheduled to end in 2006. The act raised the estate tax exemption from $600,000 in 1997 to $1 million in 2006; indexed the annual gift exclusion and GST exemption for inflation from their respective 1998 levels of $10,000 and $1 million; and created the qualified family-owned business interest (QFOBI) exclusion, which increased the estate tax exemption for family-owned farms and businesses to $1.3 million.

EGTRRA accelerated the phase-in of provisions of TRA97 and further reduced transfer taxes, eliminating the estate tax completely for people dying in 2010 only. To keep the cost of the act down to agreed-upon levels and to satisfy procedural rules in the Senate, Congress chose to allow EGTRRA to expire after 2010. Thus, unless Congress acts to extend these provisions, the estate, gift, and GST taxes will revert to their pre-EGTRRA levels in 2011.

EGTRRA raised the estate tax exemption to $1 million in 2002 and scheduled its further rise to $3.5 million in 2009 (see table). Before EGTRRA, the estate tax exemption matched the lifetime gift tax exemption. EGTRRA broke this linkage by fixing the gift tax exemption at $1 million in 2002.

Under pre-EGTRRA law the exemption for the GST tax was $1 million in 1998 and indexed for inflation thereafter (in $10,000 increments). EGTRRA set the exemption for the GST after 2003 equal to the exemption for the estate tax. Like the estate tax, the GST disappears in 2010, only to return in 2011 with a forecast exemption of $1,350,000 (depending on measured inflation).

Before EGTRRA, estates faced tax rates ranging from 37 to 55 percent plus a 5 percent surtax on taxable estates between $10 million and $17.184 million that phased out the benefits of the exemption and the graduated rate structure. Gift tax rates matched estate tax rates. The GST tax rate equaled the 55 percent top statutory estate tax rate.

EGTRRA repealed the 5 percent surtax on estates for 2002 through 2010 and gradually reduced the top rates for the estate, gift, and GST taxes to 45 percent by 2009. Only the gift tax will remain in 2010, with a 35 percent rate, the same as the top individual income tax rate.

EGTRRA also made several other changes to the estate tax. Before EGTRRA, estates could claim a credit for state "death taxes" of up to 16 percent of the taxable estate. Almost all states taxed estates or inheritances at the level that would take maximum advantage of the federal credit. EGTRRA phased out the credit over three years and replaced it in 2005 with a deduction for estate taxes paid to states. That change affected states differently, depending on their tax laws. States whose estate taxes were tied directly to the federal credit saw their taxes disappear when EGTRRA eliminated the credit. Others repealed their taxes. And some states left their estate taxes unchanged, generally resulting in an increase in total taxes paid by estates of their residents.

EGTRRA also effectively eliminated the $1.3 million QFOBI exclusion in 2004, when the exemption available to all estates exceeded the QFOBI exemption for farms and small businesses.

For 2010 only, EGTRRA eliminated stepped-up basis for inherited assets. In all other years, heirs may use the value of an inherited asset at the time of the donor’s death as the asset’s basis, thereby eliminating any tax on gains accrued between the time of purchase and the date the...
owner died. In contrast, heirs receiving inheritances from people who die in 2010 also inherit
the donor’s original basis. Estates can, however, claim stepped-up basis in 2010 for up to $1.3
million of assets plus up to $3 million for assets left to a spouse.

For the latest on the estate tax, see: www.taxpolicycenter.org/taxtopics/estatetax.cfm

See Also

Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer (GST) taxes
work?

Wealth Transfer Taxes: Who pays the estate tax?

Wealth Transfer Taxes: How many people pay the estate tax?

Wealth Transfer Taxes: What is an Inheritance Tax?

Further Reading

Burman, Leonard E., William G. Gale, and Jeffrey Rohaly, "Options to Reform the Estate Tax"

Burman, Leonard E. and William G. Gale, "The Estate Tax is Down but not Out" (Washington:
Urban Institute, 2001).


Author: Jeffrey Rohaly
Last updated June 8, 2011
Wealth Transfer Taxes: What Is an Inheritance Tax?

An inheritance tax is a type of wealth transfer tax that applies to the amount of gifts and bequests a taxpayer receives. It differs from an estate tax and gift tax in that the tax rate depends on the amount of gifts and bequests the taxpayer receives rather than on how much the donor gives or bequeaths. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly, because each of any number of recipients can claim an exemption and take advantage of the progressive tax rates, thus reducing their effective tax rate. Currently the United States has no federal inheritance tax, but several states do.

- The economic burden of all wealth transfer taxes falls predominantly on recipients and not donors, because the former tend to receive a smaller pre-tax inheritance than they would without the tax. However, the burden on individual recipients varies widely depending on whether the tax is an inheritance tax or an estate and gift tax. For example, if the 2009 estate tax were replaced on a revenue-neutral basis with an inheritance tax, the average tax rate would be much lower on heirs of smaller inheritances, and much higher on heirs of the largest inheritances. Under one option, the tax burden on heirs inheriting less than $500,000 would fall by $42,000, while that on heirs inheriting more than $50 million would rise by $5.3 million (see figure 1).

![Figure 1. Effect on Heirs of Replacing 2009 Estate Tax with Revenue-Neutral Inheritance Tax](image)

Notes:
(a) 2009 estate tax transfers above $3.5 million subject to 45 percent tax. Amounts inherited above $2.3 million subject to income tax and 15 percentage point surtax.

Inheritance taxes come in three principal forms. An accessions tax applies to the amount an individual receives by bequest or gift over his or her lifetime. An annual inheritance tax applies to the gifts and bequests a person receives in a given year. An inclusion tax counts gifts and bequests as income and taxes them under the income tax; thus the tax rate depends on both the size of the gift or bequest and the recipient’s other income. An inclusion tax could be combined with either of the other types of inheritance taxes into one tax to take advantage of the strengths of each.

Most countries rely on inheritance taxes rather than on estate and gift taxes. More than half of a group of thirty-four industrialized countries (see figure 2) have an annual inheritance tax; a few use accessions and inclusion taxes. Only three of the countries besides the United States have estate taxes. The past several decades have seen a shift away from estate taxes: Canada, Australia, and New Zealand repealed their estate taxes, and Ireland replaced its estate tax with an inheritance tax.

Some commentators believe that inheritance taxes are simpler to administer than estate taxes, because they may curtail strategies used to avoid estate taxes, such as moving assets into complicated trusts that falsely suggest that a decedent’s estate will go to a person or entity exempt from the tax. Others believe that estate taxes are simpler because they require less recordkeeping.

Because decedents typically leave bequests to multiple heirs, under one inheritance tax proposal, the number of heirs that would have to file inheritance tax returns would be roughly twice the number of estates that now must file estate tax returns. But that same proposal would roughly cut in half the number of heirs burdened, relative to the estate and gift tax, because small inheritances would not be taxed.
See Also

Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer (GST) taxes work?

Wealth Transfer Taxes: Who pays the estate tax?

Wealth Transfer Taxes: How many people pay the estate tax?

Wealth Transfer Taxes: What did EGTRRA do to estate, gift, and generation skipping transfer (GST) taxes?

Data Sources


Further Reading


Author: Lily Batchelder
Last Updated: October 12, 2007
See Also

Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer (GST) taxes work?

Wealth Transfer Taxes: Who pays the estate tax?

Wealth Transfer Taxes: How many people pay the estate tax?

Wealth Transfer Taxes: What did EGTRRA do to estate, gift, and generation skipping transfer (GST) taxes?

Data Sources


Further Reading


Author: Lily Batchelder
Last Updated: October 12, 2007
TAXES AND ENERGY

Taxes and Energy: What tax incentives encourage energy production? ................................II-10-1
Taxes and Energy: What tax incentives encourage energy production?

Several major provisions of the federal income tax subsidize domestic production of fossil fuels, including expensing of exploration and development costs and intangible drilling costs, the use of percentage instead of cost depletion to recover costs of drilling and development of oil and gas wells and development of mining properties, and the production credit for alternative fuels. These incentives promote investment in fuel development at the expense of investment in other assets with higher pretax yields. Several recent studies have found that the effective tax rate—that is, the extent to which all applicable tax provisions reduce the after-tax return on a new investment—is much lower for oil, gas, and mineral development than for other assets.

These tax incentives are justified by some on the grounds that they reduce U.S. dependence on imported oil by increasing domestic production of oil and substitute fuels. But they also encourage more rapid exhaustion of domestic supplies, which may increase dependence on imports in the long run. The three largest energy tax incentives are expected to reduce federal tax revenue by $11 billion or $17 billion over 2007-11, depending on the agency doing the estimate (see table).

<table>
<thead>
<tr>
<th>Provision</th>
<th>Treasury estimate</th>
<th>JCT estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess of percentage over cost depletion, fuels</td>
<td>3.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Expensing of exploration and development costs, fuels</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Alternative fuel production credit</td>
<td>3.2</td>
<td>6.2</td>
</tr>
<tr>
<td>Total</td>
<td>10.5</td>
<td>16.5</td>
</tr>
</tbody>
</table>


- Intangible drilling costs consist of the labor, machinery, and materials costs of drilling and developing oil and gas wells and mines. Independent oil producers (that is, those without related refining and marketing operations) may deduct these costs from income in the year incurred even though, as capital investments, they produce returns over a number of years. Integrated oil companies may deduct 70 percent of these costs in the first year and recover the remaining 30 percent over five years.

- Under percentage depletion, producers deduct each year as capital expenses a fixed percentage of gross revenue from a property; in contrast, under cost depletion, producers deduct their actual outlays as the resources from a well or mine are depleted. The federal income tax allows independent producers, but not integrated companies, to deduct 15 percent of gross revenue from their oil and gas properties as percentage depletion, without regard to how much they have invested in the properties. Percentage depletion is permitted only on the company’s first 1,000 barrels per day from a property and is limited to net income from oil and gas properties. Percentage depletion is also available for coal and other minerals at varying rates.
The tax code also provides a credit for production of alternative fuels of about $7.25 per barrel-equivalent in 2007 dollars, indexed to future changes in the GDP deflator. The credit phases out at oil prices between $23.50 and $29.50 a barrel in 1979 prices (about $56 and $70 a barrel in prices of the second quarter of 2007); oil prices in late 2007 were above the phase-out range. Enacted in 1980, the credit initially supported some additional production of synthetic fuels (mainly oil and gas produced from coal), but subsequent reports indicated substantial abuse in claiming the credit. Investments made after July 1, 1998, and production from qualifying facilities after January 1, 2008, do not qualify for the credit. Thus without further congressional action the credit will expire even if oil prices decline.

The tax law includes a number of smaller incentives for investments in refineries, pipelines, oil and gas exploration, and selected coal technologies. In addition, domestic energy properties benefit from the domestic production deduction provided in the American Jobs Creation Act of 2004. Some members of Congress have proposed denying oil and gas companies the benefits of the domestic production deduction (although the deduction in itself does not favor oil and gas over other domestic manufacturing) and removing some additional incentives for refining and oil exploration enacted in 2005.

Subsidizing domestic production of fossil fuels is inconsistent with a broader policy goal of reducing fossil fuel use to counter global climate change. But the adverse effects of the incentives on climate change are probably very minor, because any increase in domestic production they induce mostly displaces imports instead of raising domestic or worldwide fuel consumption. A recent study concludes that the incentives reduce the world oil price by less than 0.1 percent. Thus the resulting increase in consumption cannot be large.

Further Reading

Congressional Budget Office, "Taxing Capital Income-Effective Tax Rates and Approaches to Reform" (Washington, October 2005).


Author: Eric Toder
Last Updated: December 14, 2007
TAXES AND THE ENVIRONMENT

What are green taxes? .................................................................................................................II-11-1
What green taxes does the United States impose? .................................................................II-11-3
What green taxes do European countries impose? ..............................................................II-11-6
Taxes and the Environment: What are green taxes?

Green taxes (also called "environmental taxes" or "pollution taxes") are excise taxes on environmental pollutants or on goods whose use produces such pollutants. Economic theory suggests that taxes on polluting emissions will reduce environmental harm in the least costly manner, by encouraging changes in behavior by those firms and households that can reduce their pollution at the lowest cost. In practice, green taxes—even indirect ones, on proxies for emissions or on related goods—have rarely been imposed. Some examples can be found in Europe, but virtually none in the United States.

- Pollution can be regarded as a cost of producing goods and services, but one that is borne not by the polluter but instead mostly by others in the form of a damaged environment (in forms ranging from noxious odors to impaired health to changes in climate). A pure environmental tax aims to ensure that polluters face the true cost of their activities by charging them for the damages caused to others.

- Direct taxes on emissions are economically efficient because they give polluters an incentive to reduce their pollution up to the point where further reduction would cost more than paying the tax, and to do so in the least costly way.

- Indirect taxes, such as taxes on related goods, or alternative policies, such as mandated technology standards, may not reduce pollution in the least costly way. For example, imposing a higher gasoline tax to reduce the environmental damage from automobile emissions gives drivers no incentive to maintain their cars' pollution control equipment, and mandating pollution control equipment provides no incentive to drive less.

- Direct emissions taxes are also cost-effective because they ensure that pollution reductions are undertaken by those who can do so most cheaply. Firms that find pollution abatement costly will choose to continue to pollute and pay more tax, while those who find it less costly will cut their pollution rather than pay more tax.

- Tradable permit schemes are another alternative to emissions taxes, and can be just as cost-effective. These schemes limit the quantity of allowable emissions by issuing a fixed quantity of emissions permits, which polluters may then trade among themselves. The permit price plays a role analogous to a tax: polluters with high costs of reducing their emissions will instead buy permits that let them continue to emit, while those that can cut emissions at lower cost will do so and then sell their unused permits. Tradable permit schemes may have different distributional effects than pollution taxes, however, depending on whether the permits are given away (and to whom, and on what basis) or auctioned off. Examples of such schemes are the acid rain provisions of the U.S. Clean Air Act and the European Union’s Greenhouse Gas Emission Trading Scheme.

- Subsidies for emissions reductions do not have the same effect as emissions taxes. Subsidies increase the benefits of belonging to the subsidized group and may result in more polluters, each polluting less, with no net decrease in emissions.

- One proposed green tax that has recently gained favor is a carbon tax. This would impose an excise levy on the carbon-based content of fossil fuels as a means of reducing greenhouse gas emissions that contribute to global warming. Estimates vary widely of the external costs associ-
ated with these fuels, whose combustion releases carbon dioxide into the atmosphere. In a recent review of twenty-eight published studies, the median incremental damage estimate was $14 per ton of carbon, but a handful of estimates found damages above $350 per ton.

See Also

Taxes and the Environment: What green taxes does the United States impose?

Taxes and the Environment: What green taxes do European countries impose?

Further Reading

European Commission, "Emission Trading Scheme (EU ETS)."


U.S. Environmental Protection Agency, "SO2 Reductions and Allowance Trading under the Acid Rain Program" (www.epa.gov/airmarkets/progsregs/arp/s02.html).

Author: Arik Levinson
Last updated: July 31, 2007
Taxes and the Environment: What green taxes does the United States impose?

The United States imposes virtually no green taxes. Most programs to reduce pollution rely on mandatory standards such as the Clean Air Act's New Source Performance Standards (NSPS) for stationary polluters and the Corporate Average Fuel Economy (CAFE) standards for automobiles. Among the few green taxes imposed in the United States at the federal level are the "gas guzzler" tax on new cars that exceed fuel efficiency standards, a tax on ozone-depleting substances, and miscellaneous taxes on fertilizers and pesticides used in agriculture.

- Numerous taxes and user fees are imposed at the state and local level, including pay-per-bag disposal charges for municipal solid waste and deposit-refund schemes for beverage containers and automobile batteries. In general, such policies tax pollution only indirectly and are too low to affect behavior measurably.

- Proponents often cite the gasoline tax as a green tax. The federal gasoline tax is currently 18.4 cents a gallon, and state taxes add an average of 20 cents more. Adjusted for inflation, gasoline tax rates have fallen to about half their rates in the 1930s (figure 1). Some economists do not consider the current gasoline tax to be a green tax, even indirectly, because over 80 percent of the revenue is used to subsidize road construction, which ultimately encourages more pollution.

![Figure 1. U.S. Gasoline Tax Rates, 1933-2005](image)
Advocates of increasing the gasoline tax, such as Harvard economist Gregory Mankiw, assert that the higher tax would address both pollution and other costs of driving not borne by the individual driver. These costs have been estimated at over 80 cents a gallon, divided approximately equally among pollution, congestion, and accident risk.

In the United States, sales and excise taxes on gasoline make up much less of the total cost of fuel than in other countries (figure 2).
See Also

Taxes and the environment: What are green taxes?

Taxes and the environment: What green taxes do European countries impose?

Data Sources


Further Reading


Author: Arik Levinson
Last updated: July 31, 2007
Taxes and the Environment: What green taxes do European countries impose?

Many European countries have used pollution taxes more than the United States, imposing taxes on emissions of common air pollutants such as sulfur dioxide and nitrogen oxides. The European Union has also instituted a "cap-and-trade" system to limit carbon dioxide emissions as a way of meeting targets for limiting greenhouse gas emissions agreed to in the Kyoto Protocol. Almost all of these allowances are given away to polluters. Only a handful of member states reserve any emissions allowances to be auctioned off, and these auctioned allowances account for only a tiny fraction of the total.

- The European Commission defines an environmental tax broadly as "a tax whose base is a physical unit (or a proxy of it) of something that has a proven, specific negative impact on the environment." This definition includes taxes that were not enacted with environmental goals in mind. In fact, according to Eurostat, most of these taxes are on energy (76 percent of all environmental tax revenue) and transportation (21 percent), leaving a small fraction for pure pollution taxes.

- Revenue from these taxes is equivalent to about 3 percent of GDP in Europe, and 7 percent of total revenue (figures 1 and 2). That fraction has not increased in recent years, despite growing concern about the environment and growing enthusiasm for market-based environmental policies.

![Figure 1. Environmental Tax Revenue in Selected OECD Countries, 2004](image-url)

Source: "Total environmental tax revenues as a share of total revenues from taxes and social contributions," Eurostat, the on-line data portal.
See Also

Taxes and the Environment: What are green taxes?

Taxes and the Environment: What green taxes does the United States impose?

Data Source


Author: Arik Levinson
Last Updated: July 31, 2007

Further Reading


BUSINESS TAXATION

How does the corporate income tax work? ..............................................................II-12-1
What are flow-through enterprises and how are they taxed? ........................ II-12-3
What is carried interest and how should it be taxed? ........................................ II-12-6
Business Taxation: How does the corporate income tax work?

The United States imposes a tax on the profits of U.S. resident corporations at graduated rates ranging from 15 to 35 percent. Most corporate income is taxed at the maximum rate. Corporate shareholders also pay individual income tax on dividends and on capital gains from sale of their shares. The maximum tax rate on both dividends and capital gains is currently 15 percent, but both are scheduled to revert to pre-2001 levels (ordinary income rates of up to 39.6 percent on dividends, a maximum rate on capital gains of 20 percent) after 2010.

The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes, and raised $354 billion in fiscal 2006, 14.6 percent of all revenue and 2.7 percent of GDP. The relative importance of the corporate tax as a source of revenue declined sharply between the 1950s and 1980s, but over the past quarter century it has brought in around 2 percent of GDP, with some fluctuations mostly associated with the business cycle.

- Taxable corporate profits are equal to a corporation’s receipts less its current expenses (including wages and interest), deductions for the cost of inventory when goods are sold, and depreciation of capital investments. U.S. resident multinational corporations pay tax on their worldwide profits, but tax on the profits of their controlled foreign subsidiaries is deferred until those profits are repatriated (that is, paid back as dividends) to the U.S. parent corporation. U.S companies receive a tax credit, subject to various limitations, for foreign income taxes associated with their foreign-source income. U.S.-based corporations that are owned by foreign multinational compa-
nies face the same U.S. corporate tax rules on their profits from U.S. business activities as do U.S.-owned corporations.

- Some form of corporate taxation is needed under an income tax system to prevent individuals from accumulating tax-free income within corporations. But the current U.S. corporate income tax discourages the use of the corporate form of enterprise relative to noncorporate forms by imposing tax on corporate profits twice, when earned by the corporation and again when paid out to shareholders. The earnings of "flow-through" businesses (described below) are taxable only at the individual or partner level.

- The corporate tax also encourages debt finance relative to equity finance, because the interest payments of corporations are deductible whereas dividends are not, and it encourages corporations to retain earnings instead of paying dividends. The 15 percent tax rate on dividends through 2010 is below the marginal income tax rate paid by most individual shareholders, and so provides partial relief from double taxation of dividends. Even with the lower dividend tax rate, however, retained earnings are more favorably treated than dividends because tax on them at the shareholder level is deferred until capital gains are realized.

- Many U.S. businesses are taxed as "flow-through" enterprises and are not subject to the corporate income tax. These include U.S. corporations organized under subchapter S of the Internal Revenue Code (S corporations), partnerships, and sole proprietorships. Instead their shareholders or partners include their allocated share of the businesses’ profits in their taxable income under the individual income tax.

- The tax law includes a number of preferences, in the form of accelerated depreciation deductions, immediate expensing of some capital costs, and tax credits, that make economic profits less than fully taxable for some businesses. In addition, corporations can reduce their tax liability through sophisticated financial transactions (called tax shelters) that take advantage of inconsistencies in the tax law, while incurring zero or negligible potential for pretax economic gain or loss. Multinational corporations can also shift some net reported income to low-tax foreign jurisdictions in which they operate. Although the Internal Revenue Service has disallowed some of these transactions, and its assessments are often (but not always) upheld by the courts upon challenge, it is difficult to monitor and control all such activities. Both tax shelters and intentional preferences reduce the tax revenue collected from corporate profits.

**See Also**

International Taxation: How does the U.S. international tax system work?

**Data Sources**


Author: Eric Toder
Last Updated: December 14, 2007
Business Taxation: What are flow-through enterprises and how are they taxed?

Many businesses are taxed as flow-through enterprises, which are not subject to the corporate income tax as are corporations taxed under subchapter C of the Internal Revenue Code (C corporations). Instead their shareholders or partners include their allocated share of profits in taxable income under the individual income tax. These include corporations organized under subchapter S of the Internal Revenue Code (S corporations), partnerships, and sole proprietorships.

- Domestic companies with no more than 100 shareholders may elect S corporation status. Shareholders must be U.S. citizens or residents and generally may not be corporations or partnerships. In addition, S corporations may have only one class of stock.

- Partnerships have always been taxed as flow-through enterprises, but in the past they were not afforded the benefits of limited liability that the corporate form provides. State laws allowed partnerships to organize themselves as limited-liability companies beginning in the late 1970s, and "check the box" regulations instituted by the Treasury Department in the 1990s made it easy for any business to elect limited liability status.

- C corporations and flow-through businesses generally have the same rules for inventory accounting, depreciation, and other provisions affecting the measurement of business profits. But profits of C corporations are first subject to the corporate income tax (at rates up to 35 percent) and then taxed again when paid out as dividends to shareholders or when shareholders realize capital gains arising from retained earnings. (The maximum tax rate on dividends and capital gains is 15 percent through the end of 2010.) In contrast, profits of flow-through businesses are taxed just once, at the shareholder’s individual tax rate for ordinary income, for which the top rate is currently 35 percent.

- Another benefit of flow-through status is that individuals may deduct business losses against income from other sources, subject to some limitations for "passive losses" from partnership income. In contrast, corporations may not use losses on their return for the current tax year to reduce current-year tax liability; instead losses may be carried back (up to two years) or carried forward (up to twenty years) and deducted against profits in previous or future years. To the extent corporations are unable to claim loss carrybacks, the tax offsets from these losses are delayed and reduced in present value.

- The share of businesses organized as flow-through businesses and the share of business receipts in flow-through enterprises have been rising over time (see figure). Excluding sole proprietorships, 75 percent of businesses were organized as flow-through enterprises in 2004, up from 60 percent in 1994; during that same period flow-through enterprises increased their share of business receipts from 23 percent to 33 percent. Most large businesses, however, are still corporate taxpayers. In 2004, S corporations accounted for 64 percent of all corporations with assets less than $10 million and received 56 percent of gross business revenues of those companies, but for only 37 percent of corporations with assets greater than $10 million and only 12 percent of business receipts in that category.
Notes:
Shares are calculated as the ratios of numbers of returns filed and business receipts for flow-through businesses (computed as the sum of partnerships and S corporations other than sub-S corporations, real estate investment trusts, and regulated investment companies) to all businesses (computed as the sum of partnerships and all corporations). Sole proprietorships are not included in the calculations.

Source: Internal Revenue Service, Statistics of Income Division, and authors' calculations.
See Also

Business Taxation: How does the corporate income tax work?

Data Sources

Internal Revenue Service, Statistics of Income Division, SOI Tax Stats - Corporation Tax Statistics.

Further Reading

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Author: Eric Toder
Last Updated: January 23, 2008
Business Taxation: What is carried interest and how should it be taxed?

Carried interest is a right that entitles the general partner (GP) of a private investment fund to a share of the fund’s profits (see figure 1). Typically, the GP contributes 1 to 5 percent of the fund’s initial capital and commits to managing the fund’s assets. In exchange, the GP receives an annual management fee of 2 percent of the fund’s assets plus a "carried interest" of 20 percent of the fund’s profits that exceed a certain "hurdle" rate of return. The individual partners of the GP, not the GP itself, are taxed on these payments.

Carried interest constitutes on average about one-third of the payments that GPs receive, and the management fee the remainder. Under current law, the management fee is taxed like wage and salary income, with a top tax rate of 35 percent, whereas the carried interest is taxed as investment profit, which often faces a lower tax rate. In particular, any portion of the carried interest that represents long-term capital gains of the fund is taxed at a top rate of 15 percent. Many commentators believe it would be fairer and more efficient for carried interest to be taxed like wage and salary income, but others disagree.

- The amount of assets under management in private investment funds has increased substantially over the past two decades. Private equity funds and hedge funds currently manage roughly $1 trillion in assets each. Private equity funds raised capital totaling about $240 billion in 2006 (see figure 2).
Few if any analysts believe that carried interest represents entirely a return to capital rather than labor. Instead, carried interest has two components: the return on the GP's financial investment in the fund (the "investment share"), and a return (the "compensatory share") on an amount invested by the limited partners that is implicitly lent to the GP (the "compensatory loan"). The investment share is clearly a return to capital for the GP. Because the GP does not contribute any other capital, the compensatory share appears to be a return to labor.

How best to tax carried interest depends on one's views on several issues. One is the value of the GP's compensatory share. The compensatory value of a carried interest in 20 percent of a fund's profits should not be zero. If a GP typically contributes at most 5 percent of the initial assets of a fund, the compensatory share should at least be 15 percent of the fund's profits. Nevertheless, some believe that the compensatory share of carried interest is relatively small because of the hurdle rate. This seems unlikely given the amount of carried interest payments.

A second issue is what other types of managers or forms of business organization are most similar to, and thus the closest substitutes for, the GP in a private investment fund. Generally, the tax system is more efficient if income earned in two ways that are close substitutes is taxed the same. Observers differ about whether entrepreneurs or investment banks are the closer substitute for GPs. Some view entrepreneurs as closer, because GPs typically start new investment funds on their own initiative and can obtain the same tax treatment as private equity by issuing debt.
Others view investment banks as more similar to GPs. Both are business entities, not individuals, and, like GPs, investment banks engage in entrepreneurial activities by starting investment funds. In addition, GPs typically hire from investment banks, not start-ups. Which is the closer substitute matters because not all returns to labor are taxed as wage and salary income. An investment banker’s salary, bonus, and stock options are all taxed as wage and salary income, but an entrepreneur who starts a new business and contributes both capital and labor may, under current law, treat part of the return to labor- "sweat equity"- as a return to capital and not as wage and salary income. This is the case regardless of whether the entrepreneur raises funds for the business by issuing equity or debt.

- A third issue is the administrability of any potential reform of the taxation of carried interest. If the law were changed to tax the compensatory share as wage and salary income, GPs could still pursue strategies to dilute the tax effects of the reform. As a result, some observers argue that such a change in the law would raise no revenue or would be inadministrable. If these observers are correct, it is unclear why GPs continue to bargain with limited partners to receive carried interest and lobby for retention of its preferential tax treatment. The Joint Committee on Taxation has estimated that taxing the compensatory share like wage and salary income would raise about $15 billion in revenue over five years.

- A final issue concerns the impact of any future reform on the effective corporate tax rate. Some observers think the current tax treatment of carried interest helps mitigate the unfair double taxation of corporate income. Currently, income earned within a partnership is subject only to the individual income tax, whereas income earned within a C corporation is subject to the corporate tax when earned and the individual income tax when realized or distributed. Some view the corporate tax as necessary to prevent individuals from using corporations as tax shelters; others view it as an unfair and inefficient "double tax." The latter may support taxing carried interest at lower tax rates as a way of reducing the degree of double taxation on a fund’s profits that are from businesses that pay the corporate tax. However, the current tax treatment of carried interest is a very rough solution that only applies in the aggregate, not for individual investments. After all, most C corporations are not owned by private investment funds, and it is unclear what share of private investment fund assets are held in C corporations.
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TAX EXEMPT ORGANIZATIONS

How are charitable contributions treated? .................................................................II-14-1
Which entities are exempt? .......................................................................................II-14-3
Who benefits from charitable deductions? ..............................................................II-14-5
How could incentives for charitable giving be improved? .................................II-14-7
Tax-Exempt Organizations: How are charitable contributions treated?

Many types of nonprofit institutions are exempt from paying federal income tax, but only organizations set up under Internal Revenue Code section 501(c)(3) qualify their donors to deduct contributions on their income tax returns. Donations to other nonprofits are made on an after-tax basis.

- Since 1917 individual taxpayers have been able to deduct charitable contributions from income that might otherwise be taxed. Today individuals may deduct cash and certain other contributions up to 50 percent of adjusted gross income (AGI) in a given year and may carry forward any excess for deduction on future tax returns for up to five years. Only taxpayers who choose to itemize may take the charitable deduction. Taxpayers who claim the standard deduction make contributions on an after-tax basis.

- In 1935 Congress extended to corporations the ability to deduct charitable contributions. Corporations may not deduct more than 10 percent of their pretax income in a given year but may also carry forward excess donations for five years.

- Contributions by individuals or corporations may take the form of cash, financial assets, or other noncash property such as real estate, clothing, or artwork. Certain forms of contributions face greater restrictions than do cash contributions, whereas others receive more generous treatment: The limit for donations of appreciated real property is generally 30 percent of AGI, and the limit for contributions to foundations is the same. But donors may deduct the full current market value of appreciated property. This effectively allows the capital gains portion to be deducted twice: donors pay no tax on the capital gain, and then they reduce their other income subject to tax by the amount of the contributed but unrealized income.

- The deductibility of charitable contributions saved individual and corporate taxpayers $104.6 billion in 2006, according to U.S. Treasury estimates.
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Tax-Exempt Organizations: Who benefits from charitable deductions?

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Author: Gillian Reynolds and C. Eugene Steuerle
Last Updated: January 21, 2008

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Tax-Exempt Organizations: Which entities are exempt?

Nonprofit organizations that do not distribute profits can be exempt from federal income tax if organized expressly for public purposes. Although many different types of nonprofits qualify as tax-exempt, only about 70 percent also qualify to receive tax-deductible contributions, through their status as organizations of "charitable purpose," defined under section 503(c)(3) of the tax code as "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition [or]...the prevention of cruelty to children or animals." This definition covers both public charities and private foundations, the latter consisting of those organizations created to distribute funds to charities or individuals.

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- In 2006 approximately 1.5 million tax-exempt organizations were registered with the IRS (see table). These nonprofits accounted for 5.2 percent of gross domestic product and 8.3 percent of wages and salaries paid in the United States. Far fewer file annual returns (Form 990, 990-EZ, or 990-PF). About 150,000 religious congregations, as well as organizations with less than $25,000 in gross receipts (except for private foundations, all of which must file), do not file annually.

- Tax-exempt status confers multiple benefits. Not only are nonprofits exempt from federal tax on the surplus earned from their income-producing activities, but charities may also sometimes issue federally tax-exempt bonds and are often exempt from state and local property taxes and sales taxes.
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Tax-Exempt Organizations: How are contributions treated?

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- The charitable deduction subsidizes charitable giving by lowering the cost to the taxpayer of giving. How much the tax deductibility of contributions lowers the cost of giving depends on the donor’s marginal tax rate. For instance, a donor whose marginal tax rate is 30 percent pays 30 cents less tax for every dollar donated.

- Higher-income individuals generally benefit more from the charitable deduction than those with lower incomes for two reasons: they have higher marginal tax rates, and they are more likely to itemize deductions and take advantage of the tax savings. About three-fourths of charitable giving comes directly from individuals, with the balance coming from their foundations, estates, and corporations (see figure). Total contributions totaled more than $260 billion in 2005.

- The tax deductibility of contributions subsidizes charitable activity, but also is justified as an adjustment to the tax base. Many argue that a taxpayer’s tax base should be determined by income net of contributions, since a taxpayer with $50,000 of income and $10,000 of contributions has no more ability to consume than someone with $40,000 of income and no contributions.

- Donors may choose which charitable activities to support. Because part of the cost of their donations is borne by the government through reduced revenue, donors effectively have a say in which activities the government supports.

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- Although the tax deduction likely induces additional giving, estimates of the size of this effect vary, and there is considerable debate over whether the increase in giving exceeds the loss of revenue.
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Tax-Exempt Organizations: How could incentives for charitable giving be improved?

Under current law, taxpayers who itemize are allowed to deduct most of their charitable contributions and thus reduce their taxable income and their taxes. Nonitemizers have no comparable tax incentive to donate to charities. In addition, current limitations on deductions reduce existing incentives to donate. Various proposals would restructure tax incentives to encourage more giving.

- One proposal would expand the existing incentive in exchange for a floor on deductions. Incentives are more powerful for the marginal (next, or incremental) dollar of giving than for the first dollars. Consider a person who would give away $1,000 regardless of any incentive but who would give $1,100 if offered a tax incentive to do so. Clearly, an incentive applied to the last $100 of that person’s giving will have a greater effect than one for the first $100 or even $1,000, which will be given anyway. It therefore may make sense to allow deductions only above a floor; the revenue gains from disallowing deductions below the floor could be used to expand other incentives. For instance, nonitemizers who give significant amounts to charity might be allowed to deduct many of their charitable contributions (see below) in combination with a floor under contributions by all taxpayers. The revenue gains from such a floor could be significant: the congressional Joint Committee on Taxation estimated that allowing the deduction only of charitable contributions that exceed 2 percent of adjusted gross income (AGI) would increase federal revenue by nearly $100 billion over five years and about $250 billion over ten years. A much more modest floor would provide substantial revenues that could be used to increase the incentive to give.

- At present, taxpayers who take the standard deduction cannot claim a deduction for charitable giving. Extending the deduction to these nonitemizers would likely increase charitable contributions but might create compliance problems: the Internal Revenue Service cannot reasonably be expected to audit small donations. Also, simply extending the deduction to nonitemizers would increase the complexity of filing in an already complicated income tax system. Many taxpayers would have to calculate taxes two different ways to decide whether they should take their charitable deductions as an itemizer or as a nonitemizer.

- However, if a deduction for nonitemizers were combined with a reasonable floor applied to all taxpayers, much or all of the revenue loss due to noncompliance would be eliminated, as would the added complexity. (Small, merely symbolic floors would not achieve this objective.) For instance, taxpayers might be allowed to claim charitable deductions greater than $500 if they are joint filers ($250 for single filers), regardless of whether they itemize. This combination likely would increase charitable giving at little or no cost in tax revenue and would address concerns about administration and compliance. How much net giving would increase depends upon the sensitivity of giving to incentives (see table).
Another option would be to raise the limit on deductions for charitable giving above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make carryover provisions with respect to this 50 percent limit more generous. Taxpayers may currently carry over excess contributions to future returns, but only for five years, and any new contributions must be deducted before any carryover.

Yet another proposal would expand and make permanent the charitable IRA rollover provision. This recently enacted provision, which expired in 2007, allowed some taxpayers over age 70½ to donate up to $100,000 from Individual Retirement Accounts (IRAs) and Roth IRAs to charities without having to count the distributions as taxable income. Restoring this provision and making it permanent, while raising or eliminating the $100,000 annual limit on donations and lowering the age limit to 59½ (the age at which IRA owners may withdraw funds without penalty) could increase charitable giving.

A final option would eliminate or reform the excise tax on foundation income. The current excise tax on foundations’ income from assets was intended to cover the costs to the IRS of overseeing the tax compliance of charitable organizations, but it has never done so. The tax rate is either 1 or 2 percent, depending on whether giving this year equals or exceeds the average of a few past years. Under these current rules, foundations that make more grants today face a penalty of being more likely to face the 2 percent rate in future years.) Lowering or eliminating the tax would increase the net assets available to give to charitable beneficiaries. Congress could also increase the minimum payouts that a foundation must make by the amount of the tax reduction. At a minimum, Congress could impose a single tax rate on all
such income, to remove the current perverse incentive for foundations to limit current grants today to avoid a higher tax in the future.

See Also
Tax-Exempt Organizations: How are contributions treated?
Tax-Exempt Organizations: Which entities are exempt?
Tax-Exempt Organizations: Who benefits from the charitable deduction?

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- However, if a deduction for nonitemizers were combined with a reasonable floor applied to all taxpayers, much or all of the revenue loss due to noncompliance would be eliminated, as would the added complexity. (Small, merely symbolic floors would not achieve this objective.) For instance, taxpayers might be allowed to claim charitable deductions greater than $500 if they are joint filers ($250 for single filers), regardless of whether they itemize. This combination likely would increase charitable giving at little or no cost in tax revenue and would address concerns about administration and compliance. How much net giving would increase depends upon the sensitivity of giving to incentives (see table).
Another option would be to raise the limit on deductions for charitable giving above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make carryover provisions more generous. Taxpayers may currently carry over excess contributions to future returns, but only for five years, and any new contributions must be deducted before any carryover.

Yet another proposal would expand and make permanent the charitable IRA rollover provision. This recently enacted provision, which expired in 2007, allowed some taxpayers over age 70½ to donate up to $100,000 from Individual Retirement Accounts (IRAs) and Roth IRAs to charities without having to count the distributions as taxable income. Restoring this provision and making it permanent, while raising or eliminating the $100,000 annual limit on donations and lowering the age limit to 59½ (the age at which IRA owners may withdraw funds without penalty) could increase charitable giving.

A final option would eliminate or reform the excise tax on foundation income. The current excise tax on foundations’ income from assets was intended to cover the costs to the IRS of overseeing the tax compliance of charitable organizations, but it has never done so. The tax rate is either 1 or 2 percent, depending on whether giving this year equals or exceeds the average of a few past years. Under these current rules, foundations that make more grants today face a penalty of being more likely to face the 2 percent rate in future years.) Lowering or eliminating the tax would increase the net assets available to give to charitable beneficiaries. Congress could also increase the minimum payouts that a foundation must make by the amount of the tax reduction. At a minimum, Congress could impose a single tax rate on all...
such income, to remove the current perverse incentive for foundations to limit current grants today to avoid a higher tax in the future.

See Also
- Tax-Exempt Organizations: How are contributions treated?
- Tax-Exempt Organizations: Which entities are exempt?
- Tax-Exempt Organizations: Who benefits from the charitable deduction?

Further Reading
INTERNATIONAL TAXATION

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International Taxation: How does the current system of international taxation work?

The federal government taxes U.S. resident multinational firms on their worldwide income, at the same rates as purely domestic firms. (The current maximum U.S. corporate tax rate is 35 percent.) U.S. multinationals may claim a tax credit for taxes paid to foreign governments on income earned abroad, but only up to their U.S. tax liability on that income. Firms may, however, take advantage of cross-crediting, using excess credits from income earned in high-tax countries to offset U.S. tax due on income earned in low-tax countries.

U.S. multinationals generally pay tax on the income of their foreign subsidiaries only when they repatriate the income, a delay of taxation termed deferral. Deferral, the credit limitation, and cross-crediting all provide strong incentives for firms to shift income from the United States and other high-tax countries to low-tax countries.

Suppose, for example, a U.S.-based multinational firm facing the 35 percent maximum corporate income tax rate earns $800 in profits on its Irish subsidiary (figure 1). The 12.5 percent Irish corporate tax reduces the after-tax profit to $700. Suppose the firm then repatriates $70 of this profit and reinvests the remaining $630 in its Irish operations. The firm must then pay U.S. tax on a base of $80 (the $70 plus the $10 in Irish tax paid on that portion of its profits), or $28, but it claims a credit for the $10 Irish tax, leaving a net U.S. tax of $18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more, possibly all, of the U.S. tax due on its repatriated Irish profit. Meanwhile deferral allows the remaining profit ($630) to grow abroad free of U.S. income tax until it is repatriated.
• Some countries (such as the United Kingdom and Japan) use a worldwide system with a foreign tax credit similar to the U.S. system. Others (such as France and the Netherlands) use a territorial system that exempts foreign income from taxation. Still others have hybrid systems that, for example, exempt foreign income only if the foreign country’s tax system is similar to that in the home country. In theory, such an exemption system provides an even stronger incentive than a pure worldwide system to earn income in low-tax countries, but some analysts argue that cross-crediting and deferral blur the distinction between these two systems.

• The U.S. statutory corporate tax rate has changed little since 1986. Meanwhile most other advanced industrial countries have lowered their tax rates, with the result that the U.S. rate is now substantially higher than the average tax rate among member countries of the Organization for Economic Cooperation and Development (OECD; figure 2).

![Figure 2. Maximum Statutory Corporate Tax Rates, OECD Countries, 1979-2004](source: Annual publications of Pricewaterhouse Coopers Corporate Taxes: Worldwide Summaries.)

• Despite its relatively high corporate tax rate, the United States raises less revenue from corporate income taxes as a share of GDP than other countries in the OECD. In recent years, revenue has increased as a share of GDP in most OECD countries because base-broadening measures that subject more income to tax have more than offset lower tax rates. In the United States, revenue from the corporate income tax declined sharply in the most recent recession (2000-2002), but has since rebounded as corporate profits have surged. The U.S. share of corporate revenues in GDP remains relatively low, however, because of a narrower corporate tax base compared with other countries, an increasing share of business activity originating in businesses not subject to corporate tax (partnerships and subchapter S corporations) and increased incentives to shift reported income outside the United States to avoid the relatively high U.S. corporate tax rate.
The American Jobs Creation Act of 2004 replaced existing tax subsidies for exporting with new corporate tax benefits. Most prominent is the domestic production deduction, which effectively lowers the corporate tax rate by 3 percentage points on income from the domestic production activities of U.S. firms. A temporary 5.25 percent tax rate on dividend repatriations from low-tax countries provided a substantial one-year incentive to repatriate funds from such countries. Other provisions permanently reduced the taxation of foreign-source income by facilitating cross-crediting and changing the rules governing how interest expense is allocated across the countries in which a firm operates.
See Also

International Taxation: How does the tax system impact U.S. competitiveness?

International Taxation: What are the consequences of the U.S. international tax system?

International Taxation: What are the options for reform?

International Taxation: How would formulary apportionment work?

Further Reading


Data Sources

Annual publications of Pricewaterhouse Coopers Corporate Taxes: Worldwide Summaries

OECD Revenue Statistics

World Bank's World Development Indicators database

Author: Kim Clausing
Last Updated: December 12, 2007
International Taxation: What are the consequences of the U.S. international tax system?

The current U.S. system of international taxation encourages U.S. multinational firms to earn and report profits in low-tax foreign countries, primarily by allowing them to defer U.S. tax on their foreign-source income until profits are repatriated. This and other incentives also encourage firms to locate physical assets, production, and jobs in such countries.

- Differences in taxation between countries give multinationals an incentive to alter their transfer prices from what a nonaffiliated customer would be charged. For example, by underpricing sales to their affiliates in low-tax countries and overpricing purchases from them, firms can shift reported profits to those countries, thus reducing their tax.

- To deal with this practice, for tax reporting purposes most governments require firms to use an "arm’s length" standard, setting transfer prices equal to the prices that would prevail if the transaction were between independent entities. Yet ample room remains for firms to manipulate transfer prices, because arm’s-length prices are often difficult to establish for many intermediate goods and services, including intangibles, such as patents, that are unique to the firm.

- Other provisions of U.S. tax law also encourage firms to shift profits to low-tax countries. For example, cross-crediting allows firms to use excess tax credits from operations in high-tax countries to offset tax due on repatriated profits from income earned in low-tax countries. In addition, the American Jobs Creation Act recently enacted a temporary tax break on repatriations of foreign income from low-tax countries.

- Multinational firms can shift income among their affiliates in different countries in other ways. For example, by borrowing money in high-tax countries to finance their overall operations, they can claim larger interest deductions in those countries and so report more profits in low-tax countries. The tax incentive to book profits in low-tax jurisdictions also affects decisions on the location of intangible property, the payment of royalties, and the timing of profit repatriation.

- U.S. multinational firms appear to book a disproportionate share of profits in low-tax locations. Seven of the ten countries with the largest shares of non-U.S. profits earned by U.S. multinationals in 2003 had effective tax rates under 10 percent (see figure 1). Studies have confirmed that the financial decisions of multinational firms are sensitive to international differences in corporate tax rates.
Most of the advanced industrial countries have lowered their corporate income tax rates in recent years, while U.S. rates have changed little. The increasing discrepancy between U.S. and foreign rates has strengthened incentives to shift income and has reduced U.S. tax revenue. One study found that income shifting reduced U.S. corporate income tax revenue by approximately 35 percent in 2002.

Despite evidence that firms shift the location of real investment in response to tax rate differences among countries, a substantial share of U.S. multinational activity remains in high-tax countries. These tend to be large economies with close economic ties to the United States (figure 2) whose effective corporate tax rates are, on average, quite similar to the U.S. rate.

The current U.S. system treats multinational enterprises whose parent company is incorporated in the United States differently from those headquartered elsewhere. The former, but not the latter, are subject to U.S. corporate tax rules, including limitations on the foreign tax credit and deferral. This different treatment has led some U.S.-based multinationals to shift the formal incorporation of their parent company offshore without changing the location of any of their real business activities—a practice called inversion.
The formal residence of a corporation may be losing significance in an increasingly global economy where capital flows freely and a firm’s R&D, production, and sales are often spread worldwide. The location of investment, jobs, R&D, and tax revenue matter more than the site of a multinational firm’s headquarters.

**See Also**

International Taxation: How does the U.S. international tax system work?

International Taxation: How does the tax system impact U.S. competitiveness?

International Taxation: What are the options for reform?

International Taxation: How would formulary apportionment work?

**Further Reading**


**Data Sources**

Bureau of Economic Analysis, Operations of U.S. Parent Companies and their Foreign Affiliates, various years

Author: Kimberly Clausing
Last Updated: October 17, 2007
International Taxation: How does the tax system impact U.S. competitiveness?

"International competitiveness" can mean many things. It can mean the ability of a domestic firm or industry to compete with foreign firms in a global marketplace, or a country’s ability to maintain positive or at least sustainable balances in its international accounts, or its ability to maintain a high standard of living for its population.

There is little that U.S. international tax policy can do directly to increase U.S. international competitiveness under any of these definitions. But tax policy can increase U.S. competitiveness in a different sense, namely, that of making the United States more attractive, relative to other countries, as a site for new investment, new production, and new jobs. Does the tax system make the United States a good place for multinational firms to earn profits? Does it place firms headquartered in the United States at an advantage relative to those headquartered in other countries?

Today the answer to both questions is no. The current U.S. tax system actually encourages U.S. multinationals to locate assets and economic activity, and earn and realize profit, in other countries where taxes are lower. The current system also may disadvantage firms headquartered in the United States relative to those that are headquartered in countries that exempt foreign income from taxation. These undesirable consequences of the tax system may indirectly contribute to weaker U.S. competitiveness in the other senses of the term.

- Some observers maintain that the U.S. international tax system could do more to promote the health of the U.S. economy, including the level of output and jobs. National output fundamentally depends on such variables as the capital stock, the size and quality of the labor force, and the technological capabilities of the economy. The international tax system affects only the first of these factors directly and can thus affect output only by influencing the location of capital investment.

- Tax policy might enhance the domestic capital stock by favoring investment in the United States relative to investment outside the country. One way to do this would be to treat foreign tax payments by U.S.-based multinationals as a deductible expense associated with doing business abroad, rather than allow firms a tax credit for such payments as at present, and to require current taxation of foreign income in place of the present rule that taxes that income only when it is repatriated.

- Such a policy has two crucial drawbacks. First, it makes double taxation of income likely, as both the United States and the country hosting the investment might both tax the same income. From a worldwide perspective, such a policy would lead to too little foreign investment, because investments abroad would be tax disadvantaged. Second, such treatment would amount to a beggar-thy-neighbor tax policy and could encourage other governments to pursue similar policies in retaliation. This would lead to less foreign investment in the United States, further reducing both world and national welfare.

- Some economists would use international tax policy to improve the U.S. trade balance. For example, Gary Hufbauer has argued that the U.S. tax system puts U.S. goods and services at a disadvantage relative to those from countries that rely more heavily on value-added taxes (VAT). A VAT is typically charged on a country’s imports, whereas its exports receive VAT rebates. That suggests that U.S. adoption of a VAT system might encourage exports relative to imports, thus improving the U.S. trade balance.
• But there are offsetting considerations. The resulting growth in exports relative to imports might lead to an appreciation of the dollar, which in turn, by making exports more expensive to foreigners, might undo any export advantage the VAT creates. Recent empirical research indicates that countries that rely heavily on VATs for revenue actually have lower export performance than other countries.

• Persistent U.S. trade deficits make tax solutions seem attractive, but neither border tax adjustments, nor a move to a VAT, nor export tax incentives will likely affect the U.S. trade balance, which stems ultimately from a shortfall of national saving. If the U.S. is borrowing money from foreigners to cover government deficits and an excess of domestic investment over domestic saving, then as a mathematical identity it must be using these funds to import more than it exports. Reducing the federal budget deficit would increase national saving directly and thus be a more effective solution to the trade deficit than attempting to subsidize exports or tax imports.

• Concerns about the competitiveness of U.S. multinational firms often derive from the assumption that these firms generate external, or spillover, benefits for the economy where they are headquartered. For example, the knowledge created by the R&D that these firms conduct (typically at headquarters) often gets diffused to other domestic producers, boosting their competitiveness. If such benefits matter, U.S. international tax policy should favor foreign income, to make sure that U.S.-based multinational firms are not at a disadvantage relative to competitors in other countries that tax foreign income more lightly or not at all. Exempting foreign income from U.S. taxes could promote this goal, but it would work against the optimal location of world investment, causing too much capital to locate in low-tax countries.

• Although the promise of beneficial spillovers from R&D and other headquarters activities is a strong argument for using the tax code to promote them, lower taxes on such activities might lead to a shortchanging of other activities in the economy (such as education, health, and infrastructure) that also provide beneficial external effects. More direct incentives, such as subsidies for R&D, might better encourage the desired spillovers.

• In any case, the effective tax burden on the foreign income of U.S. multinational firms is currently small and is likely to have little impact on the competitiveness of U.S. firms. One study found that the effective U.S. tax rate on active foreign income in 1990 was quite low, approximately 2.7 percent, and less under certain assumptions.
See Also

International Taxation: How does the U.S. international tax system work?

International Taxation: What are the consequences of the U.S. international tax system?

International Taxation: What are the options for reform?

International Taxation: How would formulary apportionment work?

Further Reading


International Taxation: How would formulary apportionment work?

Under the current U.S. system of international taxation, U.S. resident multinational firms must determine their profits separately in each tax jurisdiction in which they operate. A system of formulary apportionment would replace this separate accounting method with a formula that allocates a multinational firm’s worldwide income across countries. The formula would reflect the distribution of the firm’s worldwide economic activity, as measured by some combination of sales, payroll, and capital stock. The firm would then pay U.S. taxes only on the share of world income that is allocated to the United States.

Moving to formulary apportionment would address many problems of the current U.S. system. It would dramatically reduce incentives to shift economic activity or income to low-tax countries, it would treat similar firms similarly regardless of where they are incorporated, and it would eliminate much administrative complexity. But because it would have major effects on virtually all multinational firms, any shift to formulary apportionment should occur in cooperation with other countries.

- Under formulary apportionment, the U.S. tax base for a multinational firm would equal a formula-based fraction of the firm’s worldwide income. The fraction could be an average of U.S. shares of the firm’s worldwide sales, assets, and payroll, or it could be simply the fraction of worldwide sales destined for U.S. customers. Reuven Avi-Yonah and Kimberly Clausing have proposed one such system.

- Formulary apportionment is similar to the method that U.S. states already use to allocate national income across states. The state system was motivated by the widespread perception that states are so highly integrated economically that it is impractical to try to determine how much of a firm’s income is earned in one state and how much in another. Similarly, in an increasingly globalized world economy, it is ever more difficult to assign profits to individual countries, and attempts to do so are fraught with opportunities for tax avoidance.

- Formulary apportionment would remove the current artificial incentives to shift reported income to low-tax locations, because it would base firms’ tax liabilities on a measure or measures of their real economic activity in each location. These measures are far more difficult to manipulate for tax purposes than the location of income.

- The United States and other high-tax countries would gain substantial revenue under formulary apportionment, because under the current system firms’ shares of real economic activity in such countries typically exceed the shares of income they report as originating there. The move to formulary apportionment could be made revenue neutral by substantially reducing the corporate tax rate.

- Because it would make an operation’s tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary), formulary apportionment would also remove any incentive for corporate inversion.

- Formulary apportionment would reduce the tax system’s complexity and the administrative burden it imposes on firms. Firms would no longer have to allocate income or expenses across countries, or worry about subpart F and the foreign tax credit (because there would be no deferral and no U.S. taxation of foreign-source income), or cope with cumbersome transfer pricing regimes.
• A U.S. shift to formulary apportionment could result in double taxation (or exemption of some income in both the U.S. and overseas) if other countries do not adopt similar schemes. However, other countries might well choose to follow a U.S. lead for two reasons. First, the European Union is already considering a move to formulary apportionment, and joint leadership by the United States and the European Union could spur still broader cooperation. Second, a multinational firm operating both in countries with and in countries without formulary apportionment would have an incentive to shift reported income to the former, because their tax liability in such countries would no longer depend on the income reported there. The consequent loss of tax revenue in the nonadopting countries would give them a strong incentive to adopt formulary apportionment.

• The transition to and some permanent aspects of formulary apportionment could prove complicated. Potential problems include defining the unitary business, determining the appropriate apportionment formula, insulating against possible behavioral responses to the chosen formula weights, creating common accounting standards (or reconciling differences between standards), and handling international tax treaty issues.

See Also

International Taxation: How does the U.S. international tax system work?

International Taxation: How does the tax system impact U.S. competitiveness?

International Taxation: What are the consequences of the U.S. international tax system?

International Taxation: What are the options for reform?

Further Reading

International Taxation: What are the options for reform?

The current U.S. system of international taxation has four significant flaws: it provides artificial tax incentives for firms to locate real economic activity and report profits in low-tax countries; it places U.S.-headquartered firms at a competitive disadvantage; it is unworkably complex; and it raises relatively little revenue, even though the U.S. corporate tax rate exceeds that in most other advanced industrial countries.

Two proposed (and mutually exclusive) changes might improve the situation: the first would eliminate deferral of U.S. taxation on the foreign income of U.S.-based multinational firms, and the second would replace the current tax system with a territorial system that exempts foreign income from taxation altogether. A third option, formulary apportionment, would involve a more fundamental reform and is discussed in a separate brief.

- Eliminating deferral of U.S. taxation on unrepatriated income would substantially reduce the incentive to earn income in or shift profits to low-tax countries and would thus increase revenue. Presidential candidate John Kerry proposed a similar, but partial, change in 2004.

- Eliminating deferral could, however, reduce the international competitiveness of U.S.-based multinationals by increasing their tax disadvantage in low-tax markets relative to firms based in other countries. U.S. firms would face a greater incentive than under current law to shift their residence overseas, although Congress could try to discourage such inversions through legislative action. Competitiveness concerns could be allayed by combining elimination of deferral with a large, revenue-neutral reduction in the U.S. corporate income tax rate.

- Roseanne Altshuler and Harry Grubert have proposed a "burden-neutral worldwide taxation" plan that would tax all foreign income currently, would require no allocation of expenses to foreign income, and would lower the U.S. corporate tax rate to maintain the current overall tax burden on foreign income. This system would effectively end deferral for U.S. resident multinationals and thus dramatically reduce incentives to shift income.

- Altshuler and Grubert estimate that the U.S. corporate tax rate on foreign income would have to be cut to 28 percent (the top rate is now 35 percent) for their proposal to be burden neutral. This, however, is a "static" estimate that does not account for behavioral responses, such as changes in income shifting behavior or reduced incentives for firms to lower their foreign tax liability.

- The proposal would not completely eliminate incentives for foreign-based multinationals to shift income, and U.S. multinationals would still have an incentive to change the location of corporate ownership through inversions. In addition, U.S. multinational firms with excess foreign tax credits would still benefit from income shifting.

- A territorial system would exempt the foreign income of U.S. multinational firms from taxation. Such a system would likely enhance the competitiveness of U.S. firms in low-tax countries, potentially increasing the external benefits associated with multinationals’ activity in the United States.

- The most important argument against a territorial system is that, by exempting foreign income, it would reinforce an already strong tax incentive to locate both economic activity and profits in
low-tax countries. Such tax-motivated changes in behavior are generally economically inefficient and could further erode the U.S. corporate income tax base.

- Depending on its design, a territorial system could bring in less tax revenue than the existing system. One recent study found evidence that, among industrial countries, those with territorial systems raise less corporate income tax revenue than countries with a tax credit system, all else equal. Harry Grubert and John Mutti have suggested that revenue could increase, however, if taxes are raised on interest and royalty income from abroad and interest allocation rules are changed.

- A territorial system could simplify taxation of international income, because exempting foreign income from taxation would reduce the need for tax planning regarding foreign income repatriation. However, firms under the new system would still have to distinguish between foreign and domestic income, identify passive income, and appropriately allocate expenses to their operations in different countries. In addition, stronger incentives to shift income would exert even greater pressure on existing transfer pricing rules.

See Also
International Taxation: How does the U.S. international tax system work?
International Taxation: How does the tax system impact U.S. competitiveness?
International Taxation: What are the consequences of the U.S. international tax system?
International Taxation: How would formulary apportionment work?

Author: Kimberly Clausing
Last Updated: October 17, 2007

Further Reading


THE TAX POLICY
BRIEFING BOOK
A Citizens' Guide for the 2008 Election and Beyond

INCREMENTAL REFORM

Why are taxes so complicated? ............................................................... III-3-1
How costly is complexity? ................................................................. III-3-2
What are the benefits of simpler taxes? .............................................. III-3-5
What policy reforms could simplify the tax code? ........................ III-3-6
Tax Simplification: Why are taxes so complicated?

Almost everyone agrees that the current tax system is too complicated, yet almost every year the system gets more complex, not less. Why? The reason is that simplicity almost always conflicts with other tax policy goals. Most people believe taxes should be fair, conducive to economic prosperity, and enforceable, as well as simple. But even people who agree on these goals often disagree about the relative importance of each. As a result, policies usually represent a balance among competing goals, and simplicity often loses out to other priorities. For example, most countries tailor tax burdens to the characteristics of individual taxpayers. That can make taxes fairer but also more complex. Income has to be traced from businesses to individuals. Individual characteristics such as marital status and number of dependents, as well as the composition of expenditure or income, have to be reported and documented. These conflicts appear to have been especially relevant in the current tax code, where desires to channel tax cuts to particular groups have added significant complexity.

- The political process creates complexity. Politicians and interest groups support tax subsidies for particular groups or activities. Targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers and among sources and uses of income.

- Some complexity is necessary to deter tax avoidance. Taxpayers have every right to reduce their taxes by any legal means. But their doing so inevitably raises questions about whether particular activities or expenditures qualify for tax-preferred status. The Treasury Department responds with rules designed to limit avoidance. Taxpayers in turn respond by inventing transactions to skirt the new rules. This can create a vicious cycle that leads to more and more complex rules and increasingly sophisticated and complex avoidance strategies.

- Many complicated provisions were enacted to raise revenue or limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986, although a remarkable accomplishment in many respects, fell short of its goal of simplicity in order to meet the requirement of revenue neutrality. The 1986 act created several complicated phase-outs and hidden taxes in order to raise revenue and meet distributional targets.

See Also

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: How costly is complexity?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Tax Simplification: How costly is complexity?

If policymakers knew how much a given change in the tax code would raise or lower taxpayers’ compliance costs (and government’s administrative costs), they could more easily evaluate the trade-offs between complexity and other goals. But complexity and its costs are hard to quantify. Calculating the total resource costs of the current tax system requires dividing those costs into several components: the value of the time it takes individuals and businesses to comply with the tax system, the out-of-pocket costs they incur (for recordkeeping, outside tax preparation, and the like), and the administrative costs borne by government. A number of surveys have tried to measure the burden of tax compliance. Although results vary, most surveys find that the average taxpayer devotes relatively little time to paying taxes, but that a small subset of taxpayers (many of them high-income and self-employed individuals) devote much more.

- One recent study estimated that taxpayers spent 3.2 billion hours and $18.8 billion preparing and paying taxes in 2000. These figures correspond to an average of 25.5 hours and $149 per taxpayer, although these estimates varied by complexity of tax form. Taxpayers filing a 1040EZ, a simplified tax form, spent an average of just 8.1 hours and $17 per return, while taxpayers filing the more complex 1040 form spent an average of 33.8 hours and $205 per return.

- In 1998, 38 percent of taxpayers filed a simplified version of the standard 1040 form, either the 1040A or the 1040EZ. Another 8 percent were eligible to file using these simple forms but elected to file a 1040 form instead. Another 6 percent had to use the 1040 but did not itemize deductions, claim capital gains or losses, or have business income.

- Another study found that although the average taxpayer reported spending 27.4 hours on filing income tax returns and related activities, 30 percent spent less than 5 hours, and 15 percent spent between 5 and 10 hours. At the high end, 11 percent spent 50 to 100 hours, and 5 percent spent more than 100 hours. Out-of-pocket costs averaged $111 (in 2007 dollars), but 49 percent of filers had no such costs, and another 17 percent had costs below $84 (in 2007 dollars). Slightly over 7 percent of taxpayers spent more than $337 (in 2007 dollars). High-income and self-employed taxpayers spent the most time and money preparing their taxes.

- Information on the use of paid preparers gives further hints about how complex individuals find the system to be. In 1998, 53 percent of tax filers used paid preparers. Among those who filed the 1040, 64 percent used preparers. Even among 1040A and 1040EZ filers, 35 percent used preparers. It is unclear, however, whether these figures indicate that individuals are using paid preparers because they cannot navigate the tax code themselves, or whether they simply prefer to pay others to do their taxes.

- The IRS currently uses the ADL models to estimate the time required to complete forms and schedules. These estimates are published with the tax forms as part of the Paperwork Reduction Act Notice. For fiscal 1997, the Office of Management and Budget estimated that taxpayers needed 5.3 billion hours to comply with the requirements of all tax forms and Internal Revenue Service regulations. This estimate applies to both businesses and individuals and includes all federal taxes, not just income taxes.
Using these and other estimates of hours spent, several notable studies have placed the dollar cost of taxpayer time within a range of $103 billion to $380 billion (in 2007 dollars), although the higher end of the range likely overstates the true cost. Adjusting for methodological issues and indexing for inflation yields a realistic range of taxpayer compliance costs of between approximately $105 billion and $175 billion annually, in 2007 dollars. New developments in taxpayer compliance, such as electronic filing, suggest that a new survey is needed to accurately measure the cost today of complying with the tax code.
See Also

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: Why are taxes so complicated?

Data Sources


Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007

Further Reading


President’s Advisory Panel on Tax Reform, Final Report (Washington, 2005).


Tax Simplification: What are the benefits of simpler taxes?

Simpler taxes could improve the tax code in at least two important ways. First, simpler taxes would lower taxpayers’ costs of complying with the tax system in terms of time, money, and mental anguish, thus reducing the overall burden of taxation. Second, tax provisions that are simpler are more likely to be used. Provisions aimed at encouraging certain activities, such as saving for college, will be less effective if people cannot understand how they work and therefore do not use them.

- Making taxes simpler would probably raise compliance rates, by reducing both inadvertent and intentional nonpayment of taxes, and illegal tax evasion. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Clarifying and simplifying tax rules can only help to make people understand the tax law better and would likely make it easier to enforce the law as well. Evidence also suggests that people are more likely to evade taxes that they consider unfair. People who cannot understand tax rules may also question the fairness of the tax system and feel that others are reaping more benefits than they are. This may make them more likely to evade taxes.

See Also

- Tax Simplification: Why are taxes so complicated?
- Tax Simplification: How costly is complexity?

Further Reading


Tax Simplification: What policy reforms could simplify the tax code?

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers’ personal characteristics. Doing so would not only reduce compliance costs, given current administrative structures, but also allow for simpler administration. For example, if everyone paid the same tax rate on dividends, the tax could be collected at the firm level, without having to trace the dividend payments to individuals. The general structure of a simple tax system would be a broad tax base with rates that are the same across different income sources or types of expenditure. Progressivity could be embodied in the rate structure (with rates rising with income, as they are now), the initial exemption amount, and the choice of the tax base, rather than in the design of specific provisions. Universal exemptions, deductions, or credits are much simpler than targeted ones.

- Several reforms could make the current tax system simpler as well as fairer and more conducive to economic growth. One reform would be to resolve the uncertainty created by the sunset, phase-in, and phase-out provisions of the 2001 and 2003 tax acts. Having numerous tax provisions dangle for an indefinite period does not simplify the tax code. (It would also make sense to decide whether to keep permanently or to abolish the entire set of temporary tax provisions that existed even before 2001.)

- Another option would be to reform the individual alternative minimum tax (AMT). To spare the middle-income taxpayers who were never its target, the AMT should be indexed for inflation, deductions should be allowed for dependents and for state and local taxes, and all personal credits should be available against the AMT. Any new proposal that cuts regular income tax liabilities should be required to make conforming adjustments to the AMT so that more taxpayers are not subjected to it.

- A third option would be to coordinate credit phase-outs. A number of tax credits phase-out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phase-outs also create hidden taxes over the phase-out range and diminish the effectiveness of the credits in encouraging the very activities they are designed to spur.

- In a number of areas, numerous provisions—each with slightly different rules—apply to the same general activity. Coordinating or consolidating these provisions would simplify taxes, often with little or no forgone revenue. Examples include the various provisions relating to families with children (the earned income tax credit, the dependent exemption, and the child credit), tax subsidies for education (the Hope and Lifetime Learning credits and the deduction for tuition and fees), and saving incentives (traditional Individual Retirement Accounts (IRAs), Roth IRAs, educational IRAs, and Keogh plans), and the plethora of different tax rates for capital gains.

- One could also reduce the top tax rates and tax capital gains as ordinary income. This was the cornerstone of the deal struck in 1986 that allowed substantial simplification of the individual income tax. It would massively reduce incentives to create tax shelters and the need to engage in complex tax planning.
See Also

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: How costly is complexity?

Data Sources

Tax Policy Center Table T04-0174, "Repealing the AMT and Disallowing the Deduction for State and Local Taxes."

Tax Policy Center Table T07-0212, "Tax Capital Gains and Qualified Dividends as Ordinary Income."

Further Reading


 Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
THE TAX POLICY
BRIEFING BOOK

A Citizens' Guide for the
2008 Election and Beyond

NATIONAL RETAIL SALES TAX

What is it? ................................................................................................................................. III-4-1
What would and would not be taxed?.................................................................................... III-4-2
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National Retail Sales Tax: What is it?

The national retail sales tax is a proposed fundamental tax reform that would replace the income tax system with a consumption tax, to be collected by levying a flat-rate tax on all retail sales from businesses to households.

- Retail sales occur when businesses sell goods or services to households. Neither business-to-business nor household-to-household transactions are retail sales. For example, the sale of a newly constructed home to a family that will occupy it is a retail sale. But the sale of that same newly constructed home to a business that intends to rent it to others is not a retail sale, nor is the sale of an existing home from one occupant to another.

- A pure national retail sales tax would represent a sharp break from the current tax system. The tax base would shift from income to consumption. Rates would be flat. All special exemptions, deductions, and credits would be eliminated. Tax administration, enforcement, and points of collection would be radically altered.

- No country in the history of the world has enacted a retail sales tax at anywhere near the rates that would be required to replace the U.S. tax system. Whether such a tax could be implemented effectively is therefore an open question.

See Also

National Retail Sales Tax: What would and would not be taxed?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: Who would bear the burden?

Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: What would and would not be taxed?

Under a pure national retail sales tax, all consumption expenditures by individuals and by federal, state, and local government agencies would be subject to the tax. (Purchases by businesses are, by definition, not retail sales and so would not be subject to tax.) However, no sales tax in history has come close to such an ideal tax base. Some items, such as imputed financial services, are quite difficult to tax. Other items might not be taxed for reasons of social policy, such as child care, rent, food, housing, and health care. Powerful political influences also often successfully lobby for exemptions from the sales tax, just as they do from the income tax. As a result, very few of the state sales taxes currently in existence tax many of the items listed above, and none tax all of them. Hence there is no precedent for a broad-based national retail sales tax that would include all consumption expenditures by individuals and government.

Exempting selected sectors, however, would cause serious problems for a national retail sales tax. The broader the tax base, the lower the tax rate can be and still raise the same amount of revenue. As discussed elsewhere, the required tax rate under a national retail sales tax would have to be very high to replace existing federal taxes, even with a broad tax base. But health, food, and housing make up about half of all personal consumption, so that exempting even one of these sectors would cut deeply into the sales tax base, forcing the required rate even higher.

- Even with extreme political discipline in avoiding subsidies, it would be difficult to tax more than 80 percent of personal consumption. Retaining some of the major preferences in the income tax could reduce the private consumption base to about 60 percent of personal consumption.

- A national retail sales tax would need to tax all consumption and investment purchases made by state and local governments. Leaving these transactions out of the tax base would reduce the base substantially, which would in turn raise the required tax rate for a given amount of revenue. Taxation of government transactions would also be necessary to ensure that private industry is not placed at a disadvantage when competing with public suppliers of goods and services. Taxing government transactions would likely add complexity to a system that its advocates laud for its simplicity.

- Although the details of the various national retail sales tax proposals vary, they generally maintain several similar tax base characteristics. Exemptions would be provided for business purchases and education, both of which are considered investment. Domestic purchases by foreigners would be taxed; foreign purchases by U.S. residents would not.

- Employer-provided health insurance would be taxed. Economists Jonathan Gruber and James Poterba have calculated that this tax change would boost the price of health insurance by an average of 21 percent. They estimate that this price increase would reduce both the number of people insured (by between 6 million and 14 million) and the amount of insurance that each remaining insured person would choose to carry.

- The existing deductions for mortgage interest and property taxes would disappear with the income tax. This would reduce the value of all residential housing. Newly constructed houses sold to occupants would be subject to the sales tax. But already existing houses would generally not, because sales of a house from one household to another would be exempt since they do not rep-
resent a retail sale (i.e. a sale from a business to a household). This would boost the cost of buying a new house relative to existing houses.

See Also

National Retail Sales Tax: What is it?
National Retail Sales Tax: Who bears the burden?
National Retail Sales Tax: What would the tax rate be?
National Retail Sales Tax: Why wouldn’t the rate be 23 percent?

Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" Tax Notes 107, no. 7 (2005): 889-991.


President’s Advisory Panel on Tax Reform, Final Report (Washington, 2005).

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: What would the tax rate be?

Perhaps the most controversial aspect of the national retail sales tax has been its rate: how high would it have to be to replace all revenue from the current tax system? Determining the revenue- and budget-neutral tax rate for such a tax requires making assumptions about three things: the rates of tax evasion and tax avoidance; the extent to which deductions, exemptions, and credits would be retained in the tax base; and the impact on economic growth. Under the optimistic assumption of a very broad base, and extremely conservative assumptions about evasion and avoidance, the tax rate would have to be 44 percent (on a tax-exclusive basis, or 31 percent on a tax-inclusive basis) to replace existing federal taxes in revenue-neutral fashion over the next ten years. Other analysts have estimated even higher required rates.

<table>
<thead>
<tr>
<th>Evasion rate</th>
<th>Extended base(^a)</th>
<th>Median State Sales Tax Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower evasion (15%)</td>
<td>34%</td>
<td>64%</td>
</tr>
<tr>
<td>Higher evasion (30%)</td>
<td>46%</td>
<td>89%</td>
</tr>
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</table>

Notes:
(a) The extended base refers to the tax base described by advocates of the FairTax proposal, which includes all sales of goods and services to consumers except educational services, expenditures by U.S. residents abroad, food produced and consumed on farms, and existing housing.

Source: President’s Advisory Panel on Tax Reform (2005).

- A key issue in determining the required tax rate is how to define the tax rate. Suppose a good costs $100 before tax and has a $30 sales tax. The tax-exclusive tax rate would be 30 percent, since the tax is 30 percent of the pre-tax selling price. The tax-inclusive rate would be about 23 percent, which is obtained by dividing the $30 tax by the total cost to the consumer ($100 + $30). Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax-inclusive rates. For example, a household that earns $130 and pays $30 in
Income taxes would normally think of itself as facing roughly a 23 percent (30/130) income tax rate.

- Although there is no single correct way to report the sales tax rate, it is crucial to understand which approach is being used. The tax-inclusive rate will always be lower than the tax-exclusive rate, and the difference grows as the rates rise. At a rate of 1 percent the difference is negligible, but a 50 percent tax-exclusive rate corresponds to a 33 percent tax-inclusive rate—a 17-percentage-point difference.

- The total sales tax rate that households would face would likely be significantly higher than the federal rates indicated above, because existing state sales tax would be added. In addition, most or all state income taxes would probably be abolished in the absence of a federal income tax system, since the state income tax systems depend on the federal system for reporting of income and other information. Today’s state income taxes would likely be converted to sales taxes, adding considerably to the combined sales tax rate.

- The President’s Advisory Panel on Tax Reform, using different but reasonable assumptions about tax evasion and the breadth of the tax base, estimated the required tax-exclusive tax rate to be in the range of 34 to 89 percent. Their highest estimate assumes that tax evasion would be moderate and that the federal tax base would equal the median state sales tax base.

- Other reforms would serve to further raise the required rate. Transition relief provided to households would reduce the tax base and raise the required rate even higher. And if major consumption items such as food, housing, or health care were exempted from the base (the assumptions above do not allow for such large exemptions), the rate on the remaining goods and services would rise still higher.

**See Also**

- National Retail Sales Tax: What is it?
- National Retail Sales Tax: Why wouldn’t the rate be 23 percent?
- National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

**Further Reading**

- Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: Why wouldn’t the rate be 23 percent?

Advocates of a national retail sales tax have suggested that such a tax at a 23 percent rate would be sufficient to replace the entire federal tax system. This estimate is misleadingly low for a variety of reasons, in part because it assumes that there will be no evasion or avoidance of the tax and no exclusion of hard-to-tax items from the tax base. Furthermore, the 23 percent rate they cite is a "tax-inclusive" rate, which corresponds to a 30 percent tax-exclusive rate. Besides all this, the 23 percent rate advocates cite is based on a mathematical error in the way they compute the changes in consumer and producer prices that would occur under the proposed tax. For all these reasons, the 23 percent tax rate can be considered unrealistic given plausible and accurate assumptions about how a national retail sales tax would be implemented.

- The 23 percent tax rate cited by advocates of the NRST is a tax-inclusive rate; the mark-up at the cash register under a 23 percent tax-inclusive rate would be 30 percent.

- Proponents assume that there will be no evasion, no avoidance, no erosion of the statutory base due to political pressure to exempt certain goods and services, and no exceptions for hard-to-tax items. This makes the effective tax base in their calculations much larger than it would be likely to be in a real-world implementation; hence the required tax rate in their calculations is much lower than it would be in a real-world setting.

- Advocates also made a mathematical mistake in calculating their required tax rate. An analysis of the required rate in a sales tax requires a consistent set of assumptions about what how consumer and producer prices will change relative to the current system. Producer prices could either remain constant in nominal terms, fall by the entire amount of the previously embedded taxes, or fall by an amount somewhere in between. Consumer prices are just producer prices plus the sales tax. (So, for example, if producer prices remained constant in nominal terms after the transition to a sales tax, consumer prices would rise by the full amount of the sales tax.) In calculating their required rate, advocates assumed that producer prices would remain constant when they calculated the revenue the government would obtain from the tax, but they then assumed that producer prices would fall when calculating the amount of spending the government would have to do to maintain current programs. These assumptions are obviously inconsistent, and they either understate government spending needs, overstate the likely revenue, or both. Making a consistent assumption about producer prices-whichever of the three above options one chooses-leads to a significantly higher rate than advocates assumed.
See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: What and would not be taxed?

National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.


President’s Advisory Panel on Tax Reform, *Final Report* (Washington, 2005)
National Retail Sales Tax: What is the difference between a “tax-exclusive” and “tax-inclusive” sales tax rate?

A tax-exclusive tax rate refers to the amount of tax paid as a proportion of the pretax value of whatever is taxed; sales tax rates are typically expressed in tax-exclusive terms. A tax-inclusive rate, conversely, refers to the amount of tax paid as a proportion of the after-tax value; income tax rates are often expressed in tax-inclusive terms. Thus the difference between the two definitions is whether or not the tax paid is included in the denominator when calculating the tax rate.

- Although there is no single correct way to report a sales tax rate, it is crucial to understand which approach is being used. The tax-inclusive rate will always be lower than the tax-exclusive rate, and the difference grows as the rates rise. At a rate of 1 percent the difference is negligible, but a 50 percent tax-exclusive rate corresponds to a 33 percent tax-inclusive rate—a 17-percentage-point difference.

- As an example, suppose a good costs $100 before tax and has a $30 sales tax. The tax-exclusive tax rate would be 30 percent, since the tax is 30 percent of the pre-tax selling price. The tax-inclusive rate would be about 23 percent, which is obtained by dividing the $30 tax by the total cost to the consumer ($100 + $30).

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See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: Why wouldn’t the rate be 23 percent?

National Retail Sales Tax: What would the tax rate be?

Further Reading


President’s Advisory Panel on Tax Reform, Final Report (Washington, 2005).

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: Who would bear the burden?

Under a national retail sales tax, the wealthiest households in the country would receive stunningly large tax cuts. Households in the top 1 percent of the income distribution have an average income of about $475,000. Their average tax cut would be $79,000, or more than the incomes of all but about 8 percent of households. Put another way, the roughly 1.1 million taxpayers in this top 1 percent would save a total of $87 billion on their taxes each year. This cut would be financed by tax increases on the bottom 92 percent of households. Households with income between $5,000 and $50,000 would face an average tax increase of over $1,000.

- The existing tax system, which includes income, corporate, estate, and payroll taxes, is generally progressive. Households with incomes between $5,000 and $10,000 pay an average effective tax rate-defined as taxes actually paid divided by income-of under 9 percent. The average effective tax rate rises with income to about 25 percent for households with incomes between $100,000 and $200,000, and then to about 32 percent for the fewer than 1 percent of households with incomes above $200,000. The current system is not completely progressive, however. Households in the lowest income group, those with incomes less than $5,000, pay an average effective rate of almost 12 percent, which is higher than households in the next group.

- The proposed national retail sales tax has been shown to be a relatively proportional tax for much of the population; that is, effective rates would vary little with income. Average effective tax rates would at first rise modestly as incomes rise, from about 20 percent for households with incomes between $5,000 and $10,000 to 23 percent for households in the $20,000 to $40,000 range, and would then fall back to 20 percent as income rises to $100,000 to $200,000. At the extremes, however, the national retail sales tax would be quite regressive. The average rate for the lowest income group would exceed 33 percent, while the average for the top group would fall to less than 16 percent. These results suggest that converting to a national retail sales tax would be a highly regressive shift when measured against annual income.

- A common claim is that a reform that includes a national retail sales tax would be "pro-family." Advocates usually point to the proposed demogrant as proof of this assertion. However, the demogrant is only one policy that affects children and families with children. Families with children would likely be hurt both by the elimination of current deductions for health insurance, mortgage interest, and state and local income and property taxes (which finance schools and other government services) and by the elimination of various tax credits (the earned income credit, child care credits, education credits, and child credits). Moreover, at any given income level, families with children have higher consumption requirements than couples without children, so that switching to a consumption tax would present an inherent disadvantage for families with kids.
### Distributional Implications of Replacing Total Personal Income Tax (TPIT) with a National Sales Tax

<table>
<thead>
<tr>
<th>Income ($) (millions)</th>
<th>Tax units (millions)</th>
<th>PIT</th>
<th>TPIT</th>
<th>Food, medical housing</th>
<th>Retail sales tax exempt-</th>
<th>Retail sales tax with demogrant based on family size and poverty</th>
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<td>0 - 5,000</td>
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<th>Income ($) (millions)</th>
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<td>6.8</td>
</tr>
</tbody>
</table>

**Notes:** Authors' tabulations using Tax File CPS-CES merged file as described in text. Food exemption relates only to food consumed at home. Income concept used includes the imputed value of owner occupied housing and medical expenses that are not out of pocket.

**Source:** Feenberg, Mitrusi, and Poterba (1997).
See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: How much avoidance and evasion would there be?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: How much avoidance and evasion would there be?

Advocates of the national retail sales tax claim that tax avoidance and tax evasion on legally generated income would decline and that tax revenue collected from the underground economy would rise significantly. Critics view these claims as somewhere between overoptimistic and nonsensical. The President’s Advisory Council on Tax Reform noted in its final report that "A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide substantial inducement for evasion at the retail level."

- By eliminating the current tax system, the national retail sales tax would eliminate the use of current avoidance and evasion schemes, but that does not mean it would eliminate avoidance and evasion. It would simply change the locus and nature of such activities.

- The overall rate of evasion of the U.S. income tax is estimated at around 15 percent, or possibly a bit higher. But this figure masks great heterogeneity in evasion by form of income. At one extreme, for income where taxes are withheld and reported to government by a third party (predominantly wages), the evasion rate is about 5 percent. At the other extreme, where taxes are not withheld and there is no cross reporting, the evasion rate is as high as 50 percent. A national retail sales tax would feature no withholding and no cross reporting, and so the possibility of high rates of evasion needs to be taken quite seriously.

- Individuals might engage in tax avoidance under a national retail sales tax in several ways. They might misreport personal consumption as business activity, for example using the company car for personal use. The treatment of property that involves mixed consumer and business use would also be a problem, as would the verification of retail goods purchases by business representatives for personal use (think of a bar owner purchasing a television or a restaurant manager buying cooking supplies).

- Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than what would be expected under a national retail tax, since the tax rate under a national plan would be significantly higher than the rates applied by the states. Underreported sales would be much higher under a national retail tax than under current sales taxes, for two reasons: enforcement currently relies on cross verification with federal and state income taxes, and the effective state sales tax rates are currently quite low. Under a national retail sales tax, both of these conditions would change.

- One of the major claims of national retail sales tax advocates is that it would be more effective than the current system at raising revenue from the underground economy. The example frequently offered is that of a drug dealer who does not pay income tax on his earnings today but would be forced to pay the national retail sales tax if he took the funds and bought, say, an expensive car. The problem with this argument was laid out by former Congressman Dick Armey: "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers" and send them to the government. In the end, neither system taxes the drug trade.
See Also

National Retail Sales Tax: What is it?
National Retail Sales Tax: What would the tax rate be?
National Retail Sales Tax: Why wouldn't the rate be 23 percent?
National Retail Sales Tax: What is the experience of other countries?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


National Retail Sales Tax: What would be the effect on economic growth?

In theory, moving to a national retail sales tax would provide additional avenues for economic growth. Estimates using plausible assumptions suggest that if a relatively pure version of such a tax were effectively implemented, the growth effects would be positive but modest, especially over the first ten years or so.

- Changing the tax base from income to consumption enhances the after-tax return to saving and investment. More saving and investment results in a larger capital stock, which improves workers’ productivity and raises output. The double taxation of previously existing assets during the transition to a national retail sales tax would allow for lower rates on the rest of the tax base, and thus would encourage additional growth.

- However, the world is not that simple. Many forms of saving—including all pensions and 401(k) plans and most Individual Retirement Accounts—already receive consumption tax treatment, and many forms of corporate income are not taxed at all. Moreover, under a national retail sales tax the transitional rules governing existing assets could reduce the effect on saving further.

- A number of analysts have constructed models capable of generating realistic estimates of the impact of fundamental tax reform on growth. The most complete model, developed by David Altig and colleagues, shows the effects of moving from the current system to a flat-rate consumption tax. Their analysis of such a reform, which assumes a less generous demogrant than proposed by national retail sales tax advocates, transition relief for existing assets, and no avoidance or evasion of the new tax, finds that the economy would be 0.6 percent larger than otherwise after two years, 1.8 percent larger after ten years, and 3.6 percent larger in the very long run. Plausible allowances for avoidance, evasion, and the incorporation of a more generous demogrant would reduce these already modest estimates.

- It appears on both conceptual and empirical grounds that switching to a national retail sales tax would raise consumer prices, with several economic effects. First, anyone holding nominal (that is, non-inflation-protected) financial assets—such as balances in saving accounts, CDs, or bonds—would see a drop in the value of those assets. Conversely, issuers of nominal debt, including the government, would see a reduction in the real burden of their debt outstanding.
See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What transition rules would be needed?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading

National Retail Sales Tax: What transition rules would be needed?

Any tax reform that seeks to collect the same amount of revenue in a new way may redistribute tax burdens among taxpayers, affect asset values, and change price levels. Those who stand to lose often seek to prevent the reform or to secure "transition relief," which avoids or delays the full brunt of the new law. The national retail sales tax proposal illustrates these issues starkly, because it would impose a single tax rate on all consumption, with limited, or no special provisions and only limited transition relief. A practical question is whether such a proposal can withstand the inevitable political pressures to restore preferential treatment or introduce transition relief. The issue is pivotal, because adding these changes would fundamentally alter the character of the reform.

Determining how to handle these transition issues creates an interesting dilemma. At one extreme, the pure sales tax would allow no adjustments. At the other logical extreme, policymakers could choose to grant extensive "transition relief," by adjusting Social Security benefits, allowing consumption to be tax-free if financed by assets existing at the time of the reform, and so forth. In practice, the transition relief that has accompanied much smaller tax reforms has tended to turn into a bonanza of hidden tax breaks and subsidies.

- The economic case for transition relief depends on the impact of such relief on the simplicity, efficiency, and equity of the tax system. Not providing transition relief is, in a sense, simpler. Transition rules could prove very complex, and the transition period could stretch out for years. However, not providing relief would also cause complexity by instituting strong incentives for individuals to adjust their behavior before the tax takes effect.

- Not providing transition relief would also be more efficient. Because future consumption can be financed only from future wages or existing assets, a consumption tax is a tax on those wages and assets. A consumption tax that exempts old assets is just a tax on future wages. Whereas a pure consumption tax (one that taxes all old capital) is usually found to be more efficient than a pure income tax, a wage tax (which exempts all old capital) is usually found to be less efficient than a pure income tax. The reason is that not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, and this creates more distortions of people's work decisions.

- Surely the strongest argument for transition relief is fairness. The assets that people own today were priced, purchased, and used under the current tax system. Is it fair to them to change the rules in midstream? But the answer may not be as obvious as it seems. First, a one-time implicit tax on existing capital would be very progressive. The distribution of such capital is more skewed toward wealthy households than is the distribution of overall wealth, which in turn is more skewed than the distribution of income. Second, within any age group, wealthy households do most of the saving. Since these households will benefit most from eliminating the double taxation on future saving, it is reasonable that they should pay for some of the costs. Third, older households tend to have more assets than younger ones, and therefore taxing existing capital places heavier burdens on older generations. But those older households have received transfers through Social Security and Medicare that far exceed what they have put in. And the vast majority of the income and wealth of most elderly households is in the form of earnings (which have not yet been taxed), housing (which receives extraordinarily preferential treatment under the current tax system), pension income (which already receives consumption tax treatment), Social Security benefits (which everyone agrees would be indexed for inflation with tax re-
form), and Medicare benefits (which are not taxed). Relatively few elderly households finance much of their living expenses from other assets, and those that do tend to be very well off.

- Ultimately, the political case for transition relief would determine whether such relief occurs. And political factors overwhelmingly suggest that it would. Even in much smaller tax reforms, the losers-households or businesses made worse off by the reform-have been compensated. Transition relief would therefore almost surely be needed to garner sufficient support for major tax reform.

See Also

National Retail Sales Tax: What is it?
National Retail Sales Tax: What did the President’s Advisory Panel on Tax Reform say?

Further Reading


Gale, William G., "The National Retail Sales Tax: What Would the Rate Have To Be?" *Tax Notes* 107, no. 7 (May 16, 2005).

National Retail Sales Tax: Would it simplify the tax code?

As a flat-rate consumption tax with a universal demogrant for families, the proposed national retail sales tax contains many of the features that make taxation simpler. Most individuals would no longer need to keep tax records, know the tax law, or file returns. Only those who own sole proprietorships, partnerships, or S or C corporations that make retail sales would have to file. And even for these taxpayers the complexity of filing a return would decline dramatically. But a national retail sales tax could create new areas of complexity, for example in administering the proposed demogrant, in enforcing the tax code to ensure that personal and business consumption are not mixed, and in monitoring exemptions for the importation of foreign goods.

- The demogrant that, in many proposals, would accompany a national retail sales tax would likely be based on the existing poverty line, which rises less than proportionally with the number of family members. For example, in 1998 the poverty line was $8,050 for a single individual and rose by $2,800 for each additional family member. Thus the poverty level for a family of four in that year was $16,450, just over twice the level for an individual. Basing the demogrant on the poverty line would thus create incentives to conceal family relationships so as to claim the demogrant for more than one individual in a family. It is also not obvious how the demogrants would be administered, or even which agencies would be responsible for determining eligibility and monitoring claims. Thus compliance and administrative costs could be significant.

- Another area of potential complexity stems from the threat of tax avoidance and evasion. The most likely way that people would try to avoid the tax would be by disguising personal consumption as business activity, since business-to-business transactions would not be taxed. For example, individuals might seek to register as firms, or to purchase their own consumption goods using a business certificate; or employers might buy goods for their workers in lieu of paying wages. Ensuring that all business purchases are not taxed and that all consumer purchases are taxed would require all businesses to keep records of their transactions, even though only retailers would actually have to remit the tax. Certain proposals deviate from a pure retail sales tax by requiring that taxes be paid on many input purchases, and that vendors file explicit claims to receive rebates on their business purchases. This would raise compliance costs further.

- Imports would be another potential source of tax avoidance and evasion. Under some proposals, each year a certain amount of imported purchases would be exempt from the tax. This feature would likely be exploited fully by many taxpayers, even those who do not travel abroad: it would be simple for firms to set up offshore affiliates, warehouses, or mail order houses, ship goods from them to domestic customers, and claim that the goods are tax-exempt imports. It would be very difficult to monitor such arrangements, and it seems quite likely that taxpayers could end up importing more than their annual exemption. Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes, under which taxpayers voluntarily make tax payments on goods purchased in other states. One analyst described enforcement of such taxes as "dismal at best." The development of electronic commerce could amplify avoidance and evasion problems.
See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would and would not be taxed?

National Retail Sales Tax: What transition rules would be needed?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: What did the President’s Advisory Panel on Tax Reform say?

The President’s Advisory Panel on Tax Reform rejected replacing the current tax system with a national retail sales tax on the grounds that the tax would be too regressive and difficult to administer. The report noted that "lower and middle-income families would be especially hard hit by a stand-alone retail sales tax." The panel was also concerned that although the proposed demigrant program to provide relief for families would make the retail tax system less regressive, it would be a massive program to administer, "by far the largest in American history," and would "inappropriately increase the size and scope of government." The panel’s estimates also showed that, with the demigrant, a national retail sales tax sufficient to replace the current tax system would require a tax rate somewhere between 34 and 89 percent. The panel’s estimated tax rates are "tax-exclusive," which means that the tax rate is equal to the tax paid as a percent of the pre-tax price of the good or service.

• The panel found that a national retail sales tax would not provide substantial tax simplification. Taxpayers would still be required to complete state income tax returns (unless states abolished income taxes as a result of a switch to a national retail sales tax), which would limit the potential simplification gains from abolishing the federal income tax. In addition, a new government agency would be required to monitor both the collection of the tax and the proposed allocation of demigrants to families.

• The panel estimated the necessary tax rate under a variety of different scenarios using alternate assumptions about the frequency of evasion. Under the most optimistic scenario, which assumed no taxpayer evasion and the broadest feasible base, and excluded demigrants to low- and middle-income families, the required rate would be 22 percent (in tax-exclusive terms). And taxpayers would continue to pay state sales taxes, at rates currently averaging 6.5 percent. Under scenarios that did include a demigrant, the required rate ranged from 34 percent to 89 percent (in tax-exclusive terms).

• The panel’s report expressed concern about the level of evasion, stating, "A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide substantial inducement for evasion at the retail level." The report stated that third-party reporting, notably absent from the proposal, would significantly improve the likelihood of compliance. In circumstances where there is no third-party reporting, "evasion rates are estimated to be around 50 percent."

• The panel voiced several concerns about the ability of the federal government to administer the tax, and of small businesses to collect it. It noted that the states would lack the ability to collect the tax, and that an agency analogous to the Internal Revenue Service would be required for administration. The panel also observed that state income taxes, whose administration relies on the federal income tax system, would become much more difficult to administer if that system were to disappear. Lastly, the report cited concern that the burden of collecting the tax would disproportionately fall on small businesses and small service providers.
See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: Who would bear the burden?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
National Retail Sales Tax: What has been the state and local experience?

The first sales tax in the United States was a tax of last resort, established in Mississippi in the 1930s to raise revenue during the Depression. Today sales taxes are relatively common in the United States, used by 45 states, the District of Columbia, and over 6,000 localities. State sales tax rates currently range from 3 percent to 7 percent (in tax-exclusive terms). The tax base used varies widely across states. The states with higher-yielding sales taxes tend to have tourist economies, so that taxes in these states are collected in large measure from nonresidents.

The state sales taxes appear to be poor models for broad-based federal tax reform, for several reasons. States show little inclination to exempt producers completely. But without a much more complete exemption of producer purchases in a national retail sales tax, cascading would present a significant problem. Furthermore, states make little effort to tax services, and they exempt broad categories of purchases for reasons relating to social and economic policy, tax administration, and political pressure. The federal base would have to be much broader than the typical state base, or else rates would skyrocket. The states offer only limited and varied experience in taxing government, but the federal proposals envision taxing every dollar of government purchases and investment. Finally, in state systems relief for low-income households is provided through product exemptions, as opposed to the demogrannts proposed for a national tax.

- A uniform retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. About twenty-five states exempt food, twenty exempt electricity, seventeen exempt telephone service, and six exempt at least some type of clothing. The most commonly exempted good is prescription medicine. Commodities subject to excise taxes—motor fuel, alcohol, and cigarettes—are usually exempt, even though this at least partly defeats the purpose of imposing separate excise taxes.

- Product exemptions raise important issues. Family cash allowances would be simpler to administer, would induce fewer distortions of household behavior, and—according to some studies—would be at least as progressive as specific product exemptions. Yet product exemptions are quite popular. State legislatures may find them attractive because they appear progressive, and industry groups that benefit from them may effectively advocate their continuance.

- The taxation of services is even more problematic. Although many states do tax some services, only three—Hawaii, New Mexico, and South Dakota—attempt to place all services in the tax base. Twenty-three states make no real effort to tax services at all.

- The taxation of purchases by state and local governments varies significantly across states; only eight states generally apply the sales tax to such purchases. (The federal government is exempt under the Constitution.) Sales to nonprofits and to educational, hospital, religious, charitable and similar organizations are exempted in twenty-seven states, and another fifteen exempt certain purchases by these groups. Sales of goods by nonprofits are usually subject to tax.

- Enforcement of sales taxes on services has proved difficult. These taxes are hard to administer and easy to evade, since there are fewer records to audit. This raises several red flags for a national retail sales tax. Besides the obvious erosion of the tax base, the state experience suggests that items that are difficult to tax are simply excluded from most retail sales tax systems and, again, that political pressures can easily affect the form and substance of a retail sales tax.
A retail sales tax should exempt all business purchases, but most state-level sales taxes do not come close to this ideal. A variety of estimates indicate that, on average, between 20 and 40 percent of state sales tax revenue comes from business-to-business sales. Estimates for individual states range as high as 70 percent.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What is the experience of other countries?

National Retail Sales Tax: What would and would not be taxed?

**Further Reading**


Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007
National Retail Sales Tax: What is the experience of other countries?

Many other countries have attempted to implement a national retail sales tax or variants of such a tax, such as wholesale-level taxes or "ring" taxes (retail sales taxes with business exemptions certificates for businesses "in the ring"). Almost all of these countries have ended up with value-added taxes (VATs). The general lesson from these countries is fairly clear, if perhaps often overstated. In 1967 nineteen OECD countries had some form of wholesale, retail, or turnover tax. By 1995 all nineteen had converted to VATs. Developing countries as well have largely abandoned retail sales taxes in favor of VATs.

- Retail sales tax rates are generally lower than VAT rates. According to Ken Messere, countries that have relied on retail sales taxes "tend to charge around 4-6 percent of the tax exclusive value of goods...wheras standard VAT rates tend to vary between 14 percent and 25 percent."

- The typical retail sales tax rate is also much lower than the rate advocated by proponents of the national retail sales tax. Only a few countries-Iceland, Norway, South Africa, Sweden, and Zimbabwe-have ever instituted a retail sales tax with a rate in excess of 10 percent. And none of this select group currently maintains such a tax.

- A retail sales tax with a rate in excess of 10 percent is difficult to administer, in large part because of the increased incentive for evasion. One tax policy expert, Vito Tanzi, noted, "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under an RST."

- There are good reasons why retail sales taxes get replaced with VATs, namely, cascading and evasion. Cascading occurs when taxed inputs are used to produce taxed outputs, so that the total tax on the goods compounds beyond what was intended. This can be avoided by exempting all business purchases from taxation, but it is difficult administratively, and possibly politically as well, to enforce this provision. Moving to a VAT removes the problem, since businesses receive tax credits for the taxes they paid on their input purchases.

- Evasion is higher under a retail sales tax than under a VAT for several reasons. First, retailing is the weakest enforcement link in the entire production chain. Second, if a retailer evades the tax, the full tax on the sale is lost under a retail sales tax, but only the tax on value added at the retail level is lost under a VAT. Third, there is no paper trail with a sales tax.
See Also

National Retail Sales Tax: What is it?
National Retail Sales Tax: What has been the state and local experience?
National Retail Sales Tax: What would and would not be taxed?

Authors: William Gale and Benjamin Harris
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Further Reading


RETURN-FREE FILING

What is it and how would it work? ................................................................. III-5-1
What are the benefits? .................................................................................. III-5-3
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Return-Free Filing: What is it and how would it work?

In a return-free tax system, revenue is collected through some combination of withholding and end-of-year reconciliation by the tax agency; individual taxpayers do not file annual returns. In an exact withholding system, the tax agency makes every effort to withhold the exact amount of taxes due from paychecks and other income, so that no end-of-year filing, payment, or refund is needed. In a tax agency reconciliation system, withholding occurs as under the present U.S. system, but taxpayers may elect to have the tax agency prepare their return and thus avoid the burden of tax filing.

- In a tax agency reconciliation system, tax filing occurs in four steps. Taxpayers electing the option provide certain basic information to the tax authority. The tax authority then calculates their tax liability from this information and from information returns it receives from employers, financial institutions, and other payers. The taxpayer then has a chance to review (and contest) these calculations. Finally, the agency issues a refund or the taxpayer sends a payment.

- In exact withholding systems taxpayers must report certain minimal, nonfinancial information to either their employer or the tax authority. In a U.S. system this would likely consist of the taxpayer’s name, address, Social Security number, filing status, and the names and Social Security numbers of any spouse and dependents. The employer or the tax authority uses this information to calculate withholding allowances. Taxpayers may be required to report this information on a regular basis or whenever there is a change in their circumstances.

- Two types of exact withholding systems exist. Cumulative systems (used in the United Kingdom and the Russian Federation) aim to withhold exactly the right amount of tax at each point throughout the year; final withholding systems (used in Germany and Japan) make adjustments to the final paycheck in the tax year to achieve exact withholding. Some countries combine one of these approaches with other requirements.

- A return-free system in the United States could include a larger number of taxpayers, and would be more effective, if the tax code were adjusted in several important ways: by having the vast majority of taxpayers face the same marginal (“basic”) tax rate; by making the unit of taxation the individual rather than the family; by taxing interest and dividend income at a flat rate and withholding it at the source; by largely exempting capital gains from taxation; and by limiting the number of deductions. None of these conditions, however, is necessary for the operation of a return-free system for at least some taxpayers.

- Neither an exact withholding nor a tax agency reconciliation system provides an easy way to handle capital gains, itemized deductions, business income, employee business expenses, moving expenses, or Individual Retirement Accounts, although some accommodation is possible. A key issue in either system is who bears responsibility for mistakes on the return prepared by the tax authority, and for mistakes in exact withholding made by either the tax authority or the employer or other payer. One major difference between the systems is in where the burden of tax preparation is placed: the tax authority bears much of the additional burden in a tax agency reconciliation system, whereas the burden is largely on employers and other payers in an exact withholding system.
See Also

Return-Free Filing: What are the benefits?
Return-Free Filing: What are the drawbacks?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Toder, Eric, Testimony Before the President’s Advisory Committee on Federal Tax Reform.


Return-Free Filing: What are the benefits?

The primary benefit of a return-free system is the eased burden of tax compliance on taxpayers. Depending on the extent of changes made to the current U.S. income tax structure and administration to accommodate return-free filing, the requirement to file a final tax return could be eliminated for between approximately 8 million and 60 million taxpayers. Secondary benefits include the increased simplification that could accompany such a reform, and perhaps a lessened administrative burden on the Internal Revenue Service (IRS) and correspondingly lower federal expenditure for tax collection.

- For many taxpayers, the burden of filing any tax return may involve significant psychic or emotional costs, in addition to time spent and, for some, the cost of hiring a paid tax preparer. Thus, even if the vast majority of affected taxpayers already face relatively simple tax situations, a return-free system could still provide them significant benefits. However, because state income tax systems piggyback on the federal system, unless states also shifted to a return-free system, the reduction in filing and in psychic costs would likely be minimal.

- Although taxpayers participating in the return-free system would be spared the cost of preparing a final return, the net administrative savings might not be great. Of the 62.5 million taxpayers potentially eligible, over two-thirds (44.2 million) currently file the relatively simple 1040A and 1040EZ returns. Even under a return-free system, these taxpayers would still have to provide, on a regular basis, some of the same information (such as filing status and dependents’ identification) that they do now. Further, some administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS.

- In a 1996 report, the U.S. General Accounting Office estimated that a tax agency reconciliation system could reduce the time spent preparing tax returns by as much as 155 million hours a year for 51 million taxpayers and reduce the IRS’s annual costs by up to $37 million. These estimates, however, do not take into account certain ways in which such a system might increase the administrative burden on taxpayers and the IRS. For example, 1 billion information reports would have to be filed earlier and processed much sooner by the IRS in order to complete returns by April 15 (with refunds to follow somewhat later). State income tax systems would also incur additional costs or delays.
See Also

Return-Free Filing: What is it and how would it work?

Return-Free Filing: What are the drawbacks?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Eric Toder Testimony Before the President’s Advisory Committee on Federal Tax Reform.


Return-Free Filing: What are the drawbacks?

Drawbacks to a return-free system include the potentially heavier administrative burden on employers and other businesses charged with withholding income tax, and on state and federal tax collection agencies. In addition, taxpayers and opponents of the plan have expressed concern that a return-free plan would shift taxpaying discretion to the government, limiting taxpayer independence and constraining taxpayers’ ability to appeal tax decisions by collection agencies.

- Taxpayers appear to like receiving refunds, perhaps viewing them as a form of forced saving. Moving to a cumulative exact withholding system would eliminate refunds. In a tax agency reconciliation system, however, refunds could still be obtained.

- It may be important to have a "visible" tax system, as now, on the principle that a well-informed citizenry can make better economic and political choices. In a return-free system that eliminates filing, taxpayers would presumably be less well informed about how they are being taxed, and hence less aware of the tax consequences of their actions. However, the link between filing and understanding may be overblown. Payroll taxes in the United States already operate under a return-free system for almost all taxpayers, yet interest in Social Security and Medicare does not appear to have suffered as a result.

- The Internal Revenue Service concluded in 1987 that "there are serious timing and accuracy problems" in developing a tax agency reconciliation system. Even after almost a decade of technological improvements, the U.S. General Accounting Office in 1996 agreed that significant investments in IRS processing capabilities would likely be needed to implement such a system.

See Also

Return-Free Filing: What is it and how would it work?
Return-Free Filing: What are the benefits?

Further Reading


Toder, Eric, Testimony Before the President’s Advisory Committee on Federal Tax Reform


Return-Free Filing: How would the tax system need to change?

Although many other countries have adopted return-free tax systems, most of them have much simpler tax codes than the United States. Implementing a return-free system in which most U.S. taxpayers could participate would likely require changes in the tax code that would bring the U.S. system closer in several important respects to those of other countries that use return-free filing. Common elements of such codes include a "basic" rate for most taxpayers, individuals (as opposed to families) as the unit of taxation, interest and dividend income taxed at one rate and at the source, exemption of some capital gains from taxation, and few deductions, allowances, and credits. But the current system could still accommodate return-free filing for tens of millions of taxpayers with just minor reforms. Most studies place the potential number of taxpayers that could relatively easily be accommodated by the current system as ranging from 10 million to 60 million.

- The current system would have to be modified in several ways to eliminate a filing requirement even for most of the 20 million taxpayers with relatively simple returns (those in a low tax bracket with wage income only, no credits other than the earned income tax credit, and no itemization of deductions). The current withholding formulas are not designed to be exact for dependent filers, dual-income couples, or taxpayers with more than one job during the year. If dependent filers and filing units with income from more than one job were still required to file a return, only 8 million taxpayers with wage income could be exempted from filing. Even among these 8 million, changes in personal circumstances during the year could cause withholding errors. Without changes in the law, it may still be possible to fine-tune withholding formulas to meet the needs of most taxpayers, but the additional precision would add significant complexity to the Form W-4 and the computation of withholding allowances.

See Also

Return-Free Filing: What is it and how would it work?
Return-Free Filing: What are the benefits?
Return-Free Filing: What are the drawbacks?
Return-Free Filing: Would it raise taxes?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
Return-Free Filing: Who would qualify?

The size and scope of any return-free system in the United States would depend on its administrative and structural features. Depending on the extent of changes to the current tax structure and administration, a final tax return filing requirement could be eliminated for between approximately 8 million and 60 million taxpayers. Those taxpayers who derive all or most of their income from wages and do not itemize deductions are the most likely to qualify. The system could be expanded to include taxpayers with income from dividends, interest, pensions, Individual Retirement Account (IRA) distributions, and unemployment insurance benefits, and those taxpayers qualifying for the earned income tax credit (EITC). Taxpayers with relatively uncomplicated itemized deductions could also be brought into the system.

| Filers Qualifying for Alternative Return-Free Systems by Type of Income and Return, 1999 (Millions) |
|-------------------------------------------------|----------|--------|--------|--------|--------|
| Type of filer                                  | All      | 1040   | 1040   | 1040   | 1040   |
| All filers                                     | 127.1    | 74.2   | 5.2    | 27.0   | 20.8   |
| No taxable income or in 15 percent bracket:    |          |        |        |        |        |
| Wage income only, no itemized deductions or credits other than child credit |          |        |        |        |        |
| (A) Only those with earnings from one job and not claimed as dependent | 6.9      | 0.8    | 0.2    | 2.0    | 3.8    |
| (B) Add dependent filers                      | 9.2      | 1.1    | 0.3    | 2.2    | 5.7    |
| (C) Add those with earnings from more than one job | 21.5     | 2.4    | 0.7    | 4.8    | 13.6   |
| Add those with income only from “withholdable sources”\(a\) | 34.5     | 5.2    | 1.3    | 10.3   | 17.8   |
| Add those with EITC                            | 47.5     | 6.3    | 1.8    | 20.5   | 19.2   |
| Add those with capital gains distributions     | 47.8     | 6.6    | 1.6    | 20.5   | 19.2   |
| 28 percent and higher brackets:               |          |        |        |        |        |
| Wage income only, no itemized deductions or credits other than child credit |          |        |        |        |        |
| (A) Only those with earnings from one job and not claimed as dependent | 1.0      | 0.2    | 0.0    | 0.2    | 0.7    |
| (B) Add dependent filers                      | 1.1      | 0.2    | 0.0    | 0.2    | 0.7    |
| (C) Add those with earnings from more than one job | 1.8      | 0.4    | 0.0    | 0.3    | 1.0    |
| Add those with income only from “withholdable sources” | 3.9      | 1.3    | 0.1    | 0.9    | 1.6    |
| Add those with EITC                            | 3.9      | 1.3    | 0.1    | 0.9    | 1.6    |
| Add those with capital gains distributions     | 4.0      | 1.4    | 0.1    | 0.9    | 1.6    |
| Total filers                                   | 51.8     | 7.9    | 1.7    | 21.4   | 20.8   |
| Percent of filers                              | 41.1     | 11.3   | 33.3   | 79.0   | 100.0  |

Notes:
(a) Withholdable sources include pensions IRAs, interest, dividends, and unemployment benefits.


- Approximately 20 million taxpayers in 1999 had income solely from wages and salaries, claimed no credits (including the EITC), did not itemize deductions, and were in either the zero
or the 15 percent tax bracket. Since almost all wage income is subject to withholding already, these taxpayers could more easily be shifted into a return-free system than the rest of the filing population.

- If withholding at source were extended to interest, dividends, pensions, IRA distributions, and unemployment insurance benefits, the number of eligible taxpayers would rise by 21.6 million. To some extent, taxes are already withheld on these forms of income. Mandatory withholding would expand the scope of a return-free system and could improve compliance but would place new administrative costs on taxpayers. To reduce these costs, relatively small payments and some payers (for example, individuals who hold debt such as seller-financed mortgages, and foreign banks and other foreign-resident debt holders) could be exempted from the withholding requirements.

- Administering the EITC under an exact withholding system would prove complex, but feasible. Under a tax agency reconciliation system, the EITC could continue to be administered through the tax system. An additional 13.5 million taxpayers would be eligible for a return-free system if the EITC were included.

- Certain deductions could be accommodated within a return-free system. The three most common itemized deductions in the United States are for state and local taxes, mortgage interest, and charitable contributions. Incorporating these into a return-free system would raise the number of eligible taxpayers by 1.7 million in the zero and 15 percent brackets and another 1.9 million in higher brackets. This is a small fraction of the current 33 million itemizers and reflects the fact that itemizers do not generally meet the other types of restrictions assumed for eligibility for nonfiling.

See Also

Return-Free Filing: What is it and how would it work?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


Return-Free Filing: Would it raise taxes?

Despite opposition from antitax groups who argue that return-free filing would limit taxpayer independence, a return-free system would not raise taxes for any taxpayer. In any case, participation would be completely voluntary. Nor would anyone need to place more trust in the government or share any more information with the Internal Revenue Service (IRS) than they do now.

- Certain conservative members of Congress, along with some antitax groups such as Americans for Tax Reform and the American Conservative Union, oppose return-free filing on the grounds that it would place the burden of contesting tax payments on the individual taxpayer rather than the IRS. In a press release opposing return-free filing, Americans for Tax Reform stated that implementing such a system is dangerous because it "would create a conflict of interest where the Internal Revenue Service would become both tax preparer and enforcer." These groups further argue that return-free filing shields taxpayers from awareness of the costs of paying taxes and, consequently, is a means of implementing tax increases without taxpayers’ knowledge.

- Return-free filing should be viewed as a taxpayer tool, not a shield from information. Taxpayers could still file returns as they did before, but they would also be given the option of filing "return-free" if their taxes are simple enough to qualify. All taxpayers would retain the right to challenge their tax liability as calculated by the IRS.

See Also

Return-Free Filing: What is it and how would it work?
Return-Free Filing: What are the benefits?
Return-Free Filing: What are the drawbacks?

Further Reading


Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007
Return-Free Filing: What was the experience in California?

The State of California operated a pilot program for return-free tax filing for tax years 2005 and 2006. Participation was offered to 50,000 prescreened Californians who had previously filed as single taxpayers with no dependents, with income from wages only, and claiming the standard deduction. These taxpayers were sent "ReadyReturns," or already-completed state tax returns, and were given the option of either filing their ReadyReturn (on paper or online) or discarding it and filing their own conventional tax return later. The pilot program was popular among those taxpayers who used it, and California recently authorized the widespread availability of the ReadyReturn program for tax year 2007.

- The ReadyReturn pilot program had a participation rate of about 21 percent. Of the 11,000 participants, approximately half filed a paper copy and half filed electronically.

- The California Franchise Tax Board estimates that, in 2007, about 1 million taxpayers will be eligible for the ReadyReturn under the above criteria. About 3 million California taxpayers earn income from wages only, indicating that the program could be expanded relatively easily to a significant portion of the state’s population.

- An evaluation of the program indicated that it was a success. Of those filing an electronic ReadyReturn, 95 percent indicated that it saved time, as did 87 percent of participants filing a paper copy. Almost all participants indicated that they would opt to use the service the following year.

See Also

- Return-Free Filing: What is it and how would it work?
- Return-Free Filing: What are the benefits?
- Return-Free Filing: What are the drawbacks?

Further Reading


State of California Franchise Tax Board, "ReadyReturn Pilot Preliminary Studies" (Sacramento, September 2006).
Return-Free Filing: What other countries use it?

Return-free systems are clearly feasible: thirty-six countries—including Germany, Japan, the United Kingdom, and several other industrialized nations—use some form of return-free system for at least some of their taxpayers.

- Nearly all countries that offer return-free systems have exact withholding systems, of which there are two types: cumulative systems (used in the United Kingdom and the Russian Federation) and final withholding systems (used in Germany and Japan). Some countries combine one of these approaches with other requirements; in Chile, for example, taxpayers may not file for refunds of overwithheld amounts.

- Only Denmark and Sweden, both relatively small countries, operate tax agency reconciliation systems. About 85 percent of Denmark's taxpayers and 74 percent of Sweden's had their returns filled out by the tax authorities in 1994.

- The British system, which has incorporated exact withholding since the 1940s, has several features that facilitate return-free filing. One is that it treats the individual as the unit of taxation. Another is that a large proportion of taxpayers are taxed at the same marginal rate (about 64 percent of taxpayers are in the "basic" rate bracket), which makes the return-free system easier to administer.

- The proportion of taxpayers who still have to file returns varies by country. About 90 percent of taxpayers eligible for final withholding in the United Kingdom did not have to file in 1991. In Germany in 1986 and in Japan in 1988-90, the corresponding figures were 46 percent and 63 percent, respectively.

- Many countries maintain a filing requirement for taxpayers with more than one job. At least one country, Kenya, requires taxpayers to file a tax return if their personal circumstances change during the year.

See Also

Return-Free Filing: What is it and how would it work?

Authors: William Gale and Benjamin Harris
Last Updated: December 14, 2007

Further Reading


STATE AND LOCAL TAX POLICY

State and Local Tax Policy: What are the sources of revenue for state governments? ................. 1
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State and Local Tax Policy: What are the sources of revenue for state governments?

States collected general revenues totaling nearly $1.3 trillion in 2005. About one-third of that revenue came as transfers from the federal government and, to a much smaller degree, from local governments. The remainder came from state taxes, fees, and miscellaneous receipts.

- States received just over $400 billion in intergovernmental transfers in 2005, which accounted for 32 percent of their general revenues.
- Sales and gross receipts taxes were the largest source of states’ own tax revenues in 2005, totaling about $311 billion or about one-fourth of general revenues.
- Individual and corporate income taxes accounted for one-fifth of state general revenues in 2005. The individual share totaled $220 billion and the corporate share just under $40 billion.
- Other taxes, charges, fees, and miscellaneous receipts totaled just over $300 billion in 2005, about one-fourth of general revenues.

See Also

The Numbers: What is the breakdown of tax revenues among federal, state, and local governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

Further Reading


Data Sources

U.S. Census Bureau, "State, and Local Government Finances"

State General Revenue, by Source, 2005, Tax Policy Center Tax Facts

Author: Roberton Williams
Last Updated: March 10, 2008
State and Local Tax Policy: What are the sources of revenue for local governments?

Local governments collected general revenues totaling $1.16 trillion in 2005. Nearly 40 percent of that revenue came as transfers from the federal and state governments. The remainder came from local taxes, fees, and miscellaneous receipts.

- Local governments received about $450 billion in intergovernmental transfers in 2005, which accounted for 39 percent of their general revenues.
- Property taxes constituted the largest source of local governments’ own revenue in 2005, totaling nearly $325 billion, or 28 percent of general revenues.
- Charges and miscellaneous receipts accounted for 22 percent of local government revenues in 2005, about $260 billion.
- Sales and gross receipts taxes, individual income taxes, and other revenues made up the remaining 11 percent of local general revenues, yielding about $125 billion in 2005.

See Also

The Numbers: What is the breakdown of tax revenues among federal, state, and local governments?

State and Local Tax Policy: What are the sources of revenue for state governments?

Further Reading


Data Sources

U.S. Census Bureau, "State, and Local Government Finances"

Local General Revenue, by Source, 2005, Tax Policy Center Tax Facts

Author: Roberton Williams
Last Updated: March 10, 2008
State and Local Tax Policy: How have the sources of revenue for state and local governments changed over time?

State and local governments collected general revenues totaling $2 trillion in 2005. About 20 percent of this, or $438 billion, came as transfers from the federal government, with the remainder coming from state and local taxes, charges, and miscellaneous revenues. Although revenue collections have been relatively stable as a share of GDP over the past 30 years, their composition has changed: relatively less now comes from property taxes and relatively more is from charges and miscellaneous revenues (see figure 1).

- At $486 billion, charges and miscellaneous revenues were the largest source of state and local governments’ own-source revenue in 2005. Collections accounted for 24 percent of total revenue, an 8 percentage point increase from 1972 but a slight decrease from the 2002 peak of 25 percent.

- State and local governments’ reliance on the property tax has declined over the past 30 years. Property tax revenues decreased as a share of general revenues from 26 percent of general revenue in 1972 to just 16 percent in 2001, with virtually all of the decrease occurring in the 1970s and early 1980s. This decline was largely offset by the growth of charges and miscellaneous revenues.
Together, general and selective sales taxes provided the largest share of state and local tax revenue in 2005, totaling $383 billion, although their share of general revenue declined from 22 percent in 1972 to 19 percent in 2005. Selective sales tax revenue accounted for nearly this entire decline, falling from 10.2 percent in 1972 to 5.9 percent in 2001, while general sales tax varied between 12 and 14 percent. Most of the decline in selective sales tax collections was due to decreasing tobacco and motor fuel tax revenue.

Personal income taxes increased from 9 percent of all revenues in 1972 to a peak of 14 percent in 2001 at the end of the 1990s boom before falling back to 11 percent in 2003. Collections in 2005 totaled $241 billion, or 12 percent of general revenue.

Total state and local revenues increased slightly as a share of GDP over the past 30 years, growing from a low of 13.4 percent in 1979 to a high of 16.3 percent in 2001. Revenues remained at approximately this level in 2005.

State and local revenues and intergovernmental transfers have grown at different rates (see figure 2). State own-source revenue increased as a share of GDP by over one-fourth between 1972 and 2001 from 5.7 percent of GDP to 7.3 percent. Local own-source revenue grew more slowly, from a low of 4.6 percent of GDP in 1979 to a high of 5.7 percent in 2001. Transfers from the federal government varied between 2.3 percent of GDP in 1989 and 3.6 percent of GDP in 2004.
See Also

The Numbers: What is the breakdown of tax revenues among federal, state, and local governments?

State and Local Tax Policy: What are the sources of revenue for state governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

Data Sources

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U.S. Census Bureau, "State, and Local Government Finances"

Further Reading

Rueben, Kim, and Carol Rosenberg, "State and Local Revenues," Tax Notes (April 7, 2008)

Authors: Kim Rueben and Carol Rosenberg
Last Updated: March 19, 2008
State and Local Tax Policy: How do state and local income taxes work?

Forty-three states and the District of Columbia impose individual income taxes. The definition of taxable income varies by state (for example, New Hampshire and Tennessee tax only income from dividends and interest), but most states generally follow the federal definition, except that taxpayers may not deduct state income taxes paid. In addition, states often apply different rules than the Internal Revenue Service for other types of income and have differing tax rates. Nine states apply a single tax rate to all incomes, while the rest have multiple tax brackets and rates. Top marginal rates for state income tax in 2008 ranged from 3 percent in Illinois to 10.3 percent in California. Individual income taxes account for a relatively small share of state and local revenue: across all states, their contribution to general revenue rose from a low of 9.1 percent in 1972 to a peak of 13.7 percent in 2001 at the end of the 1990s boom, before falling back to 11.3 percent in 2003. Collections in 2005 totaled $241 billion, or 12 percent of general revenue.

- Fourteen states permit local governments to impose an income tax in addition to the state income tax. Local income taxes are currently imposed in specific localities in eleven of these states, but at significant levels in only three (Maryland, Ohio, and Pennsylvania). In most states, local income tax takes the form of a tax on wages; other states levy local income tax simply as a percentage of the state income tax.

- Most state income taxes are fairly flat, even in those states that apply graduated tax rates. In several states the top tax bracket begins at a very low level of taxable income; Alabama, for example, starts its top rate at $3,000. In other states the difference between the lowest and the highest tax rates is small: just 2 percentage points in Connecticut and Mississippi, for example.

- In the middle and late 1980s, most states followed the federal government’s lead in reducing the number of income tax brackets: nineteen states did so within three years of enactment of the federal Tax Reform Act of 1986. But that trend has reversed more recently. Some states have imposed new brackets for high-income taxpayers, often called "millionaire’s taxes." In 2005 California initiated a 1 percent additional tax on income over $1 million, and New Jersey enacted an additional tax bracket for income over $500,000. Most recently, Maryland expanded its effectively flat system to include an additional three marginal tax brackets, with the highest beginning at $500,000, effective in tax year 2008. But some states have gone in the opposite direction: New York added two high-income brackets in 2003, with the top bracket starting at $500,000, but reverted to a top bracket beginning at $20,000 in 2007.

- In 2005 fifteen states treated capital gains and losses the same as under federal law, taxing all capital gains and allowing the deduction of up to $3,000 in net capital losses. New Hampshire fully exempted all capital gains, and Tennessee taxed only capital gains from the sale of mutual fund shares. Massachusetts had its own system for taxing capital gains, applying a 12 percent rate to short-term gains (net of capital losses) and long-term gains from collectibles and pre-1996 installment sales, and a 5.3 percent rate to all other long-term gains. Hawaii had an alternative capital gains tax. The remaining twenty-four states that tax income and the District of Columbia generally followed federal treatment, with the exception of various state-specific exclusions and deductions.

- Income tax is generally imposed by the state in which the income is earned. However, various states have entered into reciprocity agreements with one or more other states that allow income earned in another state to be taxed in the state of residence. For example, Maryland’s reciprocity
agreement with the District of Columbia allows Maryland to tax income earned in the District by a Maryland resident. As of 2004, sixteen states had adopted reciprocity agreements; typically these are states with employment centers close to a state border and large flows in both directions.

- State income tax rates appear to have little effect on rates in neighboring states. A 2003 study estimated that a 10 percent increase in personal income tax rates in neighboring states would actually induce a decrease of less than 1 percent in the home state’s tax rate. The author suggests that the relative immobility of the tax base explains the counterintuitive result: few workers move across state lines simply to reduce the income taxes they pay.

![Figure 1. Top Marginal State Individual Income Tax Rates, 2008](image)
See Also

State and Local Tax Policy: What are the sources of revenue for state governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

State and Local Tax Policy: How have the sources of revenue for state and local governments changed over time?

Data Sources


Tax Policy Center, State and Local Government Finance Data Query System.

Authors: Kim Rueben and Carol Rosenberg
Last Updated: May 23, 2008

Further Reading

American Council on Intergovernmental Relations, Significant Features of Fiscal Federalism (Ocean Grove, N.J., various years).


State and Local Tax Policy: How do state and local sales taxes work?

Forty-five states and the District of Columbia impose a general sales tax, applied with only specified exemptions to sales of all types of goods, and in some states to certain services as well. In 2008 state sales tax rates ranged from 2.9 percent in Colorado to 7 percent in Mississippi, New Jersey, Rhode Island, and Tennessee. Thirty-six states (including one, Alaska, that has no state sales tax) also allow sales tax at the county, municipal, or special district level. In 2008 maximum local sales tax rates ranged from 0.25 percent in Mississippi to 8 percent in Alabama. The highest maximum combined state and local sales tax rate in 2008 was 12 percent in parts of Alabama; the lowest (among states that have a sales tax) was 4.5 percent in Hawaii. General sales taxes have accounted for a roughly constant percentage of state and local general revenue over the past thirty years, varying from 12.1 percent in 1972 to 14.5 percent in 1988. This stability in revenue reflects tax rate increases that have offset the shrinking of the tax base due to changes in economic behavior.

- Only eight states fully tax food sales, and five of those states allow a rebate or an income tax credit to offset the burden on poor households. Seven states tax food at a lower rate than other goods, and the remaining thirty-one states exempt food completely.

- Only Illinois taxes prescription drug sales, and it taxes them at a lower rate than other goods. Other common exemptions include books and clothing.

- Local sales tax is generally imposed on the same goods and services that are taxable at the state level, with a few notable exceptions. Colorado, Georgia, Louisiana, and North Carolina allow local governments to tax certain products—specifically, food—that are exempt from state sales tax.

- As economic activity has shifted from manufacturing to services over the last several decades, some states have incorporated services into their sales tax base, but to greatly differing extents. For example, out of 168 services tracked by a 2005 Federation of Tax Administrators survey, Hawaii taxes 160 while Colorado taxes only 14. Services commonly subject to taxation include event admissions, utilities, and lodging.

- Most states also apply selective sales taxes to particular goods and services separately from the general sales tax. The most common such taxes are on alcoholic beverages, motor fuels, and tobacco products. Revenues from these taxes have been falling despite increases in rates.

- State and local governments may impose taxes only on sales that occur in their jurisdiction, but determining the location of catalog or online sales may be difficult. A retailer with sufficient physical presence in a state to be obligated to charge the state’s sales tax is said to have nexus. A state or local government may tax sales by a retailer with nexus in the state or locality, but nexus rules are complicated, and many questions about their application to online transactions remain unresolved.

- Expanding sales taxes to cover remote sales is complicated by the lack of coordination in tax rates and in definitions of goods across states. Nearly all states that levy sales taxes participate in the Streamlined Sales Tax Project, whose goals are to increase uniformity in definitions and rules across states and to simplify tax rates and administration within states.
Figure 1. Maximum Combined State and Local Sales Tax Rates, 2008


Figure 2. General Sales Tax Share of Total State and Local Own-Source Revenue, 2005

Note: (a) "Own-source" revenue excludes revenue contributed by the federal government.
See Also

State and Local Tax Policy: What are the sources of revenue for state governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

State and Local Tax Policy: How have the sources of revenue for state and local governments changed over time?

Data Sources

Federation of Tax Administrators, "Sales Taxation of Services" (Washington, various years).


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Further Reading


State and Local Tax Policy: How do property taxes work?

Jurisdictions in all 50 states and the District of Columbia impose property taxes, which provide local and some state jurisdictions with a stable and reliable source of revenue. Most property tax revenue comes from levies on real property (land and improvements to land) but states often tax personal property (such as noncommercial motor vehicles) as well. The tax equals a percentage (the tax rate) of the assessed value of the property and may be levied in some form at every level of government—state, county, municipal, township, school district, and special district. In 2006, states and localities collected $359 billion, nearly 97 percent at the local level.

- The property tax gives state and local governments a stable and reliable source of revenue. Its base is immobile and, as real property values rise over time, revenue grows with no rate change. Tax jurisdictions could keep revenues constant by lowering rates but they tend to do so only with a lag.

- The property tax is very unpopular among taxpayers. It is highly visible, different assessments for similar properties give a sense of unfairness, and the tax may unduly burden fixed-income property owners.

- The share of total revenue provided by property taxes varies widely from state to state, ranging in 2006 from just 6 percent of general revenue in New Mexico up to 34 percent in New Hampshire.

- The importance of property taxes differs greatly across levels of government.
In total, local governments – counties, cities, townships, school districts, and special districts – get 28 percent of their general revenue and 72 percent of their tax revenue from property taxes, a total of $347 billion in 2006.

Independent school districts rely most heavily on the property tax for own-source general revenue, receiving 79 percent from this source. They also receive intergovernmental aid, usually from the state.

Counties raise 39 percent of own-source general revenue from the property tax, while property tax revenues make up 34 percent of own-source general revenue for cities and townships.

States get only a small fraction of their tax revenue from property taxes, less than 2 percent in 2006. However, states that lack a sales tax or an income tax (or both) typically rely more heavily on property tax revenue: the levy’s share of total tax revenue exceeds 8 percent in Vermont, New Hampshire, Wyoming, Washington, Montana, Michigan, and Arkansas. Some states, including Michigan, Vermont, and New Hampshire, have recently enacted state property taxes as part of school finance reform.

Reliance on the property tax has declined over the past 30 years, as state and local collections have dropped from 26 percent of general revenue in 1972 to just 16 percent in 2001. Virtually all of the drop occurred in the 1970s and early 1980s with some increases in reliance on the property tax in the last five years. State and local governments raised 16.4 percent of their general revenue from property taxes in 2006. The revenue share remained relatively constant at the state level, varying between 1.3 percent and 0.9 percent. Local collections, however, fell from 39.5 percent of general local revenues in 1972 to 26.5 percent in 2001. Local reliance has increased slightly since 2001; property tax made up 27.9 percent of general revenue in 2006.

In recent decades, many states have imposed limits on property tax rates, property tax revenue, or increases in assessed property values, reducing reliance on the property tax as a source of revenue. California, for example, limits the tax rate to 1 percent and annual assessment increases to 2 percent until a property is sold.

Many states have provisions that reduce property tax burden.

Homestead exemptions in 28 states and the District of Columbia reduce the fraction of the assessed property value subject to tax.

Seventeen states and the District of Columbia use circuit breaker credits to limit the share of income claimed by property taxes.

Property tax deferrals allow elderly and disabled homeowners to defer payment until the sale of the property or the death of the taxpayer; 22 states and the District of Columbia allow such deferrals but they are not widely used.
See Also

State and Local Tax Policy: What are the sources of revenue for state governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

State and Local Tax Policy: How have the sources of revenue for state and local governments changed over time?

Data Sources

Tax Policy Center, State and Local Government Finance Data Query System.

Further Reading


Authors: Kim Rueben and Carol Rosenberg

Last Updated October 9, 2008
State and Local Tax Policy: How does the deduction for state and local taxes work?

Taxpayers who itemize deductions may subtract general state and local taxes in calculating their federal taxable income. They may deduct either income or sales taxes they have paid (that choice expires, however, after 2007) as well as property and certain other taxes. Virtually all of the 48 million households who itemized in 2005 claimed a deduction for state and local taxes paid; these deductions totaled $420 billion. The state and local tax deduction cost an estimated $50.7 billion in tax expenditures in fiscal 2007, compared with $73.7 billion for the home mortgage interest deduction and $41.9 billion for the individual charitable contributions deduction.

- State and local taxes have been deductible since the inception of the federal income tax in 1913, when all taxes (including federal, state, and local taxes not directly tied to a benefit) were deductible against federal income. By 1964 deductible taxes had been limited to state and local taxes on real and personal property, income, general sales, and motor fuel sales. The deduction for taxes on motor fuel was eliminated in 1978. The Tax Reform Act of 1986 eliminated the deduction for general sales tax; this deduction was partially and temporarily reinstated in 2004.

- From 2004 to 2007, itemizers could elect to deduct state and local sales taxes in lieu of deducting state and local income taxes. About 73 percent of itemizers deducted income taxes in 2005, while 23 percent-mostly in states without a general state income tax-chose to deduct sales taxes. About 86 percent of itemizers deducted real estate taxes.

- Although taxpayers in all states claim the deduction, the benefits are concentrated in relatively few states: those with a disproportionate share of high-income households and relatively high state and local taxes. In 2005, taxpayers in California and New York together made up 20 percent of those claiming the deduction and accounted for 30 percent of its value. Itemizers in New York, New Jersey, Connecticut, and California (listed in descending order of the average deduction) claimed on average over $12,000 per household (see figure), well above the national average deduction of $8,764 per household.

- The alternative minimum tax (AMT) scales back or eliminates the benefit from deducting state and local taxes for some taxpayers. The deduction is the largest single AMT preference item (a deduction allowed under the regular income tax but not under the AMT): it accounted for more than 60 percent of the dollar value of all preferences in 2005. Virtually all AMT taxpayers lost at least some of the deduction that year.
Critics of the deduction argue that state and local taxes simply reflect payments for services provided by state and local governments and, as such, should be treated no differently from other forms of consumption. Moreover, the deduction most benefits the affluent: the 11 percent of taxpayers with incomes exceeding $100,000 claimed nearly 60 percent of the value of deductions in 2005.

Proponents of the deduction counter that the portion of an individual’s income claimed by a state or local government is not really part of the individual’s disposable income and that taxing it is double taxation. The deduction also may encourage higher-income taxpayers to support state programs that primarily benefit lower- and middle-income households.

Eliminating the deduction would increase federal tax receipts by about $40 billion in 2008 and about $750 billion between 2008 and 2017 (less if Congress extends the 2001-06 income tax rate cuts beyond their scheduled 2011 expiration). Elimination could be coupled with repeal of the AMT; the revenue gain from the former could help offset the fall in revenue from the latter. Eliminating both would cut revenue by $2 billion in 2008 but would increase revenue by $340 billion over ten years.

Because many fewer taxpayers pay the AMT than benefit from the deduction of state and local taxes, repealing both provisions would cause many more households to pay more taxes than to pay less: taxes in 2007 would have increased for 22 percent of households and fallen for only 11 percent, and the average federal income tax bill would have risen nearly $100. Most taxpayers with income between $200,000 and $500,000 would have gained, because most of them pay AMT: nearly three-fifths of them would have paid less tax. Losers would outnumber winners in all other income categories.
The deduction indirectly subsidizes state and local governments. Evidence on how they would respond to its elimination is limited. Estimates based on 1995 data of the effect on the tax price—the net cost to taxpayers of financing an additional dollar of state and local spending—suggest that eliminating the deduction would lead to an average increase of 8.5 percent, varying across states from less than 1 percent in Wyoming to 10 percent in Maryland. After the Tax Reform Act of 1986 eliminated the deductibility of state and local sales tax, however, the amount of state and local tax revenue coming from the sales tax changed little. Limited evidence also suggests that eliminating the deduction would induce some high-income households to move from higher-tax areas to lower-tax areas.

See Also

Alternative Minimum Tax: What is the AMT?
Alternative Minimum Tax: Who pays the AMT?
Income Tax Issues: How do the standard deduction and itemized deductions compare?
Tax Expenditures: What are the largest tax expenditures?

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Further Reading

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State and Local Tax Policy: What are rainy day funds and how do they work?

Budget stabilization or “rainy day” funds allow states to set aside excess revenue for use in times of unexpected revenue shortfall or budget deficit. In fiscal 2008, forty-seven states and the District of Columbia maintained rainy day funds. Only Arkansas, Kansas, and Montana lacked such funds. At the end of fiscal 2008, state rainy day funds (excluding that of the District of Columbia) totaled $35.0 billion, or 5.1 percent of the combined general fund expenditures. In addition, during times of economic expansion, when actual revenues exceed projected revenues, states accumulate reserves in their general fund balances, which can then act as de facto rainy day funds in later years.

- Rainy day fund balances in 2008 varied significantly across states, from zero in California and Wisconsin and less than 1 percent of annual expenditures in Michigan and Wisconsin to 17 percent in Nebraska and nearly 150 percent in Alaska (figure 1). Twenty-two states had rainy day fund balances greater than 5 percent of annual expenditures, and funds in eight states exceeded 10 percent.

![Figure 1. Rainy Day Fund Balances, End of Fiscal 2008, Percentage of Annual Expenditures](image)


- States typically transfer resources to rainy day funds through line-item budget appropriations or by designating portions of budget surpluses. Some states make deposits from specific revenue sources, such as mineral revenues in Alaska and Louisiana and oil and natural gas revenues in Texas. Forty of the states with rainy day funds cap their funds at levels that range from 2 to 15 percent of revenues or expenditures.

- States most often use their rainy day funds in times of budget deficit—every state except Vermont has some sort of requirement to balance its budget each year. Some states allow withdrawals for any purpose deemed appropriate by the governor or the state legislature, whereas others allow withdrawals only if the deficit is due to a revenue shortfall, and others only if it is caused by unexpected expenditures. Still others permit fund withdrawals to address a natural disaster or other declared emergency. Colorado’s Taxpayer Bill of Rights (TABOR) mandates an emergency
fund (instead of a rainy day fund) that does not allow withdrawals in response to economic conditions, revenue shortfalls, or government salary increases; the fund may only offset shortfalls caused by natural disasters. Sixteen states require a supermajority vote of the legislature in order to transfer money out of the rainy day fund.

- An economic downturn can cause significant fiscal stress for states, because given no changes in policy, revenues will decline as expenditure needs increase to meet greater demands for programs such as unemployment insurance and Medicaid. Savings in a rainy day fund may help states weather a fiscal downturn with fewer expenditure cuts. Analysis of state spending during the 2001 recession suggests that state savings in rainy day funds or end-of-year general fund balances at the start of the recession allowed states (in the aggregate) to maintain relatively constant spending even as revenues declined.

- Rainy day fund savings peaked at the start of the 2001 recession, totaling 6.0 percent of aggregate state expenditures at the end of fiscal 2000, before declining to 1.4 percent of expenditures in 2002 (figure 2). Thereafter fund balances climbed to 5.2 percent of expenditures in 2006. Fund balances totaled 5.1 percent of expenditures at the end of fiscal 2008.

![Figure 2. State Rainy Day Fund and Ending General Fund Balances, 1988-2008](source: National Association of State Budget Officers, Fiscal Survey of the States (Washington, various years).)

Source: National Association of State Budget Officers, Fiscal Survey of the States (Washington, various years).
See Also

State and Local Tax Policy: What are the sources of revenue for state governments?

Further Reading


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National Association of State Budget Officers, "The Fiscal Survey of States" (various years).

Authors: Kim Rueben and Carol Rosenberg
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State and Local Tax Policy: What are tax and expenditure limits?

Tax and expenditure limits (TELs) restrict the level or growth of government revenues or spending to a fixed numerical target or to increases in an index such as population, inflation, personal income, or some combination of these measures. As of 2008, thirty states had at least one TEL. Twenty-three states imposed state spending limits, four had state revenues limits, and three had both. Another way states limit growth in revenues is through requiring legislative supermajority or voter approval requirements for passage of new taxes. Sixteen states had such requirements in place in 2008 (Waisanen, 2008). In addition, forty-six states limited property taxes or other revenues or expenditures of local governments (Mullins and Wallin, 2004). Several local governments also operated under their own locally imposed TELs (Brooks et al., 2007).

- Most TELs emerged during the “tax revolt” of the late 1970s or the economic recession of the early 1990s. Although many of the best known local property tax limits such as California’s Proposition 13 and Massachusetts’s Proposition 2 1/2 were adopted through citizen initiatives, most state TELs come from state legislatures. As of 2008, legislatures had enacted 14 TELs and referred ten more to popular vote. Eight TELs were passed as voter initiatives and two emerged from constitutional conventions.

- More stringent TELs require that surplus revenues go back to taxpayers as rebates or into rainy day funds. Some TELs prohibit states from evading the limit through unfunded mandates or transfers of program responsibility to local governments.

- Colorado enacted a Taxpayer Bill of Rights (TABOR) in 1992 that is arguably the nation’s most restrictive TEL. TABOR applies to all taxing districts in Colorado and requires that voters approve all tax rate increases, new taxes, and increases in property tax assessments. The law also
explicitly prohibits particular types of taxes. Finally, and arguably most importantly, TABOR limits general revenues to the previous year’s revenues adjusted for population growth and inflation. All excess revenues must go back to Coloradans through tax reductions or cash rebates. Only voters can override these provisions or any other spending or revenue limits. Colorado voters agreed in November, 2005, to suspend their revenue cap for five years, resetting the level of the limit based on current limits (McGuire and Rueben, 2006).

- Related to TELs are legislative supermajority and voter approval requirements for new taxes. Sixteen states had such requirements in 2008. Thresholds for a legislative supermajority ranged from three-fifths to three-fourths. Supermajority or voter-approval requirements may pertain to all taxes or only to specific revenue sources such as corporate or sales taxes.

- TELs can also interact with other constraints. Knight (2000) found that states with both TELs and supermajority requirements to raise taxes had lower expenditures than states with just one or the other constraint. Poterba and Rueben (1999) found that TELs affect the costs of state borrowing in two ways: spending limits lower the costs while revenue limits increase them.

- Evidence on whether TELs limit state and local spending is mixed (Gordon, 2008). Rueben (1996) found that specific details of the laws matter. She also found that TELs requiring a legislative supermajority or popular vote to modify spending led to a 2 percent reduction in state general fund expenditures, but that those savings were offset in part by higher local spending.

- Recent volatility in state and local government finances has renewed interest in TELs with many states proposing limits modeled on Colorado’s TABOR or other limits on property taxes or public spending. As of mid-2009, no other states had enacted measures like TABOR.
See Also

State and Local Tax Policy: What are the sources of revenue for state governments?

State and Local Tax Policy: What are the sources of revenue for local governments?

State and Local Tax Policy: What are rainy day funds and how do they work?

Data Sources


Further Reading


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